9 Developments in Foreign Securities Markets

The international financial markets witnessed extraordinary turbulence during the larger part of 1998 and 1999 on account of the spillovers of the Asian crisis which began in 1997, the crisis at Russia, followed by difficulties at a major hedge fund (LTCM) and financial difficulties in Japan. Both the advanced and emerging market countries were affected by the developments in international financial markets and the capital flows to the emerging markets fell to unprecedented low levels. Though due to concerted action by the international community, stability returned to the international markets by the end of 1999, certain vulnerabilities still prevail in both the advanced countries and emerging markets.

DEVELOPMENTS IN ADVANCED COUNTRIES

The equity markets in the advanced countries were generally buoyant in the first half of 1998 and remained relatively immune from the Asian crisis. The crisis in Russia, however, sparked a period of turmoil in advanced countries beginning in August 1998 even in the absence of a major inflationary or economic shock. The situation gave rise to reassessment of risk, especially regarding emerging market investments, and large-scale portfolio rebalancing across a range of global financial markets. The advanced countries faced further challenges in the second half of 1998 when liquidity started drying up following the near-collapse of the hedge fund Long-Term Capital Management (LTCM), which had large, highly leveraged and complex positions across a broad range of markets. The financial markets in advanced countries were also influenced by continued sharp differences in macroeconomic performance and policies across the major advanced countries and spillovers from problems in the emerging markets. The whole situation resulted in intensification of equity market sell-off, which largely wiped out the gains recorded earlier in the year. The market volatility increased sharply in view of rapid deleveraging. In the US, the equity markets bottomed out in late August, roughly 20% below their highs, while European markets continued to decline through the first half of October, falling on average by about 35%. The response to these developments was cut in US interest rates starting in late September. The interest rates were also eased in Japan, Australia, Canada and Europe.

The financial markets in advanced countries began to stabilise by the end of 1998. The economic climate started improving due to prompt action by central banks, robust growth in the US economy, adoption of important measures by Japan to stabilise its economy and signs of recovery in the Asian crisis. The impact of interest rate cuts implied that the turbulence stemmed mainly from a sudden and sharp increase in pressures on liquidity, defined rather broadly to include securities market liquidity, alongwith a reassessment of risk. The major equity markets staged impressive recoveries, though some markets performed much better than the others. As the Dow Jones Industrial Average crossed the 10,000 mark in March 1999, there were concerns over the high valuation level of the US equity market thus leading to growing risk of a correction in equity markets. The European markets too posted strong gains, though the prospects of European equity markets remained clouded by uncertainties about the pace of recovery in Europe. The Japanese stock markets which were volatile during mid-November 1999 to end-February 1999, rose abruptly in April 1999, but declined thereafter and rebounded in June 1999. The developments in the domestic financial system

continued to guide the stock market movements.

Developments in Emerging Markets

The effects of the 1997 Asian crisis initially remained limited to the region and by mid-1998, some of the Asian crisis countries started witnessing a pick-up in capital inflows. However, the pressures emerged as reflected in the slowing down of gross capital flows and a fall in equity prices. The decline in commodity prices, sharper-than-expected output declines in some of the Asian countries and continued difficulties in Japan worsened the outlook in the Asian region. The global outlook also turned bleaker following Russia's decision in August 1998 to unilaterally restructure its domestic debt and sharp depreciation of the ruble and the turmoil in the advanced countries due to near-collapse of LTCM. The international lending effectively dried up and more vulnerable economies in Latin America were brought into the crisis. After declining in 1997 for the first time during the 'nineties, the private market financing for the emerging markets fell dramatically in 1998, with the decline being particularly sharp during the latter half of the year in the wake of international turbulence. While most types of inflows fell, the foreign direct investment remained fairly stable.

The emerging markets recovered substantially during the last quarter of 1998 as official interest rates eased in most industrial countries and the agreement was reached on program between IMF and Brazil. A further shock to emerging markets occurred early in 1999 with the devaluation, followed by float, of the Brazilian real. The Brazilian devaluation, however, did not have any major impact on other emerging markets reflecting the deleveraging that had occurred in 1998. Due to overall favourable global economic environment, strengthening oil prices and improvements in macro-economic conditions in emerging markets, emerging equity markets rallied between February-April 1998. The rally slowed down somewhat in May 1999 due to fears of rise in US interest rates in response to increasing inflationary pressures. The pressures on emerging markets, however, eased by mid-1999 as equity markets in advanced economies recovered in June 1999 and the emerging markets remained largely unaffected by announcement by US Federal Reserve to increase federal funds rate on June 30, 1999. The emerging markets may, however, suffer due to restricted access to global financial markets and a diminished investor base. They also continue to remain susceptible to global shocks and developments in advanced countries.

PRIVATE CAPITAL FLOWS TO EMERGING MARKETS

As per the balance of payments data, there was a further sharp fall in net private capital flows to emerging markets in 1998 to the lowest level this decade. The preliminary estimates indicate that total net private capital flows in 1998 were about $60 billion, a level roughly 55% lower than the 1997 figure and around 70% lower than the peak level of 1996. Further, while recent data are not available, any pick-up in 1999 is expected to be modest.

The major component of the fall in net private capital inflows was a further sharp withdrawal in bank financing of emerging markets. Bank financing, including syndicated bank lending, trade financing, etc., became more sharply negative in 1998, with most of the net outflows from Asia. Foreign direct investment (FDI) in emerging markets fell for the first time in 1998 during this decade. The decline in FDI in 1998 took place for Asia and Russia, while it remained fairly healthy in other regions. Issuance of bonds and other fixed-income instruments (in gross terms), which is now the major source of private market financing (excluding FDI) for emerging markets, also fell substantially in 1998

and showed only modest recovery in the first half of 1999. An important development in the international bond market has been the reduction in access for private sector entities from the emerging markets, thus reflecting the economic health of borrowers. In Asia, the high leverage of many companies has precluded the issuance of new debt. International equity issuance by emerging market companies has also been adversely affected by the emerging markets crisis, as increase in losses and high volatility in returns in the equity market have led to worsening in perceptions of emerging market equity as an asset class.

POLICY CHALLENGES POSED BY TURBULENCE IN INTERNATIONAL FINANCIAL MARKETS

The turbulence in the international financial markets in the last two years have raised concerns about the market dynamics of highly leveraged and increasingly integrated financial systems and the adequacy of current approaches to assessing systematic risk. The international financial system has been transformed drastically by factors, such as, financial liberalisation, innovation in financial instruments and globalisation. More recently, the developments including growth of derivative markets (especially the OTC market) and the development of off-balance-sheet finance have substantially altered the portfolios and the risk assessment. The main question is whether the official safety nets and monitoring systems have adapted sufficiently to face the challenges posed by the new financial environment.

While several factors contributed to the build-up of vulnerabilities in the advanced economies in mid-1998, market participants have identified following factors as providing the major explanation for the crisis:

- Negligent attitudes toward risk-taking, including in emerging markets, which manifested in ineffective risk management (including the presumption of continuous market liquidity) and over-reliance on collateral (instead of counter-party risk assessment);
- Inadequate transparency about counter-party risk, due to excessive reliance on off-balance-sheet items, OTC products and cross-border and cross-market transactions;
- Mark-to-market accounting, which has contributed to liquidity pressures; and
- Unsustainably high levels of leverage, which amplified the market shocks. High leverage had become necessary in view of severe competition and expectations of continued high returns.

The financial vulnerabilities in international financial markets during the last two years have highlighted the importance of several factors. These are:

- Improving internal and market discipline has been identified as the most important challenge emerging from the turbulence, which, in turn, depends on the availability of relevant information and the effectiveness of private and regulatory incentive structures. Greater financial disclosure and transparency about risk exposures is an essential element of private market discipline and regulatory and supervisory oversight. In addition, appropriate incentive structures are also required to promote better market discipline as without such incentives, disclosure would not create sufficient market discipline to discourage the build-up of concentrations of exposures and unsustainable leverage within individual financial institutions.

- In times of crisis, official involvement becomes necessary for reducing moral hazard. Apart from prudential oversight, the other elements of official involvement constitute preventive and corrective mechanisms, which provide a degree of insurance and stability to national financial systems and, more broadly, to the international financial system. The policy-makers face a difficult balancing act in encouraging normal risk-taking and at the same time ensuring the financial system against systemic problems.
- The national financial systems and international financial systems have evolved over time with a much greater reliance on securitised finance, which have created a more market oriented form of systemic risk, involving an array of markets. The regulatory frameworks need to be continuously well adapted to the changing nature of private financial risk and systemic risk.

In view of the above, a number of proposals have emphasised the role of private risk management (the first line of defense) for containing leverage and have viewed regulatory and supervisory activities (the second line of defense) primarily as instruments for strengthening market discipline. However, much less attention has been paid to reforms for improving the ability of supervisory and regulatory frameworks to effectively monitor and influence the levels of leverage and risk-taking. Some improvements are also required in the area of financial policy making and implementation, aimed towards better coordinating micro and macro-prudential oversight; narrowing the gap between the regulators and the regulated; and better understanding the linkages between monetary and financial stability.

Table No. 1: Growth of Hedge Funds and Assets under their Management

Type	1980	1990	1995	1996	1997	1980	1990	1995	1996	1997
	(In Numbers)					(In US $ Million)				
Global	1	40	248	334	404	193	1288	14931	20401	30862
Macro	0	13	40	50	61	0	4700	18807	25510	29759
Market-Neutral	0	18	123	159	201	0	638	5707	10317	17970
Event-driven	0	17	73	95	120	0	379	3827	5574	8602
Sector	0	1	16	23	40	0	2	187	691	1752
Short sales	0	6	10	11	12	0	187	432	488	538
Long only	0	0	7	11	15	0	0	85	180	376
Fund of Funds	0	32	181	221	262	0	1339	9416	13163	19717
Total	1	127	698	904	1115	193	8532	53392	76325	109576
Total (Excluding fund of funds)	1	95	517	683	853	193	7193	43976	63162	89859

Note : Global - invest in emerging markets and other specific regions of the world, Macro – take position on changes in global economic conditions, Market - neutral - attempt to reduce market riskby taking offsetting long and short positions, Event-driven – attempt to capitalise on events that are seen as situations, Sector – have an industry focus, Short sales – borrow securities they judge to be over valued from brokers to sell them on the market, hoping to buy them back at a lower price when repaying the broker, Long only – traditional equity funds structured like hedge funds, Fund of funds – allocate their portfolio of investments among a number of hedge funds.

Table No.2 : Location-wise Distribution of Hedge Funds and their Assets at the end of 1997									
Location	**Global**	**Macro**	**Market-Neutral**	**Event-Driven**	**Sector**	**Short sales**	**Long only**	**Fund of funds**	**Total**
									(In Numbers)
Bahamas	18	2	10	5	0	1	1	16	53
Bermuda	38	4	29	2	5	0	0	23	101
British Virgin Islands	67	9	21	17	3	2	0	66	185
Cayman Islands	73	15	31	14	2	2	2	9	148
Curacao	0	1	0	0	0	0	0	0	1
Guernsey	4	0	0	0	0	0	0	6	10
Luxembourg	3	0	4	0	0	0	0	0	3
Nether land Antilles	5	4	0	1	0	0	0	9	19
USA	190	23	101	78	30	7	12	128	569
Others	6	3	5	3	0	0	0	5	26
Total	**404**	**61**	**201**	**120**	**40**	**12**	**15**	**262**	**1115**
									(In US $ Million)
Bahamas	977	16	241	207	0	28	1	1181	2649
Bermuda	3427	119	1531	17	451	0	0	1057	6602
British Virgin Islands	6259	2494	1421	2045	15	116	0	3452	15801
Cayman Islands	4186	7525	4440	997	12	121	87	72	17440
Curacao	0	4000	0	0	0	0	0	0	4000
Guernsey	1083	0	0	0	0	0	0	640	1723
Luxembourg	304	0	1292	0	0	0	0	0	1597
Nether land Antilles	5196	14045	24	787	0	0	0	6548	26576
USA	9311	1554	8663	4158	1275	273	289	6269	31792
Others	119	6	358	391	0	0	0	498	1395
Total	**30862**	**29759**	**17970**	**8602**	**1752**	**538**	**376**	**19717**	**109575**

HEDGE FUNDS IN FINANCIAL MARKETS

Bouts of turbulence in the international financial markets in recent years have drawn attention to the role played by institutional investors, especially hedge funds. Following the 1992 crisis in the European exchange rate mechanism (ERM), turbulence in international bond markets in 1994, and financial upheavals in East Asia in 1997, it was suggested that the hedge funds precipitated major movements in asset prices either directly through their own transactions or indirectly via the tendency of other market participants to follow their lead.

The term “hedge fund” is a misnomer. Hedge funds are not limited to hedging or any specific strategy or market. Nor it is that they carry on certain activities exclusively. Other institutional investors like mutual funds, pension funds carry on the same activities as the hedge funds. These are eclectic investment pools, organised as private partnerships

and often domiciled offshore to capitalize on tax and regulatory advantages, whose managers are paid on a fee-for-performance basis. Their legal status places a few restrictions on their portfolios and transactions, but allows them freedom to use a variety of investment tools like short sales, derivatives, and leverage to raise returns and cushion risk. There are two possible explanations as to why these funds yield better returns than other investment vehicles. First, they do prefer to assume risk. Second, they can design more attractive risk-return strategies/products because they have more freedom than, say, mutual funds.

Though these funds have received much attention in the last few years, the first such fund was launched in 1949. Since then the number of hedge funds has increased dramatically, and become a rapidly growing part of the financial markets. These funds are, however, not subject to same kind of reporting and disclosure requirements as other collective investment vehicles. For example in the U.S., hedge funds offer their shares through private placement and restrict share ownership to less than 100 high net worth individuals and institutions and thereby free themselves from disclosure and regulatory requirements of the Securities Exchange Commission. Off shore funds are subject to even less regulation. This makes availability of data in respect of hedge funds very difficult. Despite limitations, the data available, as presented in Table No.1 indicate explosive growth of hede fund industry since 1980s. The number of funds increased from 1 in 1980 to 1115 funds at the end of 1997, of which one quarter are funds of funds. Global funds consistently account for nearly 50% in terms of number. Assets under the management of hedge funds, including fund of funds, are about $ 110 billion. There has been a secular decline in the share of assets under management of macro funds through the 1990s. Global and macro funds account each for about one third of assets under management. At the end of 1997, global funds had the largest share of 34% followed by macro funds (33%), market neutral funds (20%) and event-driven (10%).

Most of the hedge funds are registered in the US (51%), or in one of the Caribbean offshore centres such as the British Virgin islands (17%), the Cayman Islands (13%), Bermuda (9%), The Bahamas (5%) and the Netherlands Antilles (2%), as may be seen from Table No. 2. Such uneven distribution indicates relative advantages the locations offer to these funds. In terms of share in the assets under management, the USA leads with 29% followed by Netherlands Artilles (24%), Cayman Islands (16%), British Virgin Islands (14%), and Bermuda (6%).

Hedge funds typically operate under exemptions from many of the regulatory requirements imposed by securities and commodities laws. Regulators in the United States and the United Kingdom see little need for a specialized policy response to regulate and limit the funds' activities in order to increase financial market stability. Nevertheless, limited measures to strengthen supervision, regulation, and market transparency are considered. These are motivated by issues of investor protection, market integrity, and systemic risk.