10 International Scenario

The international financial markets recovered from the turbulence, which began in 1997 with Asian crisis and got exacerbated due to the near-collapse of the hedge fund LTCM in 1998. The international security prices staged a worldwide rally in the second half of 1999, which continued upto February 2000. The rebound in the security markets was fuelled by strong US economic growth, improvement in macroeconomic outlook for the world economy and smooth Y2K transition. The rally was, however, particularly pronounced for the IT stocks reflecting strong growth prospects for this sector. The global capital markets witnessed historically high P/E ratios in stock markets, greater volatility in stock prices and stronger international linkages.

Developments in Advanced Countries

The developments in the international capital markets during 1999 were strongly influenced by the general market perception that US markets offered highest risk-adjusted returns on assets. The US markets thus continued to receive considerable attention from international investors. In this context, it may be observed that the US economy accounts for about 30% of global GDP, the US equity market accounts for about 40% of global equity market, and US fixed income markets account for around half of global fixed income markets. The relatively high gains in US equity prices during 1999 were fuelled by confidence in continued buoyant economic conditions, productivity gains, and on-going corporate share purchases through buy-back programmes and mergers. The broader equity indices in US markets, however, suffered due to portfolio shifts toward high-technology shares. In contrast to this, in the euro area, the broader market indices advanced more sharply. Even in Japan, equity markets recovered on emergence of signs that the decline in output may have bottomed.

Another notable trend was the worldwide and concentrated allocation of funds into the equity and debt instruments of companies in the technology, telecommunications, and media sectors. The technology securities globally increased sharply throughout 1999, but declined thereafter, especially during March-May 2000. The technology indices outperformed broader indices by considerable margins, upto March 2000. The European technology sectors benefited from a surge in investment funds allocated towards technology shares. In Japan, the sharp rise in technology share prices was also aided by new specialised stock exchanges and investment funds that eased access for investors. The first few months of the current financial year witnessed heightened volatility in technology stocks. This was followed by market correction in US and Japan, which also spread to Europe.

The uncertainty that pervaded financial markets in the early months of 2000 shifted to cautious optimism towards mid-year. In April and May 2000, fears of a prolonged period of monetary tightening contributed to equity market declines in the US and Europe. The price declines were greatest on NASDAQ and other technology focused equity markets. In June 2000, US stock markets led a rally in global equity and fixed income markets as fears of further monetary tightening by Fed abated.

Developments in Emerging Markets

The asset prices in emerging markets witnessed sharp increases in 1999 mainly due to improvement in economic fundamentals in many countries and also improvement in the domestic and external financing situation of most emerging markets. The outlook for most Asian countries continued to strengthen and the credit ratings of a number of emerging markets improved. The declines in net private flows to emerging markets in 1997 and 1998 were partly reversed in 1999. Within domestic markets, there was substantial development of bond markets in many countries and an internationalisation of emerging equity markets.

The emerging markets witnessed 15% increase in new issue of capital in the bond and equity markets in 1999. The growth in 1999 was strongest in the equity market, with new issues by technology, media and telecommunication companies increasing by four times over that in 1998. The growth in bond markets was more subdued. New issue of capital remained strong in the first half of 2000.

In the secondary market, the emerging market bonds posted strong returns in 1999, significantly outperforming the low or negative returns in most fixed income assets in advanced countries. The peak in the emerging market bond prices in early March 2000 coincided with the peak in the US NASDAQ Index. The secondary equity market in emerging markets was largely driven by technology, media and telecommunications stocks. The recovery in emerging market equity prices reflected an improvement in the prospects for companies in emerging markets. The returns in equity markets were higher than the average returns in advanced countries, but not as strong as in the US NASDAQ market. Between January 1999 and end-February 2000, the telecom, media and technology stocks in emerging markets grew by about 95, 100 and 170% respectively, compared to overall price growth of about 65%. The emerging market equities were however adversely affected by the decline in NASDAQ and other indices in March-May 2000. This is reflective of the fact that emerging market assets remain heavily dependent upon developments in advanced countries.

Private Capital Flows to Emerging Markets

The international capital flows to emerging markets had fallen sharply in 1997 and 1998 in the wake of the financial crises in Asia and Russia. The net private capital flows to emerging markets stabilised in 1999. Total net private capital flows to emerging markets in 1999 were about US $ 81 billion, 7.2% higher than the 1998 figure, and 64.5% lower than the peak level of 1995 (Table 10-1). The stabilisation of net private capital flows reflected continuing growth in foreign direct investment (FDI) and a recovery in portfolio investment, which more than offset a continuing decline in bank lending. It may, however, be noted that gross private financing has picked up substantially, which is not reflected in net capital flows due to sizeable debt repayments by some large economies.

Table 10-1: Net Private Capital Flows to Emerging Markets

(US $ billion)

	1992	1993	1994	1995	1996	1997	1998	1999
Emerging Markets Total	112.6	172.1	136.3	226.9	215.9	147.6	75.1	80.5
of which:								
Net foreign direct investment	35.4	59.4	84.0	92.6	113.2	138.6	143.3	149.8
Net portfolio investment	56.1	84.4	109.6	36.9	77.8	52.9	8.5	23.3
Bank loans and other	21.0	28.3	-57.3	97.4	24.9	-44.0	-76.7	-92.5
Africa	-4.0	-1.8	2.9	10.9	7.5	16.7	11.5	14.8
Asia	20.8	57.4	63.6	104.9	104.1	-1.4	-42.6	-27.0
Europe	6.5	27.4	1.8	48.8	26.7	32.2	16.3	18.0
Russia	0.7	5.9	0.6	16.4	-0.1	1.4	-13.4	-16.2
Middle East	33.7	22.3	18.6	9.1	5.6	14.6	19.9	20.6
Western Hemisphere	55.6	66.8	49.4	53.1	72.1	85.5	70.0	54.1

Source: IMF.

FDI continued to grow in 1999. Given the large reduction in bank exposures, FDI more than accounted for the total of all net private capital flows to emerging markets in 1999. FDI grew or was stable in most regions. According to IMF estimates, the FDI now accounts for 2.1% GDP of emerging markets and is nearly as large as gross private market financing in the bond, equity and loan markets combined.

Internationalisation of Emerging Equity Markets

During the last few years, the emerging markets have been forging increasing linkages with the global capital markets. The "internationalisation" of the emerging equity markets has taken place in various forms:

i. Several companies belonging to the emerging markets have raised capital through issue of American/Global/European Depository Receipts, which are traded on a foreign exchange.

ii. Many emerging markets have, over the last few years, opened their domestic capital markets to attract foreign investors, especially institutional investors, to invest in domestic equity.

iii. Some newly listed emerging market companies have floated IPOs in mature markets, bypassing local markets completely. In particular, information technology companies from Latin America have recently chosen to list directly on the US NASDAQ market.

iv. Some established emerging market companies have been taken over by advanced market companies and have subsequently been de-listed from the local exchanges. This has happened in the case of some oil, banking and telecom stocks from Latin America.

v. A number of companies from advanced markets are considering spinning off or creating tracking stocks for their emerging market operations. Several US companies are considering this with Latin American internet operations.

The above trends have many implications. Firstly, the companies in emerging markets have witnessed rapidly increasing proportion of foreign ownership. Secondly, some of these developments can have potentially negative implications for emerging stock markets by making them vulnerable to developments in global markets. Thirdly, it is increasingly being felt by policy makers in emerging markets that price determination is moving offshore, which is affecting the interests of domestic investors.

Stock Market Indicators

The stock markets worldwide have grown in size as well depth over last one decade. Tables 10-2 and 10-3 present select indicators for major markets. As can be observed from Table 10-2, the turnover on all markets taken together has grown nearly six times from US $ 5.5 trillion in 1990 to US $ 31 trillion in 1999. The turnover in developed markets has, however, grown more sharply than in emerging markets. It is significant to note that US alone accounted for nearly 60% of world-wide turnover in 1999. US nearly doubled its share in total turnover between 1990 and 1999. Despite having a large number of companies listed on its stock exchanges, India accounted for a meagre 0.4% in total turnover in 1999.

The market capitalisation of all listed companies taken together on all markets increased by 283% from US$ 9.4 trillion as at end-1990 to US$ 36 trillion as at end-1999. The share of US in world-wide market capitalisation increased from 32.6% as at end-1990 to 46.2% as at end-1999. Indian listed companies accounted for 0.5% of total market capitalisation.

Table 10-2: Market Capitalisation and Turnover for Major Markets

(US $ million)

Country / Region	Market Capitalisation (end of period)			Turnover		
	1990	1995	1999	1990	1995	1999
Developed Markets	**8,795,239**	**15,861,615**	**32,956,939**	**4,616,473**	**9,180,430**	**28,154,198**
Australia	108,879	245,218	427,683	40,113	98,654	105,999
Japan	2,917,679	3,667,292	4,546,937	1,602,388	1,231,552	1,849,228
UK	848,866	1,407,737	2,933,280	278,740	510,131	1,377,859
USA	3,059,434	6,857,622	16,635,114	1,751,252	5,108,591	18,574,100
All Emerging Markets	**604,420**	**1,910,688**	**3,073,871**	**898,233**	**1,038,064**	**2,866,867**
China	—	42,055	330,703	—	49,774	377,099
India	38,567	127,199	184,605	21,918	13,738	122,247
Indonesia	8,081	66,585	64,087	3,992	14,403	19,903
Korea	110,594	181,955	308,534	75,949	185,197	733,591
Malaysia	48,611	222,729	145,445	10,871	76,822	48,512
Philippines	5,927	58,859	48,105	1,216	14,727	19,673
Taiwan	100,710	187,206	375,991	715,005	383,099	910,016
World Total	**9,399,659**	**17,772,303**	**36,030,809**	**5,514,706**	**10,218,494**	**31,021,065**
US as % of World	**32.55**	**38.59**	**46.17**	**31.76**	**49.99**	**59.88**
India as % of World	**0.41**	**0.72**	**0.51**	**0.40**	**0.13**	**0.39**

Source: Emerging Stock Markets Factbook 2000.

There has also been an increase in market capitalisation as per cent of GDP in all major country groups as is evident from Table 10-3. The increase has, however, not been uniform across countries. As expected, the market capitalisation as per cent of GDP was the highest at 115.7% for high income countries as at end-1998 and lowest for low income countries at 22.2%. Market capitalisation as per cent of GDP for India stood at 24.5% as at end-1998. The turnover ratio, which is a measure of liquidity, was higher for low income countries at 99.4% in 1998 as compared to 91.6% for high income countries. The corresponding figure for India was 84.4%. The total number of listed companies stood at 22,612 for high income countries, 15,764 for middle income countries,

Table 10-3: Select Stock Market Indicators

Markets	Market Capitalisation % of GDP		Turnover Ratio (%)		Listed Domestic Companies	
	1990	1998	1990	1998	1990	1998
High Income	**56.0**	**115.7**	**-**	**91.6**	**17,064**	**22,612**
Middle Income	**24.0**	**27.0**	**-**	**54.6**	**4,914**	**15,764**
Low & Middle Income	**19.8**	**25.6**	**70.4**	**67.9**	**8,360**	**24,853**
East Asia & Pacific	21.3	33.0	117.2	124.2	1,443	3,702
Europe & Central Asia	2.1	11.8	-	59.2	110	9,071
Latin America & Caribbean	7.6	20.8	29.9	41.8	1,748	2,166
Middle East & N. Africa	27.8	26.6	-	17.9	817	1,619
South Asia	10.6	20.4	58.4	64.5	3,231	7,178
Sub-Saharan Africa	52.0	80.3	-	19.9	1,011	1,117
Low Income	**7.5**	**22.2**	**90.8**	**99.4**	**3,446**	**9,089**
India	**11.9**	**24.5**	**65.9**	**84.4**	**2,435**	**5,863**
World	**51.2**	**97.4**	**-**	**86.8**	**2,5424**	**47,465**

Source: World Development Indicators 2000, World Bank.

9,089 for low income countries as at end-1998. The number of listed companies in India was 5,863 as at end-1998.

Consolidation of Stock Exchanges

During the decade of 1990s, there have been substantial changes in the way stock exchanges are being run, by whom they are run, how trading takes place and at what cost, and how clearing and settlement is done. Several factors have contributed to transformation of the structure of traditional markets:

(i) the stock exchanges are increasingly consolidating themselves in the form of corporate entity rather than being run as cosy clubs,

(ii) the development of information technology has been associated with development of cheaper ways of trading shares than the traditional systems, which relied heavily on brokers and telephones,

(iii) there has been an emergence of highly successful electronic communication networks (ECNs), which now account for a growing electronic marketplace in US stocks and some of which have applied for "exchange status",

(iv) substantial decline in trading costs, and

(v) transfer of value away from trading, which is the core service provided by every stock exchange, to clearing and settlement. Due to above factors, the pressures are mounting on stock exchanges from different directions and there has been an intensive debate on the future of stock exchanges. As worldwide securities markets become increasingly homogenous and competitive, the current number of exchanges is not expected to remain viable. As a consequence, the exchanges worldwide are reviewing their ownership structures and have begun the process of consolidation. The idea of mergers came from the argument that if liquidity is dispersed over a number of trading systems, price discovery becomes more difficult. The growth of ECNs and other trading systems that compete with traditional stock exchanges has certainly led to a dispersal of liquidity.

In 1998, the London Stock Exchange (LSE) and the Deutsche Bourse envisaged creation of a unified pan-European market. The implementation of this plan has, however, faced several hurdles. This initial vision was replaced by a much looser alliance between London, Frankfurt and six other European stock exchanges.

A major step in consolidation among European stock exchanges came in March 2000, with the creation of Euronext, which merged the stock exchanges of Amsterdam, Brussels and Paris. Euronext is second in size only to LSE in the ranking of European stock markets and aims to create one single market for all products, including equities, commodities and derivatives. The vision behind Euronext is of single membership, a single order book, a single rule book, and single clearing and settlement solutions. The Euronext merger is likely to become operational by October 2000.

The creation of Euronext was followed in May by plans to create the International Exchange (iX), combining the LSE and the Deutsche Bourse. The plans for iX also included creation of a pan-European market for technology stocks in a joint venture with NASDAQ. However, the alliances between stock exchanges are proving harder to achieve, although Euronext is a notable beginning. This was clearly proven when the deal to create the iX was called off by the LSE, in view of a hostile takeover bid for LSE from the OM Group, which runs the Stockholm Stock Exchange. It was always apprehended whether the iX deal would actually work, as the Deutsche

Bourse despite having a much smaller market, was to have 50% share in the new exchange. The merger of LSE and Deutsche Bourse, together with the NASDAQ-iX joint venture had intended to offer the following benefits to investors:

- Cost savings and efficiencies, resulting from the merger, to result in reduced trading commissions and faster clearance and settlement of trades for investors.
- The new merged exchange, being considerably larger than either of its two predecessors, to result in greater liquidity and reduced volatility for investors.
- European investors to have easy access to a highly liquid market dedicated to the trading of international stocks associated with "new economy".
- European investors to have easy access to buying shares in companies listed elsewhere in the 11 Euro-zone countries.

The US has not stayed away from the ongoing debate about the stock market structure. There have been talks of merger between NYSE and NASDAQ, but the two stock exchanges have failed to reach an agreement. The merger has been opposed by many, who attribute the growth of the US stock market to competitive environment. The biggest factor in making trading in US stocks so cheap has been the competition unleashed by the two stock exchanges. Both the stock exchanges have been under threat from the growing network of ECNs. The NYSE and NASDAQ have, however, responded at different speeds to the new threats. NYSE has adopted a slower approach in deciding its future alliances and direction. NASDAQ has been more aggressive, pushing towards demutualising its structure and forming alliances in Europe.

Integration of Clearing and Settlement Systems

Along with the consolidation of stock exchanges, there has also been move towards integration of clearing and settlement systems in Europe. It is being argued by most that central securities depositories and clearing systems around the continent must consolidate into a more integrated and less complicated system. This is essential for making it cheap to buy and sell stocks across borders and currencies. There have been some indications that Euroclear and Clearstream, the two pan-European clearing and settlement giants, are willing to consider a merger of their operations. The Clearstream was created in 1999 by merger of Cedel International and Deutsche Bourse Clearing. Euroclear has been chosen by Euronext as its clearing and settlement house. The London Clearing House and Clearnet SA, the clearing subsidiary of Paris Bourse, have also announced plans for the creation of a consolidated European clearing house. The new entity, which is likely to be operational by early 2001, will be user-governed and open to all markets, systems and for users requiring clearing services. The merged entity will use a single set of clearing and netting systems and will be the largest central counterparty in Europe for capital, energy and commodity markets, cash and derivatives traded on regular exchanges and on the OTC market. The consolidation should help reduce the cost of pan-European securities trading and also diminish the settlement risks faced by individual firms and the financial system as a whole. The initiative will further the current wave of consolidation between European exchanges and their securities settlement systems. If the major clearing houses of Europe merge, the clearing and settlement system in Europe will look like that of the US, where one dominant system operates.