The globalisation of financial markets and financial regulation: implications for Latin America

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It is a pleasure to be here at the Centre for Financial Stability. Since its founding in 2002, the Centre has certainly become an important focus for research and dialogue on the most critical issues relating to financial stability and financial system development, both in Argentina and in the region.

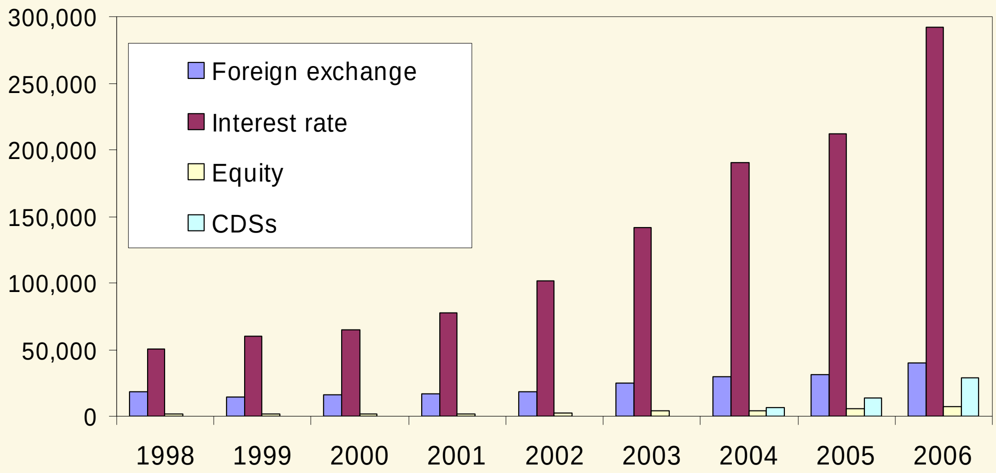
I would like to spend a little time this morning talking about some of the changes in global financial markets that have taken place in recent years, including shifts in the geography of financial transactions, new financial instruments, changing roles for the different categories of participants in financial markets, and new patterns of correlation among financial asset prices. I will touch on some of the implications for Argentina and for Latin America, but my primary focus will be on global developments. I will also talk about what all of this means for the process of regulatory cooperation in our globalised financial system.

One of the most striking developments in international financial markets in recent years has been the continued rise in gross and net capital flows across borders. Thanks to the smooth functioning of international capital markets, external current account imbalances, particularly the large external current account deficit of the United States, have been financed easily thus far. Meanwhile, higher surpluses of the oil exporters and a number of emerging economies have been recycled back into the global financial system.

The growth of capital flows has been supported by the continuous expansion that has taken place in recent years in the volume, diversity and flexibility of the financial instruments available to international investors. For example, we hear much about the enormous increase in the US securities held by official holders of foreign exchange reserves. It is very important to recall that more than 80% of the US securities that are bought by foreigners are purchased through the private sector. And more than half of these securities are not US Treasury instruments, but corporate bonds and equities.

An important factor supporting the expansion of these flows has been the growth and innovation in derivatives markets. A wide range of hedging instruments has enabled issuers, dealers and investors to manage the risks arising from cross-border flows in efficient, risk-mitigating ways. Credit derivatives (CDSs), naturally, have received the most attention lately, but as Graph 1 shows, so-called “plain vanilla” instruments such as interest rate swaps (red bars) and exchange rate derivatives (dark blue bars) still account for the bulk of derivatives activity, while CDSs (light blue bars) are less important.

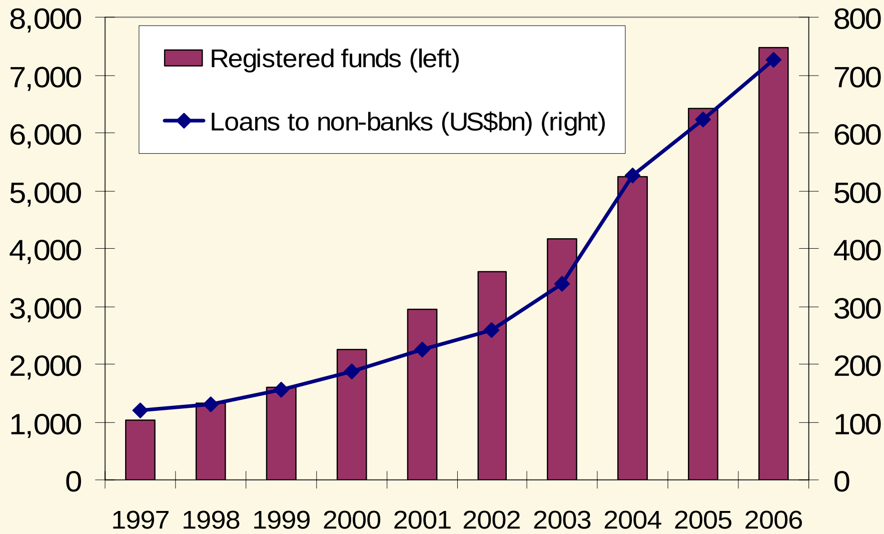
Graph 1. Notional amounts of OTC derivatives (US$bn)



Source: BIS. Data are as of end-December in each year.

We must also not lose sight of the newly important participants in financial markets, most notably private equity funds and hedge funds. The impact of these players on markets, both as trading vehicles and as channels for investment, has increased. In turn, the balance sheets and business strategies of the other major players have changed.

Graph 2. Hedge fund activity in the Cayman Islands



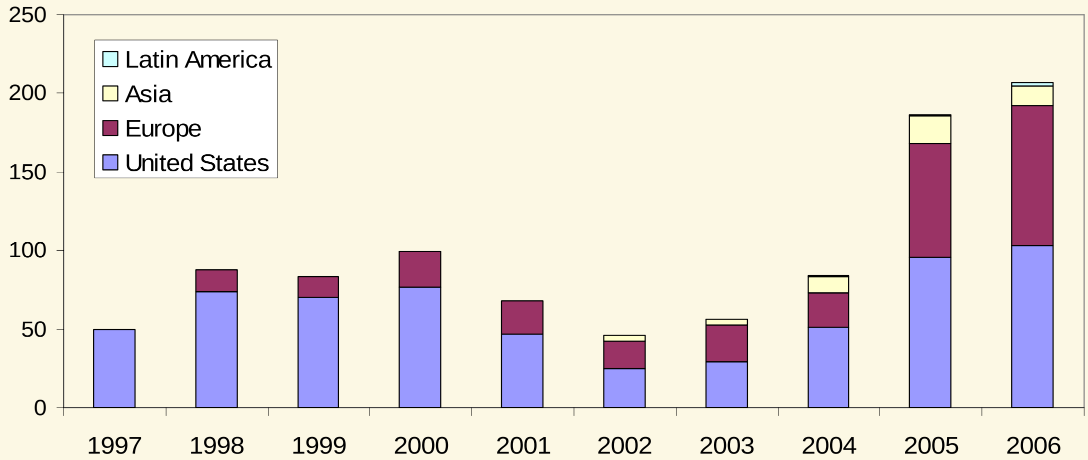
Sources: Cayman Islands Monetary Authority; BIS.

Hedge funds furnish a valuable service by providing liquidity to many previously illiquid markets and by helping to ensure that valuations across different markets are consistent. This is primarily because they can expand or reduce leverage to take advantage of arbitrage opportunities. This, however, results in higher leverage for the financial system as a whole. Graph 2 shows that the growth in the activity of hedge funds, in this case measured by the number of funds resident in the Cayman Islands (red bars), is closely matched by an increase in lending by major banks to non-banks in the Caymans, mainly hedge funds (blue line).

Despite this growth in lending, supervisors believe that the direct exposures of large dealing banks to hedge funds are well managed, though there are still areas for improvement. The jury is still out, however, on indirect effects – that is, on whether hedge funds act as a stabilising or a destabilising force in times of stress. At least so far, the record is reassuring. Nevertheless, we have to be on the lookout for "hidden" leverage and crowded trades, such as carry trades, and make sure participants understand the related risks.

With these concerns in mind, the Financial Stability Forum (FSF) recently made a number of recommendations about actions to address hedge fund-related risks. Supervisors are urged to act to strengthen intermediaries' counterparty risk management practices and to improve their robustness to potential erosions of market liquidity. Counterparties and investors are urged to strengthen market discipline by demanding more transparency from the funds. And the hedge fund industry is urged to review and enhance sound practice benchmarks. This is the "indirect approach" to address hedge fund-related issues – that is, rather than trying to regulate the funds themselves, to make sure that regulated institutions manage their hedge fund-related risks appropriately, and to encourage the private sector to develop standards that ensure that markets work effectively.

Graph 3. Private equity funding for leveraged buyouts (US$bn)



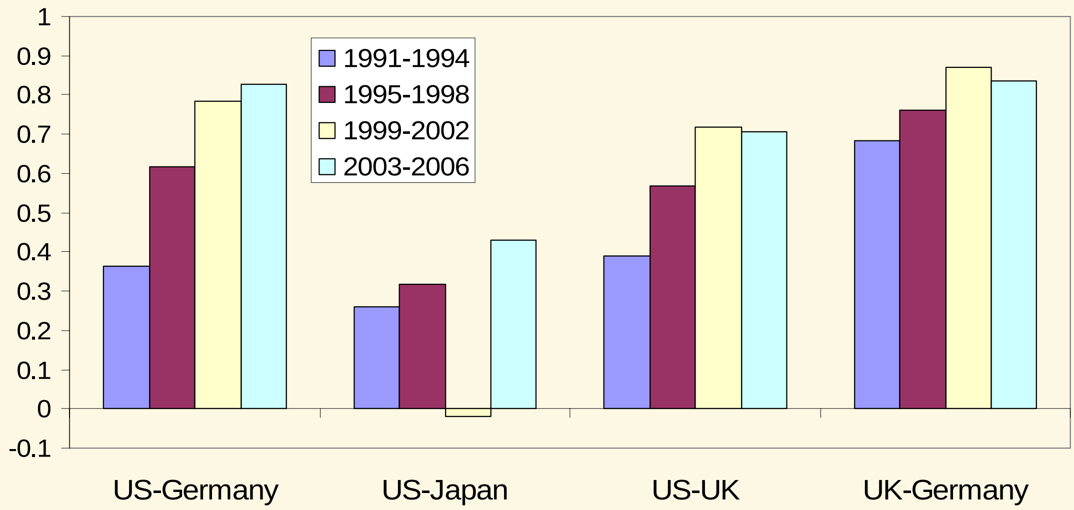
Sources: Emerging Markets Private Equity Association; National Venture Capital Association; PricewaterhouseCoopers; Thomson Financial; BIS calculations.

Private equity funds have also become part of a potentially dramatic transformation in the world of corporate finance. As can be seen in Graph 3, leveraged buyout activity has again been growing strongly in the most recent years.

Just as leverage has allowed hedge funds to change pricing relationships in traded markets, access to leverage for private equity transactions has made it easier for corporate structures to be reorganised. An important part of this story is the growth and innovation in the securitisation of credit exposures and the shift of large banks to an “originate and distribute” model. The ease of distributing debt to willing investors has indeed made it easier for private equity funds to arrange leveraged buyouts and restructurings.

One hopes that such adjustments have made the corporate world more efficient. But empirical research suggests that it is not always the case. Some of these developments raise questions about excessive leverage, the distribution of risk, market transparency and conflicts of interest. Moreover, it is unclear how robust these activities will be to a turn in the corporate credit cycle. In any case, as with hedge funds, the longer-term trends appear to be irreversible. The set of opportunities available to users of the financial system has broadened, and the old distinctions – among institutional types, sectors, and geographical regions – are breaking down. Policymakers will have to address these issues.

Graph 4. Correlations of government bond yields



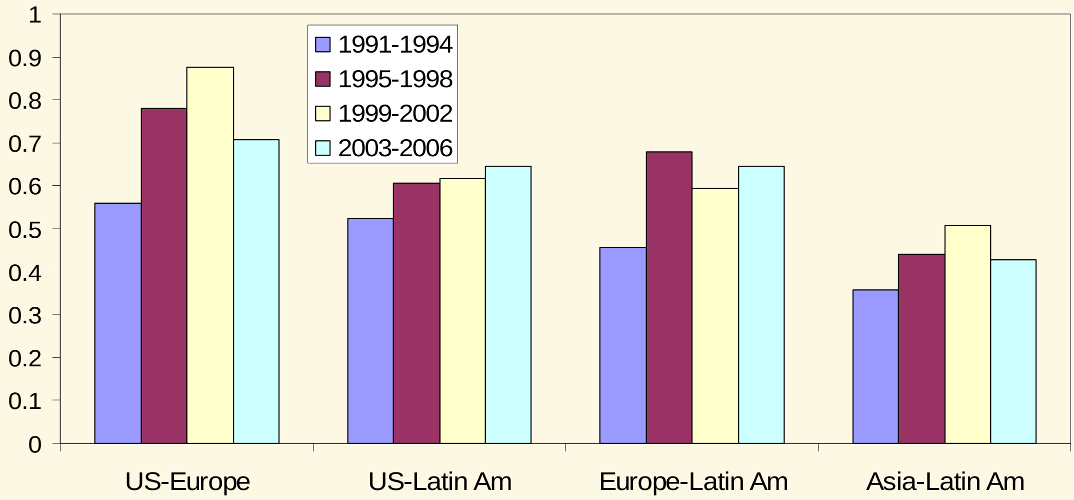
Sources: National data; BIS calculations.

As a result of these innovations, many of the relationships that we are used to seeing in financial markets have changed markedly. One remarkable long-term trend, displayed in Graph 4, has been the steady rise in price correlations across markets, especially geographically. The correlations between US and European bond yields are now between 80 and 90% – having doubled since the early 1990s. While it is not yet clear if these trends are temporary or permanent, I would argue that they stand as evidence that markets now act quickly in ways that reflect the increased ability of market participants to take positions that span countries and sectors.

Equity market price correlations have also tended to rise. Graph 5 shows the evolution in equity market correlations for different global regions since 1991. These high correlations reflect the steady increase in global cross-border flows I mentioned earlier, as well as more aggressive activity by investors holding portfolios that span multiple markets. The benefits to borrowers and long-term investors from more globalised financial markets are numerous. Borrowers get access to a pool of global capital. Savers get a greater range of investment opportunities. Domestic markets are less isolated from one another, and hence more able to weather shocks in the domestic financial system.

This reduced exposure to domestic shocks may have come at the cost of somewhat more exposure to shocks originating abroad. And yet it is interesting to note that, even as day-to-day correlations among markets have increased in recent years, we have not seen a repeat of the pattern in the 1990s where small shocks in certain markets led to serious crises in others. For example, during the episode of market turbulence in February and March this year, even though investors retreated from risks of all kinds, the impact on stock and bond markets in emerging economies was relatively mild. Even though risk appetites are now more correlated across markets than before, this would suggest that markets are more likely to be anchored by fundamentals, and less exposed to contagion effects from one local market to another.

Graph 5. Correlations of equity indices



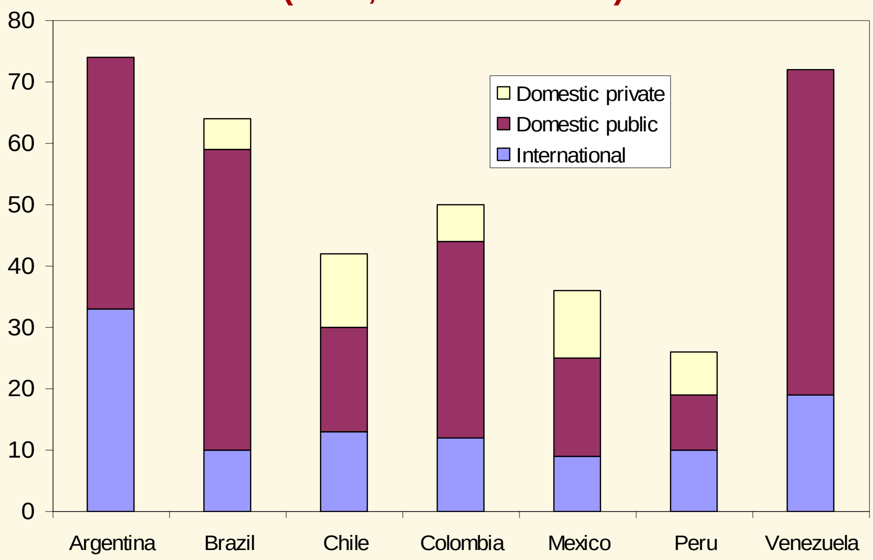
Sources: Datastream; national data; BIS calculations.

And yet, while these changes and benefits are real, the tendency of markets to push things to the limit – whether by excessive leverage, excessive optimism, or some combination of both – has not gone away. This is part of human nature. We may well discover that, even as localised financial crises become less common, the risk of a globalised shock, affecting a range of countries and markets, has increased. Such a shock may result from a global withdrawal from risk, perhaps reinforced by the forced liquidation of positions by leveraged players facing margin calls.

Having in mind these global patterns (new financial instruments, new players, more globalised markets), let me now turn more specifically to emerging market economies – and Latin America in particular.

A first point to note has been the growth over the last few years in the issuance of bonds on domestic markets. As can be seen in Graph 6, domestic debt issuance now rivals or exceeds international issuance in many countries in Latin America, though issuance by the private sector is still relatively limited. Locally issued debt has enabled governments, banks and private companies to develop new channels for financing. This should reduce the dependence of the real economy on the health of the banking system, and make it easier for domestic savings to be mobilised for the financing of domestic investment. Local currency issues also enable borrowers and investors to reduce their currency and maturity mismatches. As a result, private and public sector balance sheets should become more resilient to movements in the exchange rate and the interest rate, lessening the risk of 1990s-style crises.

Graph 6. Bond markets in Latin America
(2005, as a % of GDP)

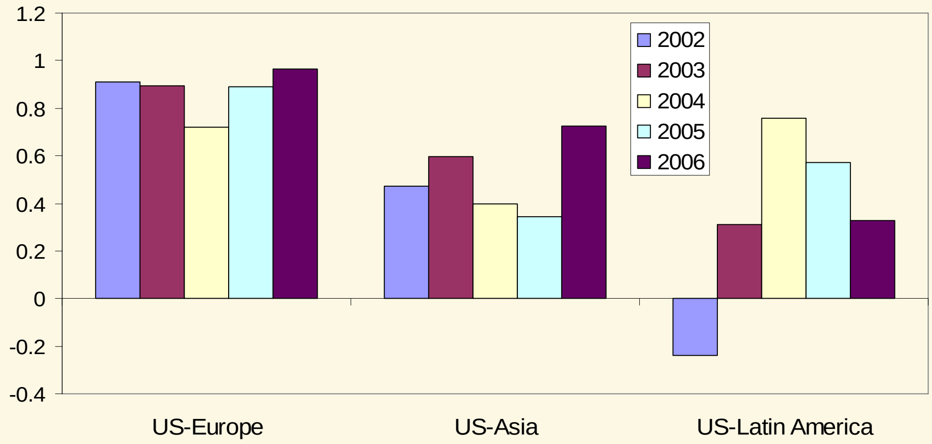


Sources: IMF; CGFS; BIS.

At the same time, these markets introduce certain risks, especially in their early stages. Currency risk may be replaced by maturity risk if local bond markets lack sufficient liquidity at the long end and long-term foreign currency borrowing is replaced by short-term instruments in domestic currency. Second, limited domestic market liquidity could create significant financial risks at times of stress. A third issue is the narrowness of the investor base. Despite the growth of funded pension systems in several countries, banks remain critical holders of local bond issues. Consequently, the health of the bond market remains dependent on the health of the banking sector, so the diversification of financing channels I spoke of earlier is weaker than might be expected. In addition, newly arrived non-bank investors such as pension and mutual funds often still lack expertise in making portfolio allocation decisions and managing the related risks.

A second point to note is the new opportunities raised by the integration of EMEs in global financial markets. This allows worldwide investors to access new markets, helping to diversify risks across the world and to reduce financial costs and in turn enhancing capital accumulation and long-term growth prospects in developing countries. Indeed, and as indicated in Graph 7, correlations of yields in emerging market currencies with those in the advanced economies have been somewhat lower in recent years than the correlations between, for example, US dollar- and euro-denominated yields.

Graph 7. Correlations in local bond indices



Sources: JPMorgan Chase; BIS calculations.

However, I should add a note of caution: as we saw earlier regarding government bonds in the mature economies, and as I will now show with respect to equity markets, these correlations may well rise over time. This is the so-called decorrelation-correlation issue: as global investors are attracted ex ante by EME assets for diversification purposes, the prices of these assets may well turn out ex post to be more correlated with global financial prices.

All of these developments point to the importance of strengthening cooperation within the worldwide community of central banks, financial system regulators, and other authorities responsible for financial stability. As financial markets, and the entities that make use of them, become increasingly global, it is critical that those who set the rules and monitor the stability of the financial system take a global perspective as well.

This is a more difficult task than one might think. For one thing, our world is still one of nation states. Each country has its own regulatory approaches, objectives and institutional framework. Each country approaches the core functions of legislation, regulation, supervision and enforcement in different ways, and distributes them differently across its domestic institutions. Even the European Union, after many years of diligent effort backed by strong political will, has really just begun to truly harmonise the regulatory approaches and structures of its member states in the financial field.

There is also room for improvement in harmonisation and coordination in the United States, where a multiplicity of agencies have responsibility for financial system soundness.

Second, the lines between different types of financial institution and different categories of financial activity have blurred. Today, a given financial transaction might have elements of a bank loan, a corporate bond issue and an insurance contract, and might involve counterparties that do business in any or all of these fields. But our regulatory systems tend to be organised along sectoral lines.

Third, the rate of innovation in financial markets is so fast that it is difficult to formulate effective rules to deal with new products or markets in a timely way that achieves regulators' mandated objectives and responsibilities.

Some in the private sector, as they deal with the consequences of globalisation and rapid innovation in their own institutions, are understandably frustrated at having to deal with differing, and sometimes conflicting, regulatory frameworks in the various jurisdictions and sectors in which they are active.

In response, I would point to several areas where progress is being made in developing common frameworks and approaches for financial system regulation and supervision. These have helped to create a common language among financial regulators, across both national and sectoral boundaries, which could well lead to a much faster pace of harmonisation in the future. For example, the Basel II Framework will facilitate the convergence of regulatory approaches to bank risk management and capital adequacy in the years ahead, as we gain experience with the new system.

Another good case study would be developments involving international accounting standards. Certainly, there has been a vigorous, and largely constructive, debate over the specifics of some of the International Financial Reporting Standards developed by the International Accounting Standards Board (IASB). But these differences of views should not distract us from the remarkable progress that has been made in the broader efforts to gain international acceptance for sound, principles-based accounting standards. These standards are implemented in an ever widening circle of countries. The IASB and a number of national accounting standard setters have chosen to work together using an open due process. This has helped the resulting standards to gain credibility and broad acceptance on a global basis.

I should also mention private sector efforts, such as the second Counterparty Risk Management Policy Group (CRMPG II), or the recent Proposal by the Institute of International Finance (IIF) for deepening the dialogue on effective regulation of the financial system. These efforts offer a potentially fruitful model for international cooperation, in which the public sector identifies broad regulatory objectives and points to problems needing collective action by the industry, while the private sector develops specific responses to address these concerns.

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Let me conclude. Large shifts in the roles of different players in financial markets have been accompanied by geographical shifts in financial market activity. In recent years, some observers have looked at the rise of some large emerging economies – the so-called BRICs, ie Brazil, Russia, India and China – as signifying a change in the distribution of power in the global financial system. At the BIS, we see this less as a matter of how power is distributed than of how we can make the dialogue for developing norms and standards of appropriate conduct in the global financial system more effective and inclusive.

One way to do this is to foster a regulatory process centred on a transparent, principles-based approach. Common standards help to provide comparability among national financial systems and offer a guidepost for structural reforms. We have also been acting steadily to bring a broader range of countries into this dialogue, for example through expansion of BIS membership – 55 members now, of which four from Latin America – and a greater say for key emerging market central banks in BIS governance. This broadening of participation ensures that regulatory initiatives fully supported by the BIS have the appropriate degree of credibility, among both the current set of mature economies and the new arrivals. An international regulatory dialogue that harmonises approaches and objectives while allowing room for national differences is clearly in everyone's interest.