VI. Financial trends in the emerging markets

Highlights

Private capital flows to the major emerging markets in Asia and Latin America reached record levels last year as industrial country investors continued to diversify their portfolios. A sizable increase in the issuance of international bonds was the biggest single factor; many more countries succeeded in launching such bonds. Despite the increased supply, risk premia for emerging market bonds narrowed during 1996 and early 1997 as persistence with stabilisation and reform policies improved the credit standing of some countries. In addition, global liquidity conditions remained easy, inducing investors to seek higher-yield and riskier investments. Maturities lengthened significantly, enabling several countries to restructure their external debt. However, for the least creditworthy emerging market countries, borrowing costs appear to have declined more slowly and they remain above those for comparably rated industrial country borrowers.

Equity markets rose strongly in much of Latin America although in some cases only after falling early in the year under the influence of political and other uncertainties. The picture in Asia was more mixed: while many major markets recorded large gains in 1996, those in Korea and Thailand suffered sharp declines. Moreover, many countries in Asia are confronted with serious property market gluts that continue to depress prices. This is putting the banking systems in some countries under strain.

Key features of the evolving pattern of capital flows – a widening range of countries and institutions receiving substantial flows of capital from large numbers of private investors – have given credit-rating agencies a much greater role than even at the beginning of the decade. This applies to ratings not only of countries but also of banks, which have come under increasing pressure to become more transparent in the reporting of their business operations.

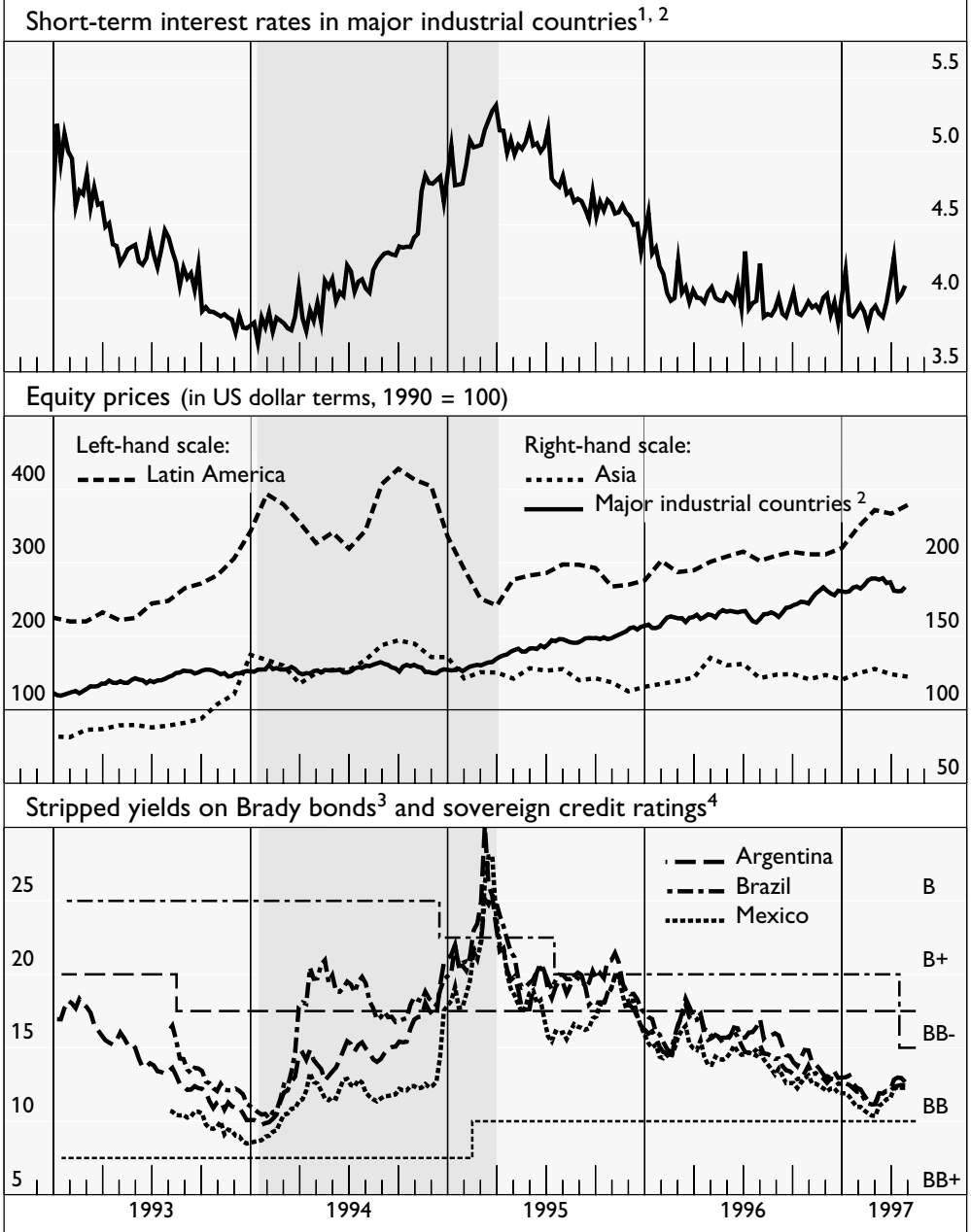
Recovery of capital flows after the Mexican crisis

After drying up in the wake of the Mexican crisis …

Last year marked a period of strong recovery of private capital flows to the emerging market economies after the gradual weakening that began with rising US short-term interest rates in early 1994 and the interruption occasioned by the Mexican financial crisis at the beginning of 1995. Yields paid by some emerging market borrowers had begun to move up from early 1994 (Graph VI.1) and the volume of capital flows fell (Table VI.1). In the early months of 1995, capital flows dried up, several countries – in particular Mexico and Argentina – suffered a heavy loss of reserves and yields on emerging market debt rose to exceptionally high levels. Capital outflows from these countries were subsequently halted by a combination of tight macroeconomic policies and a continued commitment to

liberal financial markets; foreign official lending also played a significant supporting role. Substantial foreign exchange reserves and a willingness both to raise interest rates and to limit domestic banks' short-term lending to non-residents allowed Asia to weather the storm better. An important cyclical influence was the steady reduction in US short-term interest rates from early 1995, which increased

Interest rates in the industrial countries and financial asset prices in the emerging markets



[1] Overnight rate; the peak and the trough define the shaded area. [2] Weighted average of the United States, Japan, Germany, France and the United Kingdom. [3] Yields on Brady par bonds stripped of US Treasury collateral on principal and interest (left-hand scale; thick lines). [4] Assigned by Moody's and Standard & Poor's (right-hand scale; thin lines). Standard & Poor's first assigned a rating to Argentina in August 1993 and to Brazil in December 1994.

Sources: International Finance Corporation, J.P. Morgan, Moody's, Standard & Poor's and national data. Graph VI.1

Capital flows and reserves in Asia and Latin America

In billions of US dollars, at annual rates

	1980–90	1991	1992	1993	1994	1995	1996
	Net private capital inflows						
Total	12.9	52.5	81.3	99.1	78.7	77.7	149.8
China	1.9[1]	–1.9	11.7	7.8	14.6	13.9	23.0
Other Asia[2]	4.7	26.2	19.3	34.0	26.8	37.6	56.8
Brazil	3.8	2.5	9.1	9.9	9.1	31.8	35.4
Mexico	1.6	20.6	23.6	30.3	10.3	–13.2	13.5
Other Latin America[3]	0.8	5.0	17.6	17.0	18.0	7.6	21.1
	Net official capital inflows						
Total	13.8	12.8	19.8	13.2	13.8	33.8	0.9
China	1.2	2.9	5.4	5.6	9.3	6.9	7.0
Other Asia[2]	6.8	8.3	13.3	5.7	3.7	1.9	3.8
Brazil	1.0	–1.4	–0.5	–1.2	– 0.7	– 0.7	– 1.8
Mexico	2.1	2.4	2.0	–0.9	0.3	24.5	–10.0
Other Latin America[3]	2.7	0.6	–0.4	3.9	1.2	1.1	1.8
	Net increase in reserves						
Total	13.3	55.5	71.4	59.2	48.5	62.6	83.2
China	2.7	14.1	23.2	1.8	30.5	22.5	31.4
Other Asia[2]	10.5	25.2	25.7	37.1	23.8	16.2	25.8
Brazil	–0.1	–0.4	14.7	8.7	7.2	12.9	9.3
Mexico	0.6	8.2	1.2	6.1	–18.9	10.7	1.8
Other Latin America[3]	–0.4	8.4	6.6	5.5	5.9	0.4	14.9

Note: Capital flows are calculated as the difference between the current account and the change in reserves; private flows are calculated as a residual from an estimate of official flows.

[1] 1982–90. [2] India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand. [3] Argentina, Chile, Colombia, Peru and Venezuela.

Sources: IMF Balance of Payments Statistics and Institute of International Finance. Table VI.1

liquidity in international capital markets and led industrial country investors to seek higher yields abroad.

… private inflows recover in Latin America …

Sharp increases in private inflows to Latin America in 1996 enabled countries to accumulate reserves and to repay official debt; the current account imbalance for the region as a whole was virtually unchanged. Governments of some Latin American countries, notably Mexico and Argentina, used renewed access to international capital markets to improve the maturity structure and the pricing of their outstanding debt. Sizable Mexican bond issues were used to finance early repayments of official emergency support provided in 1995 by the US Treasury and the IMF, as well as to retire some outstanding higher-yield Brady bonds. Argentina also continued to borrow heavily in private international capital markets, financing a small rise in the current account deficit and expanding its official international reserves. The maturity of its bonds was lengthened and a peso-denominated bond was issued. Finally, investing in short-term peso-denominated Mexican government debt proved particularly profitable to foreign investors last year as the depreciation of the peso fell far short of the nominal interest rate differential (short-term interest returns in US dollar terms are

Short-term interest rates:[1] real and in US dollar terms

Annual rates of return

	Real[2]				In US dollars[3]		
	1990–94	1995	1996	1997 Q1	1990–94	1995	1996
China	– 2.2	– 5.0	0.7	2.2	– 2.9	12.7	9.3
India	2.2	5.7	4.9	– 2.7	– 0.2	2.9	8.6
Hong Kong	– 3.7	– 2.7	– 0.8	– 0.4	5.7	6.3	5.4
Korea	2.2	4.2	2.4	2.7	6.2	10.8	– 1.4
Singapore	1.1	0.8	1.5	1.2	9.6	5.9	4.0
Taiwan	3.3	2.5	2.3	3.9	7.2	2.2	4.6
Indonesia	8.3	6.7	8.7	11.3	12.9	11.3	13.6
Malaysia	2.7	2.5	3.5	3.9	7.8	6.7	7.7
Philippines	5.0	3.4	3.6	5.8	15.2	4.1	12.0
Thailand	5.3	5.5	4.3	5.1	10.9	11.2	8.5
Argentina	–12.4	8.2	7.2	6.2	21.9	11.8	7.4
Brazil	10.6	25.5	10.3	12.7	20.6	33.1	19.3
Chile	6.6	5.9	6.9	6.8	15.0	12.6	8.6
Colombia	0.1	9.5	8.5	5.7	11.0	11.4	29.3
Mexico	3.3	9.8	– 1.1	– 1.8	4.2	3.0	28.9
Peru	–12.4	4.3	3.4	5.2	–24.6	9.8	2.3
Venezuela	– 2.5	–22.0	–36.2	–37.8	4.1	–26.9	–22.4

[1] Rates on three-month paper; for China, one-year deposit rate; for India and Brazil, overnight rate; for Taiwan, overnight rate and, before November 1994, weighted average of six money market rates with maturities ranging from overnight to six months. [2] Deflated by the consumer price index. [3] Calculated from monthly average interest rates and changes in the exchange rate during the month.

Sources: IMF, national data and BIS estimates. Table VI.2

shown in Table VI.2). Interest rate differentials also accounted for continued large inflows into Brazil. These inflows financed a widening current account deficit and further, though diminishing, additions to international reserves.

… and remain strong in Asia

In most Asian countries, strong growth of net private capital inflows, which had already resumed in 1995, continued last year. In Asia as a whole, reserve accumulation absorbed more than half of these inflows. High domestic interest rates, faster economic expansion and the recovery of international bond markets after the Mexican crisis allowed the Philippines to attract heavy capital inflows and finance very substantial reserve growth, as well as to retire $635 million of Brady bonds. However, in some Asian countries, in particular Korea and Thailand, current account deficits rose more rapidly than net inflows. As discussed in Chapter III, widening current account imbalances in these and several other Asian countries reflected a combination of slower export growth and continued increases in domestic demand.

Greater Asian reliance on bond issuance

An important feature of Asian capital inflows last year was a shift in external borrowing towards greater reliance on bond markets. Net international securities issuance by Asian developing countries rose by a factor of three. This reflected a desire among many Asian borrowers to diversify sources of funding, as well as official efforts to contain short-term offshore borrowing from banks (e.g. a limit was imposed by Thailand; Malaysia tightened its rules). There was indeed a sharp

fall in bank lending to entities in Thailand, where external short-term debt had reached high levels. In other Asian countries, the flow of international bank financing rose (see Table VII.3 and Graph VII.4 in Chapter VII).

Asset prices

Better access to international capital markets has also been evident in the movement of asset prices. Yields on Brady bonds, which started to decline after March 1995, have now fallen back almost to their early-1994 levels. However, the recovery in Latin American equity prices, measured in dollars, has been only partial: the International Finance Corporation's aggregate index is still below the peak levels reached in 1994. Equity prices in Asia, which had declined much more gradually in early 1995, have been weaker overall than those in Latin America. Most Asian markets fell sharply in the first four months of 1997, while most Latin American markets remained strong. The relatively subdued performance of aggregate Asian equity prices during the last couple of years or so may reflect continuing concerns about financial fragility and the sustainability of large current account deficits in certain countries. As discussed further below, however, the aggregate movements mask quite divergent trends in individual markets.

Capital flows to emerging market economies in the 1990s

Increased capital market integration

Total net private flows to Latin America and Asia in 1996 alone exceeded total flows for the entire 1980s, while official flows have remained relatively flat (Table VI.1). Two powerful forces are driving the emerging market economies towards increased integration with international capital markets. First, the widespread movement towards market-oriented economic reform in developing economies has increased the number of countries that are considered to be creditworthy, and has also led to heightened demand by these countries for investment financing. Secondly, investors in industrial countries are continuing to diversify their financial portfolios, a trend reinforced by the cyclical decline in short-term interest rates in industrial economies in the 1990s.

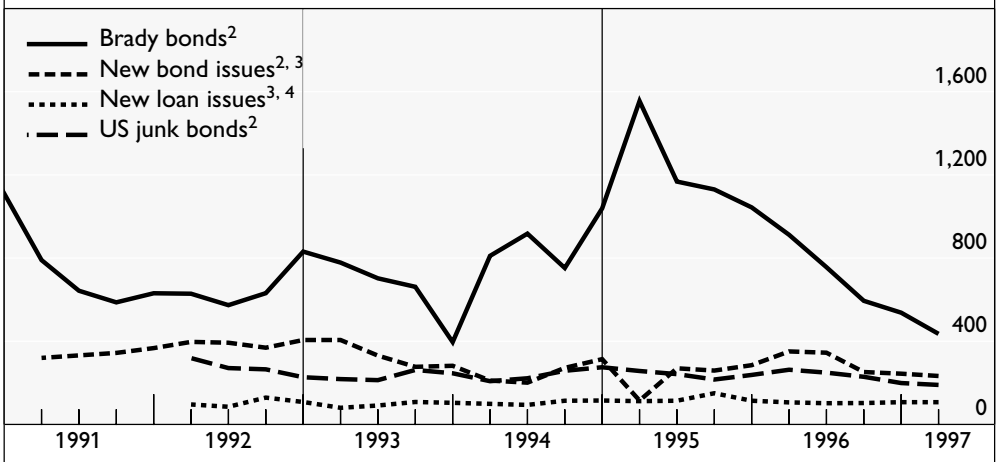
Debt finance

Increases in capital inflows during the 1990s have been quite broadly based, including bank borrowing, securities issuance and equity investment (both direct and portfolio). As shown in Graph VII.4 in the next chapter, both bank borrowing and net securities issuance by Latin American and Asian countries have grown substantially. Bank borrowing has been the principal means of fund-raising by Asian countries, while Latin American countries have relied more heavily on securities issuance. Banks may have preferred initially to lend to Asian countries as a result of the difficulties in the repayment of Latin American commercial bank debt in the 1980s. In addition, Latin American bonds generally were not restructured during the 1980s, making them seem an attractive vehicle for investment in the 1990s. At all events, as noted above, patterns of fund-raising in the two regions may recently have begun to converge.

Equity flows

Expanding equity flows have been another important feature of the surge in capital flows to emerging market countries in the 1990s. Portfolio equity flows have been particularly buoyant, with their share of total private capital inflows rising from 13% in 1991 to 19% in 1996. This is a further indication of the increasing globalisation of industrial country financial portfolios, and of the growing importance of certain types of investor – such as pension funds and

Spreads on emerging market debt instruments and US junk bonds[1]



[1] Average spreads, in basis points, weighted by US dollar value amounts. [2] Over US Treasury bonds of appropriate maturity. [3] Based on a subset for which spreads were available. [4] Over LIBOR.

Sources: Bloomberg, J.P. Morgan and Euromoney Bondware and Loanware. Graph VI.2

mutual funds – that previously had restricted themselves to domestic financial market investments.

Interest rate spreads narrow …

The evolution in the cost of funds to developing country borrowers in the 1990s provides less clear-cut evidence of integration than aggregate flows. Graph VI.2 compares the spreads over US benchmark interest rates of three developing country debt instruments (Brady bonds, new bond issues and new bank loans) with that of US BB-rated corporate "high-yield" (junk) bonds. The spread on Brady bonds, the most actively traded emerging market debt instrument, has often been used as a barometer of the cost of funding for emerging market countries. Despite recent sharp falls, this spread is still above the lows reached at the end of 1993.

… markedly on Brady bonds …

As can be seen from the graph, spreads on Brady bonds have generally been well above those on new bond issues and loans. This in part reflects the fact that Brady bonds represent restructured bank loans, and may be considered by the market to be more exposed to the risk of further rescheduling in the event of payment problems than other forms of borrowing. Moreover, because Brady bonds were issued solely by countries that experienced difficulties in repaying their external debt, their spreads probably incorporate a higher degree of risk than is believed to characterise emerging market borrowers in general.

… while for new bond issues the pattern is ambiguous …

Average spreads on new bonds issued by emerging market countries have declined from their high levels of the early 1990s, although, as with Brady bonds, they have been subject to some variation over time. Moreover, the similar decline in spreads on US junk bonds suggests that there has been no *relative* improvement in the access of emerging market countries to capital markets in the 1990s: both emerging market borrowers and issuers of US junk bonds appear to have benefited from greater liquidity, an increased appetite for risk and hence lower spreads. Finally, spreads on bank loans have been some 200 basis points lower on average than spreads on bonds issued by emerging market countries, in large

part reflecting the higher proportion of better-rated Asian countries in bank borrowing than in bond issuance. Spreads on bank loans have narrowed in the past year, along with those on Brady bonds and new bond issues, but have not exhibited a longer-term trend over the 1990s.

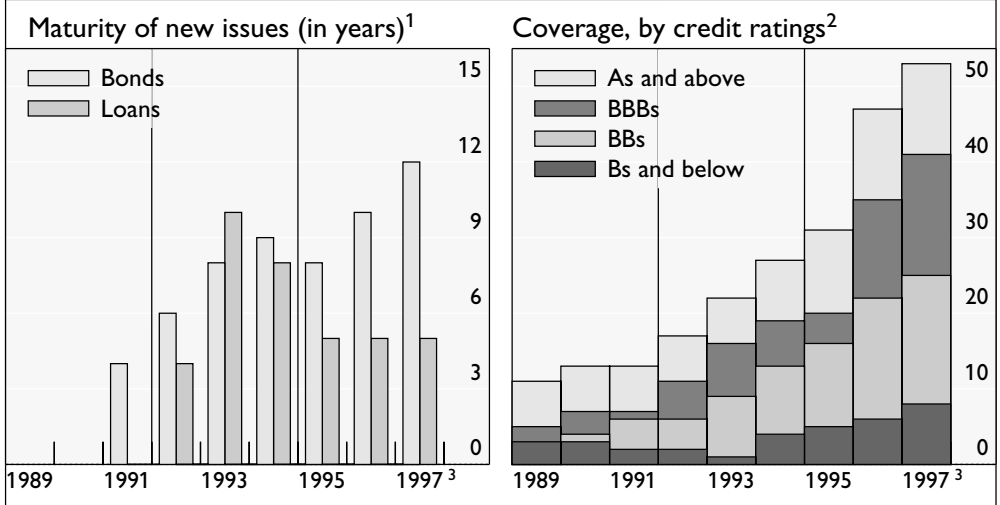
… reflecting longer maturities …

Various factors may have affected the rather ambiguous and hard-to-interpret pattern of average spreads on new bonds and bank loans shown in Graph VI.2. First, investors have been prepared to lend at longer maturities as the perceived creditworthiness of emerging market countries has improved, and emerging market countries have willingly paid higher spreads in order to lengthen the maturity structure of their debt. As indicated in Graph VI.3, average maturities for bonds increased from four years in 1991 to ten years in 1996, and this has contributed to a smaller decline in spreads than would otherwise have occurred. Average maturities for new bank loans, which include occasional large long-term project loans, have been much more erratic, and have displayed no long-term trend in the 1990s.

… and new borrowers

A second factor that may have kept up average spreads on new loans and bonds has been the entry into the market of many new borrowers. If such borrowers represent higher risks, and thus pay higher premia, this could raise average spreads in the market, even if spreads for particular risk categories were declining over time. However, the evidence from recent changes in the distribution of sovereign borrowers across different risk categories (Graph VI.3) reveals no overall trend in the average riskiness of rated emerging market countries. (The year-to-year volatility of spreads probably reflects year-to-year movements in the share of risky borrowers.) Nevertheless, it is possible that the entry of new borrowers may have raised average spreads, simply because the markets tend to require higher yields from new borrowers without a credit track record, regardless of their rating.

Emerging markets: maturities and ratings

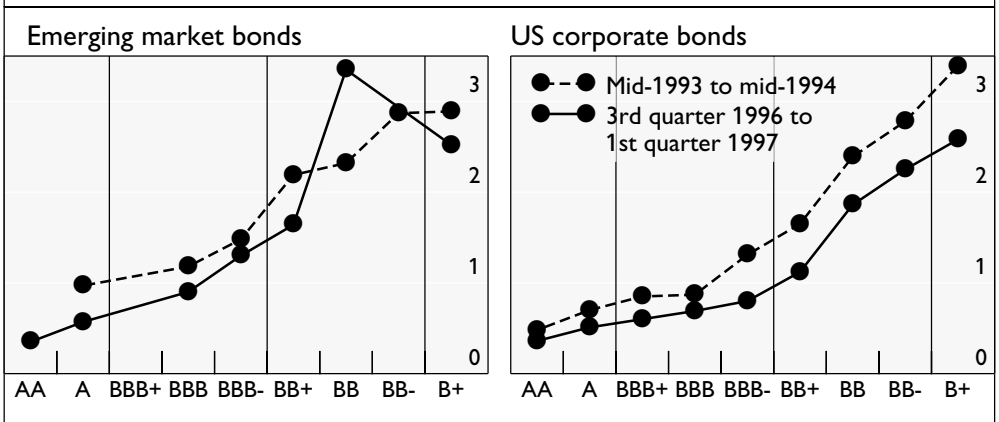


[1] Based on selected new issues for which data on credit ratings and spreads exist. [2] Number of countries with sovereign credit ratings assigned by Moody's or Standard & Poor's. [3] End-March.

Sources: Moody's, Standard & Poor's and Euromoney Bondware and Loanware. Graph VI.3

Spreads and ratings: emerging market and US corporate bonds

In percentages



Note: The dots indicate bonds for which spreads over US Treasury bonds and ratings were available.

Sources: Bloomberg and Euromoney Bondware. Graph VI.4

Continued caution about high-risk borrowers …

In order to control for changes both in the composition of borrowers and in the maturity of debt, the left-hand panel of Graph VI.4 compares spreads for new bond issues across the risk-rating scale, but with the same maturity, in two periods: mid-1993 to mid-1994 (when spreads reached their previous low) and September 1996 to the present (when spreads had fallen back). For all but the higher-risk credit categories, spreads unambiguously declined between 1993–94 and the recent period, supporting the view that emerging market country borrowers are benefiting from improved pricing of their debt. However, for the high-risk borrowers – that is, those rated BB and B+ – spreads have not uniformly declined, suggesting that investors remain cautious about the riskiest emerging market borrowers.

The right-hand panel of the graph indicates that spreads on US corporate bonds for the same maturity and for the same periods as the emerging market bond issues have also narrowed since 1994. This suggests little obvious change in the degree of discrimination between borrowers from different geographical areas. It is nonetheless notable that spreads among the least risky credit categories for which data are shown – A and BBB – fell more sharply for emerging market bonds, whose yields are now at approximately the same level as those on US corporate bonds in the AA and A risk categories. Yet, for riskier credit categories, the gap between emerging market and US corporate bonds has actually widened.

… but lower spreads for lower-risk borrowers

In sum, a closer examination of movements in spreads on new bonds confirms that the less risky emerging market borrowers have benefited from a combination of increased liquidity and, perhaps, a heightened appetite for risk, as well as a greater willingness on the part of investors to assess emerging market borrowers on the same basis as their industrial country counterparts. However, for borrowers with riskier credit ratings, spreads – while declining – remain high compared with similarly rated borrowers in industrial countries, suggesting that financial markets still apply different standards of credit access for this subset of borrowers.

Equity and property markets

Equity markets large but still volatile …

Equity markets in the developing world are now far larger than they were at the beginning of the decade: in terms of the ratio of capitalisation to GDP, markets in many countries are now comparable to those in the larger European countries (Table VI.3). Moreover, these markets, which have attracted much-increased foreign interest, are now more closely integrated with the financial markets in the developed world. Nevertheless, the volatility of equity prices, although tending to fall, has remained higher than in the industrial world.

… and diverged sharply

Price movements in different countries diverged in 1996 and early 1997. Many Latin American markets rose sharply, with substantial gains in Argentina, Brazil and Venezuela. Markets in Chile and Colombia fell back. Several Asian markets reached new records while Taiwan's market recovered from an earlier slump that had been provoked by political concerns. However, there were precipitous falls in two major centres: the Korean and Thai indices had, by early 1997, fallen by about one-half from their previous highs.

Equity markets: capitalisation, volatility and recent performance

	Capitalisation[1]		Volatility[2]		Change in market index[3]
	1990	1996	1993–94	1995–96	
China	0.5[4]	13.8	26.6	10.5	71.7
India	12.9	35.1	8.9	8.2	–25.3
Hong Kong	111.5	280.8	10.1	5.5	32.8
Korea	43.6	25.4	6.1	6.1	–47.6
Singapore	91.6	169.0	3.9	3.1	– 1.1
Taiwan	62.7	100.5	13.9	8.5	6.6
Indonesia	7.1	41.2	8.9	7.3	17.6
Malaysia	113.6	315.5	9.0	5.8	16.7
Philippines	13.4	97.5	10.2	6.4	8.2
Thailand	28.0	54.0	11.0	7.7	–54.1
Argentina	2.4	15.7	9.1	9.4	28.7
Brazil	4.0	28.6	13.6	7.6	31.3
Chile	49.1	90.8	8.7	5.1	–22.4
Colombia	3.5	20.8	8.2	6.7	–21.4
Mexico	13.5	37.1	7.9	11.4	9.4
Peru	2.2	23.0	11.0	9.0	6.8
Venezuela	17.2	15.4	12.4	15.2	26.9
Memorandum items:					
United States	*53.8*	*108.7*	*1.4*	*2.0*	*27.2*
Japan	*98.2*	*67.6*	*6.0*	*3.4*	*–25.2*
Germany	*23.6*	*29.4*	*3.2*	*1.7*	*19.4*
United Kingdom	*86.7*	*151.0*	*4.2*	*2.5*	*22.6*
Other G-10 Europe[5]	*26.9*	*47.8*	*4.7*	*3.8*	*10.9*

[1] As a percentage of GDP. [2] Standard deviation of monthly changes over the periods January 1993–November 1994 and January 1995–November 1996 (to exclude the crisis-affected month of December 1994). [3] Percentage change from the highest point reached in 1995 to February 1997, in US dollar terms. [4] 1991. [5] Weighted average based on 1990 GDP and PPP exchange rates.

Sources: International Finance Corporation, Institute of International Finance, OECD, national data and BIS estimates. Table VI.3

Property price cycles in Asia

Percentage changes in real prices, at annual rates

	Trough to peak	Peak to trough	Latest incomplete cycle		Elasticity with respect to equity price index*
			percentage	initial year	
Hong Kong	20 24	−30	56	1995	1.07
Korea			−2	1990	−0.12
Singapore	27	−26	18	1992	0.82
Indonesia	54		−8	1990	0.13
Malaysia	26	−13	−6	1991	−0.21
Philippines	42	− 8	7	1991	0.34
Thailand			−7	1991	−0.09

Note: Calculations are based on yearly data on prices usually in capital cities. The latest cycle is based on the change from the initial year shown to 1996.

* Elasticity of the year-to-year percentage change in nominal property prices with respect to the year-to-year percentage change in share prices, 1991 to 1996.

Sources: Colliers Jardine and Jones Lang Wootton. Table VI.4

Real estate prices also volatile …

Real estate prices are driven by many of the same forces that drive equity prices – bank credit, real growth, inflation expectations and so on. Property price booms in emerging markets in Asia have been much more intense than in the larger industrial economies. The average increase in real prices during property upswings in the countries for which data are readily available (shown in Table VI.4) has generally exceeded 20% a year, compared with around 10% a year typically experienced in the United States or the larger European economies. One important reason is the rapid pace of industrialisation and urbanisation, which creates an extremely strong demand for new buildings. An indicator of this is the development of office rents: since the mid-1980s, the average real rental price of offices in the central areas of Kuala Lumpur and Singapore has more than doubled and that of Hong Kong has risen almost as sharply.

… even if sometimes sticky downwards

Unlike equity prices, however, real estate prices do not always decline quickly when excess supply emerges. As in much of the developed world, there have been significant falls in prices in recent years after the massive increases registered in earlier periods, usually after a significant tightening of monetary policy. In two economies (Hong Kong and Singapore), price cycles have been shorter than in the others shown in Table VI.4; this, and the higher correlation between property and equity prices in these economies during the 1990s, implies greater and more rapid responsiveness of property prices to excess supply conditions than in Korea, Malaysia, the Philippines or Thailand. While the downward correction that followed the excesses of the 1980s has already given way to a renewed boom in Hong Kong and Singapore, the adjustment in the other countries remains incomplete. Construction industry estimates suggest that further large increases in supply during 1997 or 1998 in Bangkok, Jakarta, Kuala Lumpur and Manila may put further downward pressure on prices.

Financial fragility in Asia

Earlier crises in Latin America have triggered restructuring

The resurgence of private capital flows into the emerging markets has occurred at a time of considerable fragility of the banking systems in most recipient countries. In Latin America, Argentina, Brazil, Mexico and Venezuela are still recovering from major difficulties (analysed in last year's Annual Report). An extensive process of restructuring (which has involved government subsidies, mergers, increased foreign participation and more rigorous prudential oversight, both regulatory and market-based) is under way. One concrete manifestation of this has been deep cuts in banking sector employment, which had often been inflated by the easy profits to be made under hyperinflation: between 1990 and 1996, bank employment was cut by 34% in Brazil and 20% in Argentina. The ratio of non-performing to total loans has fallen significantly (Table VI.5). There has been a drastic tightening of credit conditions, with a steep decline in bank credit.

Asian banks exposed after years of rapid growth

Very rapid growth in Asia in the first half of the 1990s created a climate of ever-rising demand conducive to an extraordinary expansion in the ratio of bank

Non-performing loans as a percentage of total loans

	Crises in the 1980s		1990	1994	1995	1996[2]
	years[1]	average				
India[3]				23.6	19.5	17.3
Hong Kong[4]				3.4	2.8	2.7
Korea	1986	6.7[5]	2.1	1.0	0.9	0.8
Taiwan[6]	1986	5.5	1.2	2.0	3.1	3.8
Indonesia			4.5	12.0	10.4	8.8
Malaysia	1988	30.5	20.4	8.1	5.5	3.9
Thailand	1983–88	15.0	9.7	7.5	7.7	n.a.
Argentina	1985	30.3	16.0	8.6	12.3	9.4
Brazil			4.7	3.9	7.9	5.8
Chile	1983	15.5	2.1	1.0	1.0	1.0
Colombia[7]	1984	25.3	2.2	3.1	3.8	4.6
Mexico[7]	1982	4.1	2.3	10.5	14.4	12.5
Peru	1985	17.7	12.8	6.9	4.8	5.1
Venezuela	1983	15.4	3.0	24.7	10.6	3.8
Memo items:						
United States	*1987*	*4.1*	*3.3*	*1.9*	*1.3*	*1.1*
Japan[8]				*3.3*	*3.3*	*3.4*[9]
Italy			*5.2*	*8.1*	*9.3*	*10.1*
			1992[10]			
Finland			*8.0*	*4.6*	*3.9*	*2.7*
Norway			*9.1*	*5.4*	*4.1*	*3.2*
Sweden			*11.0*	*6.3*	*4.4*	*3.0*

[1] Peak years shown. [2] Preliminary. [3] Public sector banks only. [4] Locally incorporated banks only. [5] Official data are available only from 1986 onwards. [6] Past-due loans. [7] Commercial banks only. The figures for Mexico for 1995 and 1996 incorporate the effects of special programmes to deal with bad loans. Without such programmes the figures would have been 19.3 in 1995 and 24.2 in 1996. [8] Fiscal years. [9] September 1996; including restructured loans, the figure is 4.5%. [10] The peak year of the Nordic banking crises. Table VI.5

credit to GDP that has no recent parallel in the industrial countries (Table VI.6). The most rapid rates of growth in credit have been recorded in the more recently industrialising countries – Indonesia, Malaysia, the Philippines and Thailand. In Thailand, the peak rates of credit expansion occurred in 1995, and a significant slowdown set in during 1996. Credit expansion in the Philippines, where the pick-up in real growth began rather later than in the other countries, accelerated: in the space of just a couple of years, the real volume of bank credit has approximately doubled.

The recent cyclical downturn in several Asian countries has exposed structural weaknesses in their banking systems. One important factor has been increases in (or continued high) real interest rates, partly designed to cool very rapid credit growth but partly aimed as well at supporting the exchange rate in the context of very large current account deficits. After successive increases during most of 1996, real interest rates in Indonesia and Thailand had, by early 1997, risen above 10% and 8% respectively (see Graph III.3). In Malaysia, where

Growth of bank credit to the private sector relative to the growth of GDP

	1981–89	1990–94	1995	1996[1]	Memorandum item: Bank credit to the private sector as a percentage of GDP	
	average annual percentage changes				1980	1995
China[2]	4.6	3.8	– 0.5	3.8	47.5	83.9
India	2.6	–2.0	3.8	– 2.0	20.2	23.9
Hong Kong[3]	11.7	8.8	8.9	– 6.1	71.7	321.4
Korea	3.2	2.6	2.2	– 0.6	36.2	55.7
Singapore	2.1	0.8	7.8	5.7	62.9	84.9
Taiwan	7.1	9.2	1.1	– 3.9	49.2	143.1
Indonesia	15.1	10.4	4.4	5.7	8.1	49.1
Malaysia	6.8	3.1	10.5	13.1	33.1	76.9
Philippines	–7.6	10.7	27.4	31.5	37.9	39.3
Thailand	6.8	10.0	11.1	5.8	27.5	88.7
Argentina	–4.0	7.9	6.2	0.4	16.5	17.9
Brazil	3.5	1.4	6.7	– 4.9	17.5	27.4
Chile	3.8	3.1	1.3	14.4	26.5	43.6
Colombia	2.0	4.1	4.2	5.0	10.8	16.4
Mexico	–1.9	25.7	– 0.6	–36.0	12.8	33.6
Peru	–9.6	22.0	25.8	29.9	9.2	12.7
Venezuela	–2.9	–9.6	–39.4	–19.6	24.9	7.0
Memorandum items:						
United States	*1.7*	*–3.5*	*4.2*	*– 0.6*	*62.1*	*63.3*
Japan	*3.8*	*0.3*	*0.5*	*– 1.9*	*81.0*	*115.1*
Germany	*1.4*	*2.5*	*0.8*	*4.6*	*74.2*	*96.1*
United Kingdom	*9.6*	*1.3*	*2.3*	*3.3*	*39.9*	*99.7*
Other G-10 Europe[4]	*1.7*	*2.0*	*– 2.6*	*– 0.8*	*61.0*	*76.2*

[1] Preliminary. [2] Credit other than to central government. [3] Total credit. Licensed banks only. [4] Weighted average based on 1990 GDP and PPP exchange rates. Table VI.6

greater exchange rate flexibility has been allowed, real interest rates have been somewhat lower and much more stable. Real rates in Korea also remain high, although there has been a substantial decline in the exchange rate. Downward pressure on asset prices in some countries has magnified these difficulties.

Bank fragility reflects adjustment to liberal and open environment

The underlying causes of bank fragility in Asia are various. Among them are four principal common elements that typify the problems of adjustment to a more liberal and open environment – and are reminiscent of very similar difficulties seen in industrial countries not many years ago. First, a central cause of instability has been violent asset price cycles driven by an excessive expansion of bank and other credit. Banks that had developed under tight regulation often lacked the experience to evaluate credit risks properly in a new liberalised environment. Some took too many risks, with the tacit expectation of official support should they run into trouble. In many instances, the system of prudential oversight was not tightened sufficiently to cope with greater risks. Secondly, capital account liberalisation and greater freedom for domestic financial institutions to engage in international transactions have complicated the task of monetary policy (as also discussed in Chapter III). Exchange rate targets have often restricted the use of interest rates to maintain internal stability. A third cause is that the earlier policies of directed lending have left a legacy of bad debts. A final difficulty is that the intensification of competition among domestic institutions has not always led to the rationalisation of often very fragmented banking systems inherited from the past.

Asset price cycles

Asset price cycles accentuated by bank credit …

Asset price cycles funded by an excessive expansion of bank credit have been a central common feature in the financial crises in industrial countries as well as developing countries in recent years. Because the linkages between asset prices and changes in bank credit are self-reinforcing, at least in the short run, financial instability can be exacerbated as economies adjust to a more liberal financial environment. Before liberalisation, interest rate ceilings on deposits kept bank intermediation profitable. Moreover, bank credit was typically directed to government or industrial enterprises, with only a limited share typically channelled into equities or real estate. The removal of such restrictions not only gives banks greater latitude of action but also encourages them to search for new, profitable business as margins on their traditional business are squeezed.

… as new opportunities for profit …

A common development following liberalisation is that banks will extend loans for the purchase of equities and real estate. Banks themselves may acquire equities, and may even hold equity in other types of financial institution permitted to take more risks (e.g. heavy investment in property) than they are. Similarly, property-related loans may rise sharply for a number of years, fuelling an unprecedented property boom. Asset price booms will also "infect" lending for other purposes because both equities and property will appear to offer banks good collateral while prices are rising.

… tempt banks to go too far …

Borrowers will continue to borrow – even at high interest rates – to buy assets that are rapidly appreciating in value and banks will continue to lend because the value of their collateral is rising. Highly profitable property and equity investment in the early stages of the boom will encourage both borrowers and

banks to seek still further exposure, leading to renewed rises in prices. In this phase, moreover, banks and other financial institutions often compete strongly with each other, driving margins lower just as risks are rising. The point at which property prices exceed the present value of future returns is imprecise because of uncertainty about the "right" rate of discount and because future returns are themselves hard to gauge, particularly in rapidly developing countries. A speculative bubble in property is almost inevitable.

… with major difficulties when the bubble bursts

When the bubble bursts, banks and their customers will face major difficulties. At first, mounting excess supply may not be reflected in prices as owners and their creditors hold their properties off the market and transactions decline. But, as financing costs build up (often leading to escalating interest arrears), this cannot be sustained. In particular, highly leveraged investors may be forced to sell, pushing prices down. As the value of property collateral held by banks and others falls, the pressure to sell intensifies, reinforcing downward pressure on prices that may in turn induce further forced sales which may drive property prices below their long-run equilibrium values.

What should be done to temper booms?

This process presents the authorities with several policy challenges. One is what can or should be done to moderate excessive asset price increases during a boom. For many countries in Asia, where exchange rate objectives dominate the setting of domestic interest rates (see below, especially Graph VI.5), the scope for adjusting interest rates is limited. In any case, tightening monetary policy when asset prices are rising sharply – but the general level of prices is not – may be problematic because only very large increases in interest rates will be able to control asset price inflation once expectations of higher prices have taken root.

Systemic risks …

As discussed in Chapter IV, asset price increases can be of direct concern to a central bank mainly when assets are pledged as collateral for bank loans or are financed by bank borrowing. In such cases, movements in asset prices can affect the health of the entire financial system, often as a result of difficulties at small banks or other apparently marginal participants in the domestic banking system. While the larger and better-capitalised banks in Thailand, for instance, typically maintained relatively conservative loan-to-value ratios, some of the smaller banks and other institutions did not. Finance companies in Thailand are heavily exposed to property; many banks have a significant share in the equity of finance companies.

… suggest a need for prudential measures …

Central banks and other supervisory authorities have therefore often sought to tighten prudential guidelines on the extension of credit when asset prices become driven by excessive speculative pressure. Real estate loans may be made subject to maximum loan-to-value ratios or repayment periods. In early 1997, for example, Hong Kong reduced its recommended loan-to-value ratio for luxury apartments from 70% to 60%. In some cases, moral suasion may be employed in order to discourage too rapid an expansion of lending for property investment (Malaysia, Thailand and Indonesia). In several cases, the central bank has used what regulatory power it possesses to give moral suasion "teeth" (e.g. by making permission for new branches dependent on how faithfully banks follow suasion).

In many countries, there has been a sharp slowdown in new bank lending; however, the capitalisation of interest on mounting non-performing loans has

added to the volume of bank loans as published in several countries. In other cases, fresh loans have been made to keep afloat developers owning unsold buildings. These factors may help to explain why credit expansion has apparently continued to finance heavy investment in construction/property-holding well after excess supply emerged in many Asian property markets.

… which may also apply to equities

Another concern has been banks' exposure to equity market risks. The slide in equity market values in Korea saddled the banks with large, unrealised losses. As losses mounted provisioning rules were relaxed: the reserves that banks were required to set aside to cover estimated equity market losses were reduced. The boom in Malaysia's equity market continued until early 1997. Measures announced by the Malaysian central bank in March 1997, which set a limit to banks' lending for both stock market and property investment, succeeded in moderating the equity market boom. Malaysia's more flexible exchange rate policy has also served to contain the volatility of interest rates.

How to deal with the after-effects of a boom?

A second policy challenge for the authorities is what to do once a property price bubble bursts and defaults occur. Typically, banks will be left owning real estate that cannot easily be sold. If the banks do not have enough capital, then the public sector often finds itself financing the holding of property. How quickly assets should be disposed of depends on balancing two conflicting dangers. One is that of a collapse in prices provoked by too hurried selling in conditions of market weakness. The other danger is a long period of market illiquidity. Prospective buyers, aware of a large inventory of unsold property hanging over the market, are reluctant to buy. The necessary correction of prices is then prolonged while debt financing costs mount, especially when real interest rates are high.

The experience of the Resolution Trust Corporation in the United States, which succeeded in disposing of the assets of failed savings and loan associations over the period 1989–95, is instructive. Asset sales through competitive auctions started almost immediately, with the value of assets disposed of peaking in 1990–91. While the US real estate market did weaken, as a result of these sales and of other factors, it began to pick up quickly from 1991 onwards, in part because of the Federal Reserve's low interest rate policy. In Sweden, the initial intention of disposing of property acquired by the state in the wake of the 1991 banking crisis over a 10 to 15-year period gave way to a policy of more rapid sales. This was aided by the decision to float the Swedish krona in late 1992, which gave the authorities greater latitude to reduce interest rates in the face of a deep recession.

Capital mobility

The dilemma between interest rates and the exchange rate

Greatly increased capital mobility has permitted current account deficits both larger and more persistent than previously, and has accentuated the familiar monetary policy dilemma between targeting the exchange rate or interest rates. An exchange rate target makes it harder, and perhaps almost impossible, for the central bank to use interest rates to moderate credit cycles. Moreover, a fixed exchange rate may lead to potentially dangerous currency mismatches. A common source of trouble in industrial and emerging market economies has been the combination of a fixed exchange rate with relatively high domestic interest

rates and inflation, which typically encourages residents (banks and their customers) to borrow foreign currency to finance local currency business or assets. Such mismatches can leave the banking system very exposed if large current account deficits eventually cause a sizable devaluation.

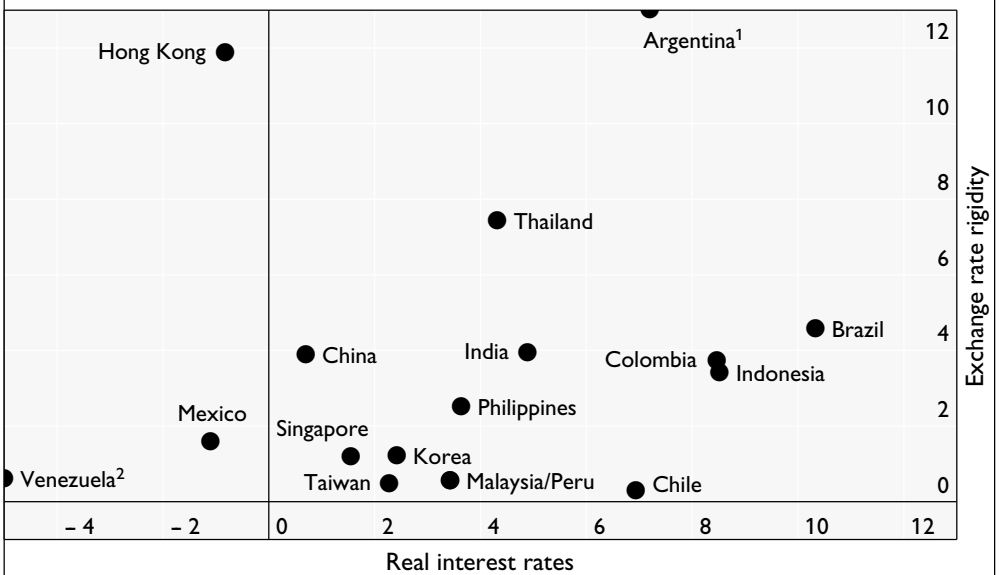
Towards freer exchange rates?

In general terms, most Asian countries have traditionally subordinated monetary policy to an exchange rate target, often at the price of accepting more volatile interest rates. Nevertheless, several countries have moved towards a freer exchange rate in recent years (Indonesia, for example, recently widened its exchange rate band) and have succeeded in keeping interest rates more stable. The ratio of interest rate to exchange rate volatility provides some, albeit imperfect, measure of the relative weights given to exchange rate and interest rate targets in setting policy (Graph VI.5). By this measure, among the Asian developing countries, Hong Kong and Thailand have had the more rigid exchange rate regimes: the volatility of their exchange rates in the last two years has been very low. Once market confidence in the exchange rate weakens, however, this policy requires a high level of real interest rates (Thailand).

Capital inflows and domestic credit

Partly because of a reluctance to allow the exchange rate to rise to restrain incipient capital inflows, inflows into many Asian countries were heavy and sustained during the first half of the 1990s, when their foreign exchange reserves rose sharply. For instance, the difficulties of Thailand's banking system can be traced in part to the creation, in early 1993, of the Bangkok International Banking Facilities (BIBFs), which, as well as promoting Bangkok as an international financial centre, allowed local banks to borrow in dollars. Given the policy of keeping the baht in a rather narrow range and the large weight of the dollar in

Exchange rate rigidity and real interest rates: 1995 – 96



Note: Exchange rate rigidity is defined as the volatility of overnight interest rates divided by the volatility of the exchange rate; volatility is defined as the standard deviation of monthly changes over the period 1995-96. Real interest rates are average 1996 three-month (for Brazil, India and Taiwan, overnight, for China, one-year) interest rates deflated by average 1996 inflation.

[1] Exchange rate rigidity: 184. [2] Real interest rate: -36%.

Source: BIS calculations. Graph VI.5

the country's currency basket, the perceived risk of exchange rate losses was rather small.

Several steps have been taken to limit the credit-expansionary effect of foreign inflows. Some Asian countries kept higher reserve requirements for foreign short-term bank deposits than for other types of bank deposit. The Bank of Thailand has taken a number of measures to limit the growth of BIBF onlending to the domestic market. From September 1995 local banks' net foreign exchange liabilities were made subject to ceilings (e.g. 20% of assets). In addition, foreign deposits were excluded from the calculation of the statutory loan-to-deposit ratios that banks have to maintain.

Directed lending

Government direction of lending weakens credit discipline

A third major cause of banking system fragility has been government-directed lending. The legacy of bad loans from earlier policies of state-directed lending is particularly heavy in China, where about one-fifth of loans are non-performing. Under central planning, banks played practically no role in assessing credit risks, and bank loans were merely the accounting dual of the physical plan. Under this system, state-owned enterprises had a captive market for their goods, which accounted for two-thirds of industrial output in China even as recently as a decade ago. Major economic reforms have allowed private, collective and joint-venture firms to enter these markets; state enterprises now contribute less than one-third of industrial output. Moreover, many of their goods fail to sell so that inventories have risen. Because the state-owned enterprises have not been allowed to go bankrupt (not only are they major employers of labour but they are also important providers of social welfare), losses have mounted, leaving the banks with bad loans. Many state-owned enterprises remain in business only because banks provide their working capital. A key objective of policy at present is to ensure that banks extend loans on commercial terms: the aim is to abolish controls on credit for fixed capital investment by the year 2000.

Bad loans in India and Indonesia are also generally concentrated in state-owned (or formerly state-owned) banks. Korean banks face problems today largely because of earlier policies of government-directed lending. These included loans at preferential rates to priority sectors in earlier phases of Korea's development and more recently a requirement to finance (riskier) small and medium-sized enterprises.

Competition and structural adjustment

Competition and the need to rationalise

A fourth element has been a failure to rationalise the financial system in the wake of domestic deregulation. In many Asian countries, profit margins have been squeezed, particularly in traditional lines of business, forcing the banks to spread into new, unfamiliar – and often riskier – areas. In many industrial countries, greater competition has triggered a strong movement towards rationalisation and mergers, often fostered by the authorities, especially after a banking crisis. Yet bank owners in many Asian countries have resisted mergers. The sheer number of banks in Indonesia (239), for example, suggests a rather fragmented system; efforts by the central bank to encourage consolidation produced only one merger last year. There have been no recent bank mergers in Korea. The recent

difficulties in Thailand have prompted the authorities to redouble rationalisation efforts. The collapse of the country's largest finance company in February 1997 – with about one-half of its loans in property and hire purchase – led the authorities to require certain institutions to raise additional capital. An official programme to encourage mergers was also announced. Under Malaysia's two-tier regulatory system, only banks with shareholders' equity above a certain threshold amount are allowed to conduct certain operations: through mergers, however, smaller banks can reach the size needed to qualify as so-called Tier One institutions. Another tactic employed by the authorities in some countries is to facilitate or allow entry into the banking industry only through the acquisition of existing banks.

Improved disclosure by banks

Effective market discipline, a potentially crucial mechanism for keeping banks prudent, depends on transparency. But because the very business of banking is built on the possession of confidential information about their customers, transparency has not always come easily to banks. Nevertheless, liberalisation, the proliferation of more sophisticated financial instruments and globalisation have given considerable impetus to fuller and more accurate disclosure by banks in the developing world as in the industrial world. (The role of improved disclosure in strengthening prudential regulation and supervision is discussed in Chapter VIII.)

Trend towards better disclosure in the emerging markets?

How the severity and persistence of recent banking crises in the emerging markets has affected the drive towards greater disclosure is somewhat unclear. On the one hand, heavy bank losses, often in the end borne by the taxpayer, have prompted many national authorities to strengthen disclosure requirements. In Latin America, Argentina and Mexico are striking recent examples. On the other hand, some supervisory authorities fear that full public knowledge of the true financial state of many banks would undermine confidence and that genuine progress towards greater disclosure – which they would support in principle – cannot be made while banks are very weak. In any event, some progress has been made in recent years in raising accounting accuracy, in increasing the frequency and detail of financial reports, in strengthening auditing procedures and in fostering the work of credit-rating agencies.

More information on asset quality …

Several countries have taken steps to ensure that banks provide better information on the quality of their loans, combined in many cases with more rigorous rules on reserves to be set aside as loans are extended or as conditions change. Argentina, for instance, has used the interest rates on individual loans as a proxy for their perceived riskiness. India has recently tightened the rules for the prompt recognition of impaired loans. Similar measures have been taken to deal with banks' securities holdings, requiring a greater degree of marking to market (India) or fuller disclosure of off-balance-sheet positions (Thailand). Steps have also been taken to ensure that banks reveal significant exposures (e.g. to particular sectors such as real estate, to large single borrowers and so on). Despite all this progress, much remains to be done. Many countries continue to allow their banks to hide the full scale of losses on securities holdings and of

… and large exposures …

… but still many gaps

non-performing loans. Only in relatively few countries are data publicly available on the unpaid debt servicing costs capitalised into bank loans.

Reports are more detailed …

A second important development has been the increased detail and frequency of reports on banks' financial performance. Such reports not only take the form of statistical returns (by means of which the supervisory agencies in many countries summarise the financial condition of all banks in their jurisdiction) but often also comprise management accounts of how risks, problems and so on are being dealt with.

… and banks are better audited

In several jurisdictions, provisions governing the use of internal and external auditors have been tightened. Minimum requirements for the internal audit function have been raised in a number of countries. Other changes have included limiting a bank's choice of auditors and extending the coverage of auditors' reports. Auditors often have the duty to directly notify the supervisory agency of any emerging problems at the banks they audit.

The role of credit-rating agencies

Bigger role for credit-rating agencies …

Market knowledge of bank performance has been enhanced in recent years by the greatly expanded activities of credit-rating agencies. The number of emerging market countries that have been assigned credit ratings has increased from 13 at the beginning of this decade to 53 in early 1997 (Graph VI.3). This crucial development reflects fundamental changes in the nature of both lenders and borrowers in international financial markets. In the late 1970s and early 1980s, foreign capital was provided primarily by banks which, in theory, had the capacity independently to assess and monitor country creditworthiness. At the same time, developing country recipients of private capital flows were dominated by a relatively small number of countries and well-known borrowers within those countries, usually governments. Close and continuous relationships between creditor and borrower were often perceived as mitigating the need for independent credit assessment. By the 1990s, however, flows of foreign capital were being channelled by pension funds, mutual funds, insurance companies and others with little experience in assessing the creditworthiness of the many emerging market countries represented in their diversified portfolios. At the same time, borrowers with little or no credit history – both governments and private institutions – sought to tap international credit markets.

… which now rate many more banks …

The major agencies now rate many more banks from a wider range of countries than before (Table VI.7). This trend has been driven by several factors. First, the supervisory authorities in some countries have compelled, or at least strongly encouraged, banks within their jurisdiction to seek and publish a credit rating. The reliance on disclosure in New Zealand is well known, although the authorities stopped short of requiring *all* banks to seek a credit rating when smaller banks argued that this would involve them in unnecessary costs. Argentina and Peru have required their banks to seek a rating. In Chile, not only do private agencies offer ratings, but official auditors also assign each bank a summary credit rating which is published.

A far more important factor for many countries has been banks' increased use of international capital markets to raise funds: a credit rating by a prominent

Banks and credit ratings

	Banks required to seek credit rating	Does a local credit-rating agency exist?	Number out of the ten largest domestically owned banks receiving ratings in February 1997 from	
			local agency[1]	international agency[2]
India	NO	YES	8	8
Hong Kong	NO	NO	–	3[3]
Korea	NO	YES	0	10
Singapore	NO	NO	–	All 6
Taiwan	NO	Starts May 1997	–	6
Indonesia	NO	NO	–	10
Malaysia	NO	YES	7[4]	2
Thailand	NO	YES	3[5]	9
Argentina	YES	YES	10[6]	10
Brazil	NO	YES	n.a.	9
Chile	YES[7]	YES	10	10
Colombia	NO[8]	NO	–	5[9]
Mexico	NO	YES	5	10
Peru	YES	YES	10	(6)
Venezuela	NO	YES	All	7

[1] For local currency deposits. [2] For long-term foreign currency debt. If only available for local currency deposits, this is shown in brackets. [3] Domestically owned banks only. Five banks have received ratings for their long-term foreign currency debt. [4] Banks receive ratings based on overall banking operations. [5] Rated for their long-term local currency bonds; none rated for local currency deposits. [6] One bank whose liabilities are guaranteed by the Federal Government is not required to seek a credit rating. [7] At least two agencies must rate bank securities. [8] However, a rating is required if certain operations are undertaken (e.g. securitisation and bond issuance). [9] For issuance of ADRs and GDRs.

Source: Central banks. Table VI.7

agency is often required and the rating awarded usually has an impact on the terms of the loan raised. Similarly, the international banking business is no longer the preserve of only the large well-known banks: many small, relatively unknown banks have developed direct cross-border business links with other small banks, a business which is greatly facilitated by the existence of reliable credit ratings.

… making a key contribution

The increased surveillance brought about by the credit-rating agencies' activities has thrown much more light on banks' financial positions. Both banks and the supervisory authorities in many countries have taken steps to ensure that the rating agencies are well informed about the financial position of banks. In addition, the agencies have in recent years shown themselves willing to downgrade large and influential banks before any public recognition of problems by official bodies.

Yet ratings have specific purposes, are conservative …

Yet it is important not to make credit ratings bear more than is intended. Rating strategy tends to be conservative because the credit-rating agencies must avoid being too influenced by purely cyclical developments and because their credibility depends on a certain rating stability. Hence a country's credit rating naturally tends to be much more stable over time either than domestic economic conditions or than spreads paid on external borrowing. Graph VI.1 (see page 98)

compares the evolution of credit ratings and the movements of spreads for Argentina, Brazil and Mexico. Brady bond spreads, a measure of the market's perception of future default risk, clearly exhibit much greater movements than the credit ratings.

Similar considerations apply to the rating of banks. Equity analysts and bank supervisors will often want to monitor even small and possibly short-lived changes in bank performance that will naturally not be captured by credit ratings.

… and sometimes count on an official bailout

Secondly, many of the ratings assigned to a bank or to bank debt will contain a judgement of the likelihood of an official bailout should the bank run into difficulties. While this is what creditors need to know, it may not accurately convey the intrinsic strength of the bank. To address this issue a number of agencies have recently developed "stand-alone" ratings that abstract from official support. A third issue is the rating of banking systems and not just individual banks. Although an assessment of certain system-wide features such as the efficacy of local supervisory arrangements plays a part in the rating of individual banks, the rating of banking systems is not common. There is a market demand mainly for the rating of individual institutions; there are also conceptual difficulties in defining the meaning of credit risk for an entire system. Fourthly, all ratings reflect an element of subjective judgement (e.g. about such matters as the quality of management) as well as a weighting of objective indicators. This element is all the more important in countries where the standards of financial reporting are low.

Agencies have yet to establish a track record for their ratings of banks

A related point is that few banks in the emerging markets have long-established track records of performance in a liberalised environment. In contrast, the statistical record of defaults in the US corporate bond market – where credit ratings have a long history – provides a check on the accuracy of ratings.

Constraint of sovereign ratings

A final, and important, issue is the relationship between a bank's rating and the rating of the country of the bank's ownership. The rating assigned to banks' foreign currency liabilities by the major international rating agencies is normally subject to the ceiling of the country's own sovereign debt rating. This applies equally to private and state banks on the grounds that the government of a country faced with default may take measures to impede banks in its jurisdiction from honouring their foreign currency debt. For this reason, the international ratings assigned to banks in many emerging markets tend to "bunch" at or just below the sovereign debt ceiling. In order to discriminate more finely between different institutions, some agencies have begun to use national rating scales designed to abstract from sovereign risk. Which rating is more useful depends on the nature of any crisis that provokes difficulties. In many countries, local credit-rating agencies also play a significant role – particularly in the rating of local currency liabilities. One question that arises is the development of internationally comparable ratings – especially where local rating scales are mandated by local regulators for specific needs.

Unresolved questions

In short, disclosure and the role of credit-rating agencies raise several issues. Such questions are likely to increase in importance with the growing number of banks conducting international business and with the "atomisation" of present-day international capital markets.