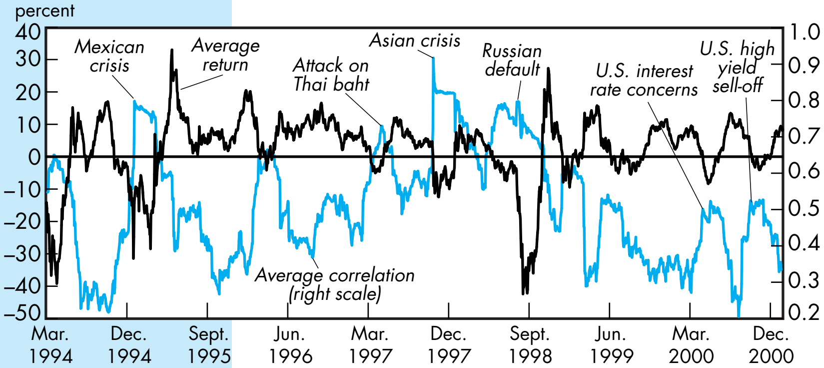
Emerging Market Financing

Report weighs bond, equity market prospects, examines contagion and periods of "drought"

Heightened expectations of a slowdown in the U.S. economy; a downgrading of the long-run earnings potential of the technology, media, and telecom sector; and a deterioration in U.S. credit markets all took their toll on emerging bond and equity markets in the last quarter of 2000. In addition to analyzing the consequences of these developments, the latest issue of *Emerging Market Financing*, which is published quarterly and forms part of the IMF's surveillance over international capital markets, also discusses the outlook for emerging market financing this year and the potential risks, notably those that would be engendered if the U.S. economy were to slow sharply. The report also examines episodes of contagion and periods of drought in emerging bond markets—two salient features of emerging markets financing.

Emerging debt markets: average return and correlation



Data: IMF, *Emerging Market Financing*, fourth quarter 2000

Performance and outlook

As spreads widened sharply in emerging markets and in U.S. high-yield markets last quarter, tighter external liquidity conditions focused investor attention intensely on the prospects for the two largest emerging market borrowers on international bond markets—Argentina and Turkey. Emerging equity markets, again led by Asia, performed less well than their broader counterparts in the mature markets. Despite bond issuance virtually drying up for much of the quarter, however, total emerging markets fund-raising on international capital markets held up relatively well, supported by a surge in equity placements from China and a robust syndicated loan market.

As it has in the last three quarters of 2000, the outlook for emerging market assets and financing remains closely tied to developments in the external environment. According to the report, changing perceptions of the relative probabilities of a "soft" versus "hard" landing for the U.S. economy are likely to keep markets volatile. *Emerging Market Financing* sketches scenarios for both outcomes, noting that expectations of a relatively soft landing will lead to a continued easing of external financing conditions for emerging markets and—history indicates—increased discrimination among the better performers. Expectations of a hard landing, however, will prompt a move up the credit spectrum in debt markets and could spark another downgrading of the technology, media, and telecom sector, thereby tightening external financing conditions for emerging markets. The baseline outlook for 2001 sees a moderation in bond financing, selective equity placements, and a supportive syndicated loan market.

Contagion and discrimination

The report takes a close look at periodic bouts of contagion—that is, high correlations in the individual country returns on emerging debt markets. It finds individual country bond returns tend to move in sync during bad times, but considerably less so during market rallies. This suggests less investor discrimination during sell-offs (see chart, this page). This is consistent with both the "crossover" nature of the investor base (which tends to head for home markets in the face of bad news rather than seek refuge in better credits within the asset class) and leveraged position taking (losses prompt margin calls and broad-based liquidation across the asset class, but gains do not). But the report also finds evidence of a systematic decline in cross-correlations after the emerging market crises of 1997–98. This is encouraging, since it suggests a greater potential for diversification between emerging markets and could encourage increased allocations to the asset class.

Why have cross-correlations declined since 1997–98? The report identifies several factors: investors are less leveraged since the Asian and Russian crises, so that bad news necessitates less need for across-the-board liquidations; the upgrading of some countries—such as Mexico—to investment grade has increased the diversity of the overall investor base for emerging market debt, and a more diverse investor base should result in more diversified investor behavior; and we have not had a "full-blown" crisis in a major emerging market for some time now. According to the report, it remains an open question how high the correlations would go if there were another full-blown crisis in a major emerging market.

During 2000, there were two spikes in the average cross correlation, though these spikes were noticeably lower than in previous years. The first episode coincided closely with revised expectations about U.S. monetary policy, suggesting expectations played the key role. In the second episode, a variety of factors coincided relatively closely with the sell-off in Argentina. Was there contagion from Argentina to other emerging markets? *Emerging Market Financing* finds that the deterioration in the external environment preceded the buildup of investor concerns about the sovereign to a critical level. By the time Argentine spreads rose above the broader market, the average cross-correlation had already risen.

The second episode had two phases. The first may be linked with concerns about Peru, the pricing-in of a global slowdown, and the Chase–J.P. Morgan merger. The second phase coincided with the sell-off in U.S. high-yield bonds. As concerns about Argentina grew—peaking on October 25 and again on November 9—the average correlation remained relatively flat. This evidence suggests that "contagion" within the emerging debt markets preceded the buildup of concerns about Argentina to a critical level and was a response to the deterioration of the external environment.

Droughts in emerging bond markets

Since 1993, emerging market borrowers have, according to the report, faced nine periods of market closure, or "droughts" in which they were unable to issue new debt securities (see chart, this page). The duration of these droughts has varied substantially, from one week (at the time of the Mexican crisis) to the most severe and prolonged drought of 13 weeks (at the time of the Russian crisis). The first five instances of market closure were associated with emerging market crises or uncertainties in the periods leading up to them, but droughts occurred even in the absence of emerging markets crises. In the four droughts since the Russian crisis, three have been associated with developments in the external environment, and the widening of spreads has been notably less pronounced in these episodes. The report found, rather surprisingly, that there was no clear relationship between the average level of emerging market spreads and droughts in emerging markets issuance.

A discrete event—such as a crisis in a major emerging market or a change in the external environment—typically prompts a sharp change in spreads and causes issuers and investors to wait, according to *Emerging Market Financing*. Issuers are loathe to lock in higher rates, and investors are concerned about taking mark-to-market losses (that is, losses accrued when their assets are marked to the prevailing market price) on new issues, because spreads might widen further. A resolution of the uncertainty about that outlook appears key for a reopening of the market. With time, issuers tend to accept higher borrowing rates, and once investors become convinced things will not worsen, they become willing to buy. Volatility of the secondary markets is, therefore, key to market closures, and its dissipation is key to reopenings.

As one would expect, droughts in issuance have also been a feature of other lower-tier credit markets, such as the U.S. high-yield market, but much less so of the high-grade market. Conditions in the U.S. high-grade and high-yield markets—the "external issuance environment"—have played a clear role in determining the receptiveness for emerging market issues. At the time of the Brazilian crisis, for example, while emerging market issuance fell markedly, U.S. high-yield issuance remained stable, setting the stage for early reaccess, and the slowdown in issuance at that time does not qualify as a drought under the report's definition.

Finally, droughts in emerging market issuance have been closely associated with spikes in the average cross-correlation of individual country returns—that is, periods of broad-based selling of emerging market debt in secondary markets (see chart). ■

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Emerging debt markets: average correlation and market closures (shaded)

Data: IMF, *Emerging Market Financing,* fourth quarter 2000

Emerging Market Financing: Quarterly Report on Developments and Prospects for the fourth quarter of 2000 is available on the IMF's website (www.imf.org).

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
February 5	4.37	4.37	5.06
February 12	4.36	4.36	5.05

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket. The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/cgi-shl/bur.pl?2001).

General information on IMF finances, including rates, may be accessed at www.imf.org/external/fin.htm.

Data: IMF Treasurer's Department