Everything under control or dancing on a volcano ?
Basic trends in international finance

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Overview

I/ Basic trends in the international financial markets & system since the Asian crisis

II/Alternative interpretations of the basic trends

I/ Basic trends in the international financial markets & system since the Asian crisis

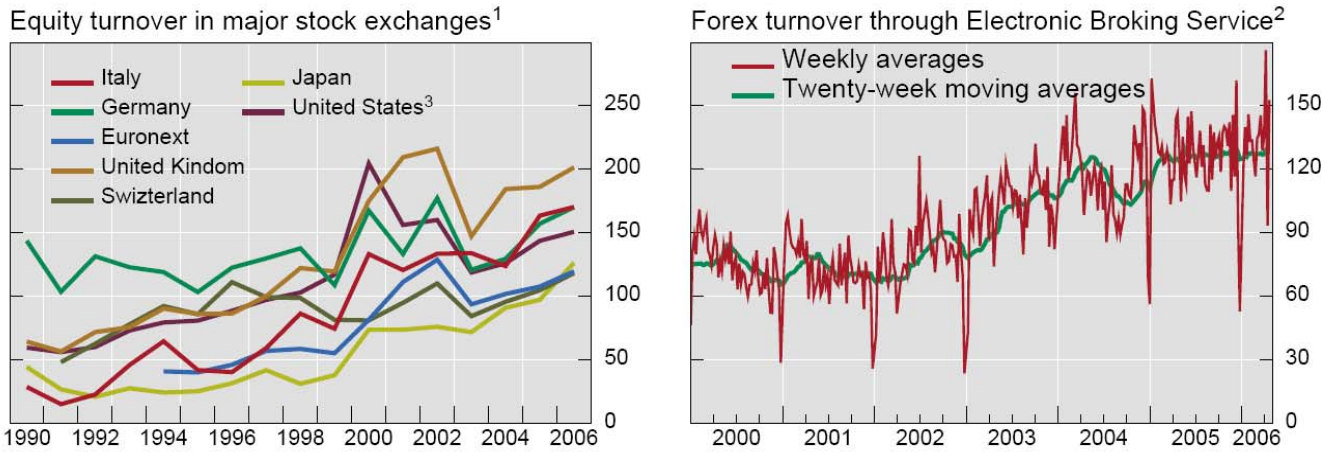
A/ Trends in financial markets

B/ Trends in balance of payments & exchange rates

A sharp increase in the size of financial and forex markets

Graph 5.2

Turnover in the stock and forex markets



[1] Ratio of the total value of share trading and the market capitalisation of domestic companies, in US dollar terms for 2006, 12-month annualised monthly velocity computed in February 2006; in per cent. [2] Daily spo transactions, in billions of US dollars. [3] NYSE and Nasdaq.

Sources: EBS; World Federation of Exchanges data.

. and carry trades

appreciating trends. These trends also induced an increase in hedging activity, which further supported trading volumes. Second, interest differentials encouraged so-called "carry trading", ie investments in high interest rate currencies financed by short positions in low interest rate currencies, if the target currencies, like the Australian dollar, tended to appreciate against the funding currencies, like the US dollar. Such strategies fed back into prices and supported the persistence of trends in exchange rates. In addition, in the

Global foreign exchange market turnover[1]

Daily averages in April, in billions of US dollars

	1989	1992	1995	1998	2001	2004
Spot transactions	317	394	494	568	387	621
Outright forwards	27	58	97	128	131	208
Foreign exchange swaps	190	324	546	734	656	944
Estimated gaps in reporting	56	44	53	60	26	107
Total "traditional" turnover	590	820	1,190	1,490	1,200	1,880
Memo: Turnover at April 2004 exchange rates[2]	650	840	1,120	1,590	1,380	1,880

[1] Adjusted for local and cross-border double-counting. [2] Non-US dollar legs of foreign currency transactions were converted from current US dollar amounts into original currency amounts at average exchange rates for April of each survey year and then reconverted into US dollar amounts at average April 2004 exchange rates. Table B.1

Cross-Border Transactions in Bonds and Equities

(in percent of GDP)

	1975-79	1985-89	1995-99	2001	2003
United States	4.0	63.6	139.0	161.4	262.1
Bonds	1.9	9.9	45.0	87.4	82.1
Equity					
Japan	2.2	115.3	63.7	73.7	77.8
Bonds	1.1	14.9	17.2	36.7	35.3
Equity					
Germany	5.3	37.8	208.7	378.7	394.0
Bonds	1.9	11.7	48.6	133.6	112.2
Equity					
France	nd	21.9	233.5	288.1	362.0
Bonds		12.1	56.1	140.2	154.0
Equity					

Source : BIS

Equity prices

End-month data, in local currency; end-December 2004 = 100

[1] Morgan Stanley Capital International equity indices. [2] Relative to the MSCI World composite index.

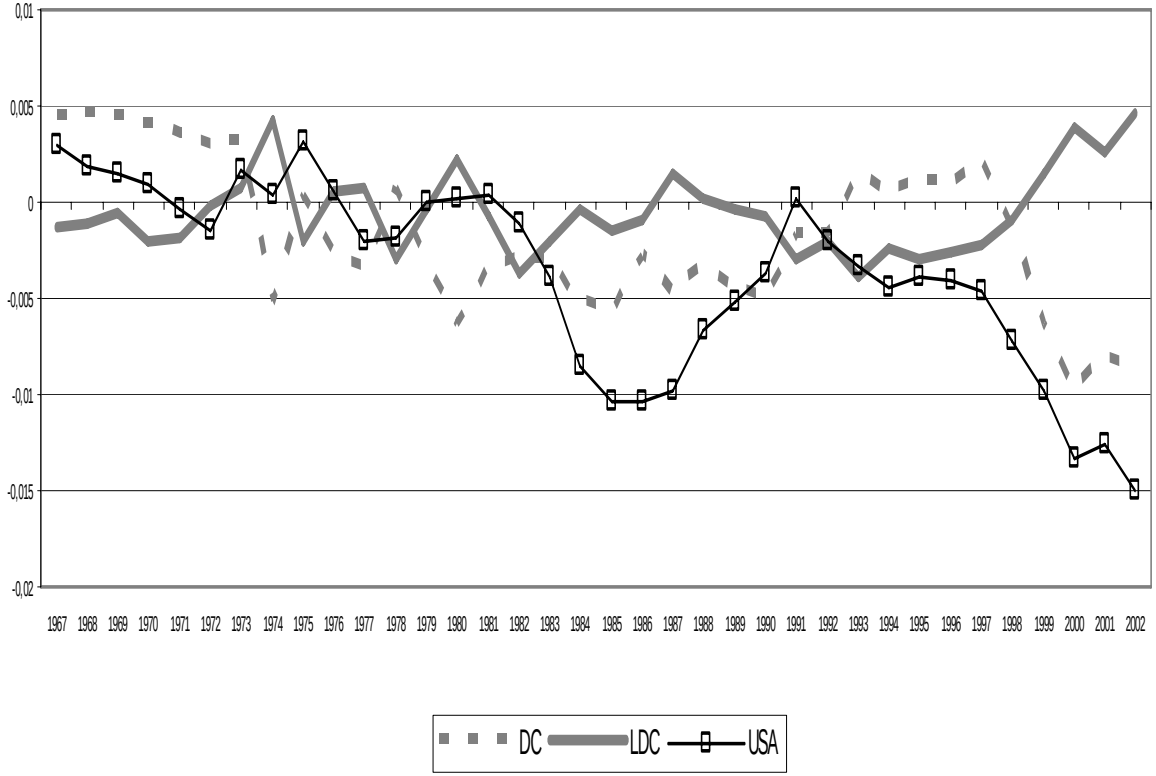
Sources: Bloomberg; Datastream.

Graph VI.7

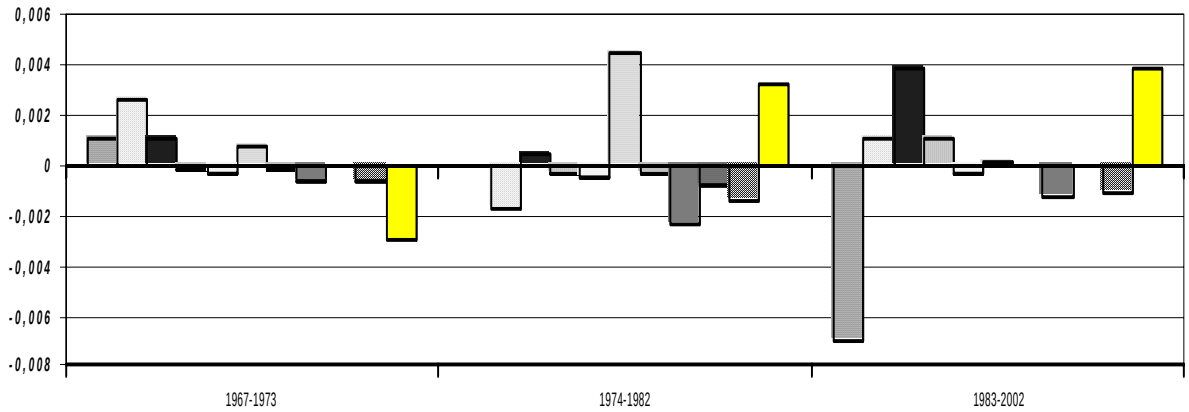
Balance of payments and exchange rates

- - Growing BoP imbalances
- - Polarisation of deficits & surplus
- - The United States is importing most (70 %) of the world savings

Growing global balance of payments disequilibrium
(percent of world GDP)



World balance of payments disequilibrium (percent of world GDP)
3 successive periods



USA
Western Europe
Japan
South-east Asia
Others Asia
OPEC
Africa
Latin America
Eastern Europe
Commonwealth
Statistical discrepancy

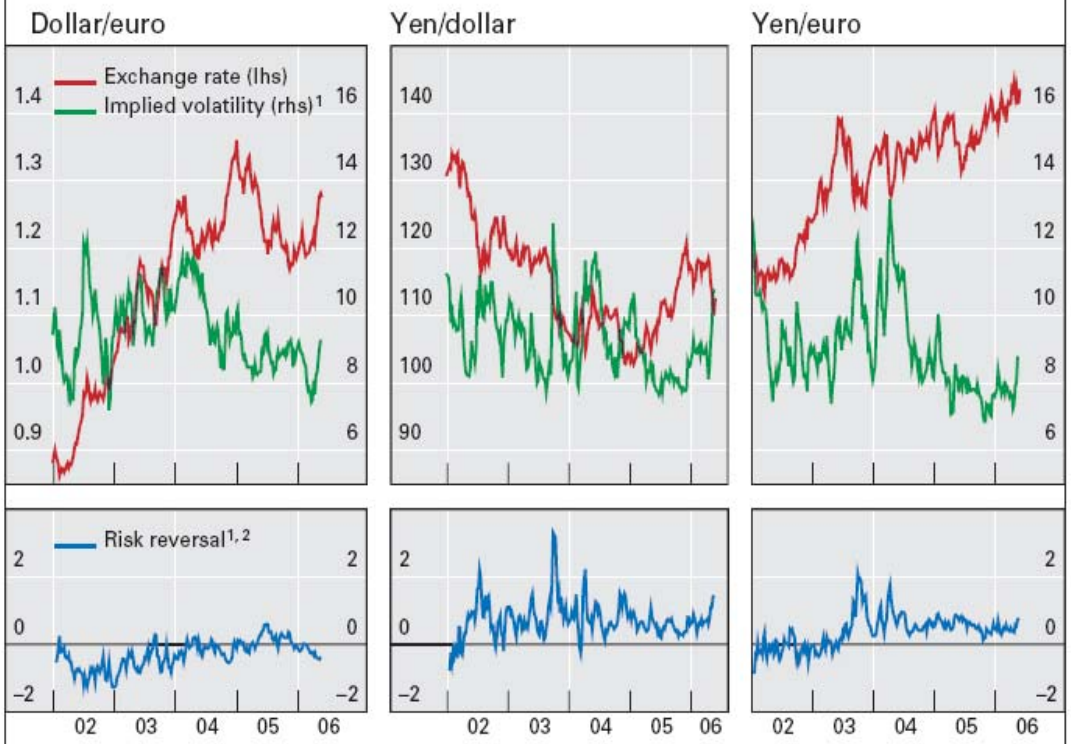
Logic of imbalances	Period	USA	Western Europe	Japan	South-east asia	Others Asia	OPEC	Africa	Latin America	Eastern Europe	"Commonwealth"	Statistical discrepancy
North-South	1967 - 1970	**32,2%**	**47,9%**	**12,1%**	***-8,1%***	***-7,4%***	**7,8%**	-3,2%	***-11,0%***	-0,6%	***-14,3%***	***-55,5%***
OPEC-RoW	1973 - 1976	**21,0%**	***-20,4%***	3,8%	-2,4%	***-8,0%***	**72,5%**	-4,1%	***-27,6%***	***-16,6%***	***-20,8%***	2,8%
	1979 - 1981	2,1%	***-25,7%***	-4,9%	***-10,6%***	-5,0%	**58,8%**	-3,2%	***-30,7%***	***-5,6%***	***-14,3%***	**39,1%**
Japan-USA	1983 - 1990	***-74,5%***	**8,8%**	**38,2%**	4,3%	-3,7%	0,6%	-0,1%	***-6,1%***	-0,2%	***-15,4%***	**48,0%**
	1992 - 2002	***-71,1%***	**14,1%**	**37,7%**	**14,4%**	-2,6%	3,5%	-1,0%	***-16,9%***	-1,4%	***-7,0%***	**30,3%**

Exchange rates

- Important medium-term instability of the dollar vs most currencies

- Decreasing short-run volatility of exchange rates

Exchange rates, implied volatilities and risk reversals of the dollar, euro and yen

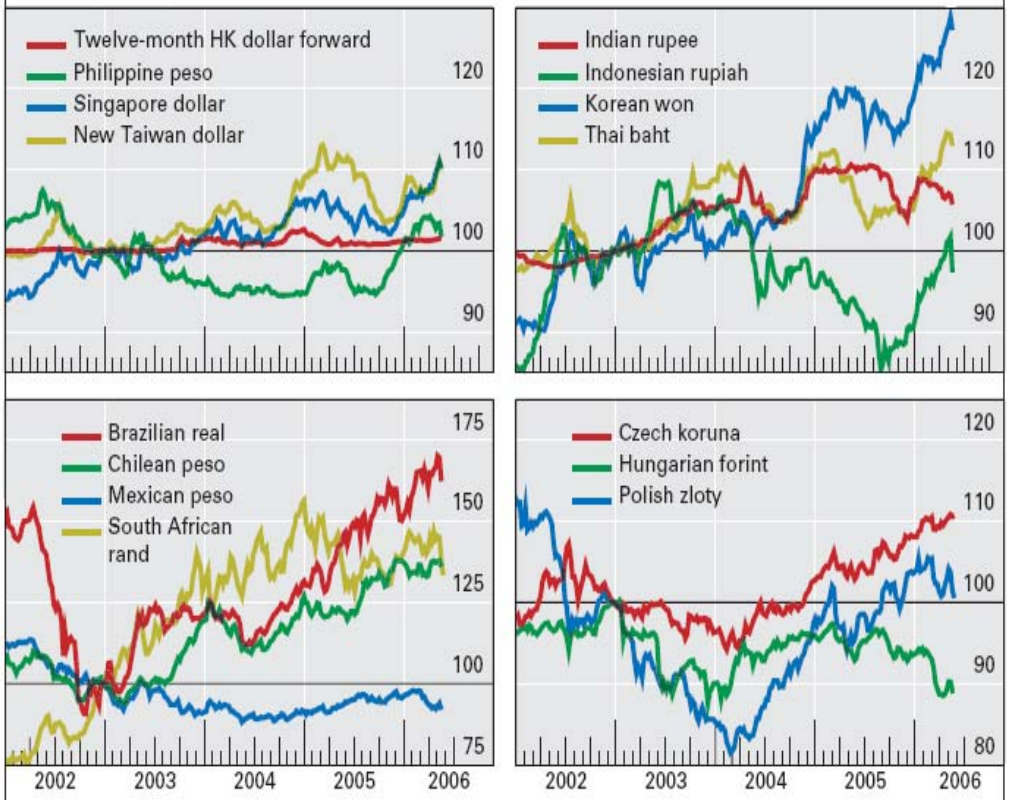


[1] One-month, in per cent. [2] A positive value indicates a bias towards dollar appreciation in the left-hand panel and towards yen appreciation in the centre and right-hand panels.

Sources: Bloomberg; Dresdner Kleinwort Wasserstein Research; national data. Graph V.1

Exchange rates in emerging markets[1]

Weekly averages, end-2002 = 100



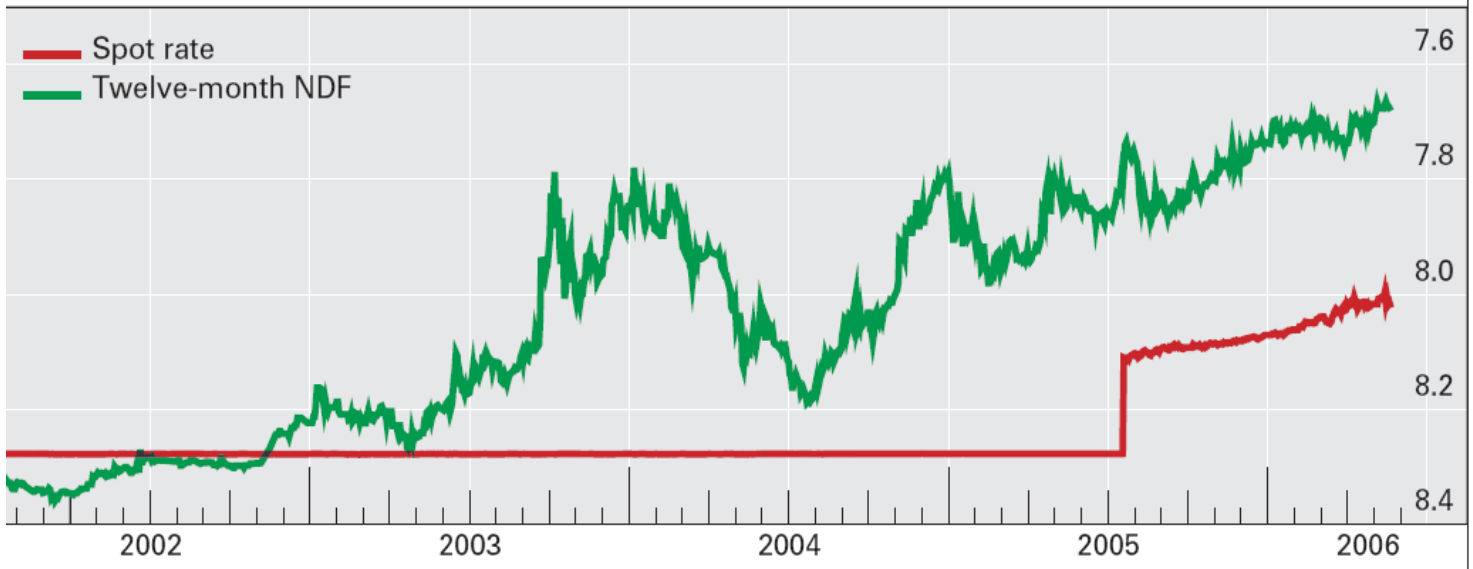
[1] Against the US dollar (in the bottom right-hand panel, against the euro); an increase indicates an appreciation. For the bottom left-hand panel, compressed scale.

Sources: ECB; Bloomberg; Datastream.

Graph V.3

Spot and forward exchange rates of the Chinese renminbi

Against the US dollar[1]



[1] Inverted scale.

Sources: Bloomberg; national data.

Graph V.8

II/Alternative views on the stability of the international financial system

A/ Everything is under control ?

B/ Dancing on a volcano !

A/ Everything is under control ?

- The « new Bretton Woods » hypothesis

Dooley & Folkerts-Landau and Garber (2003)

- The market operators are very confident …

The « new Bretton Woods » hypothesis

- The current intertional monetary & financial system works like the B-W system
- The international system is composed of :
  - a **core** (the US & the eurozone) issuing the international currencies
  - and a **periphery** with export-led growth in emerging economies based on undervalued currencies

  This new B-W system **stability hypothesis** is based on the alleged complementary situations of core/periphery countries

Market operators are very confident

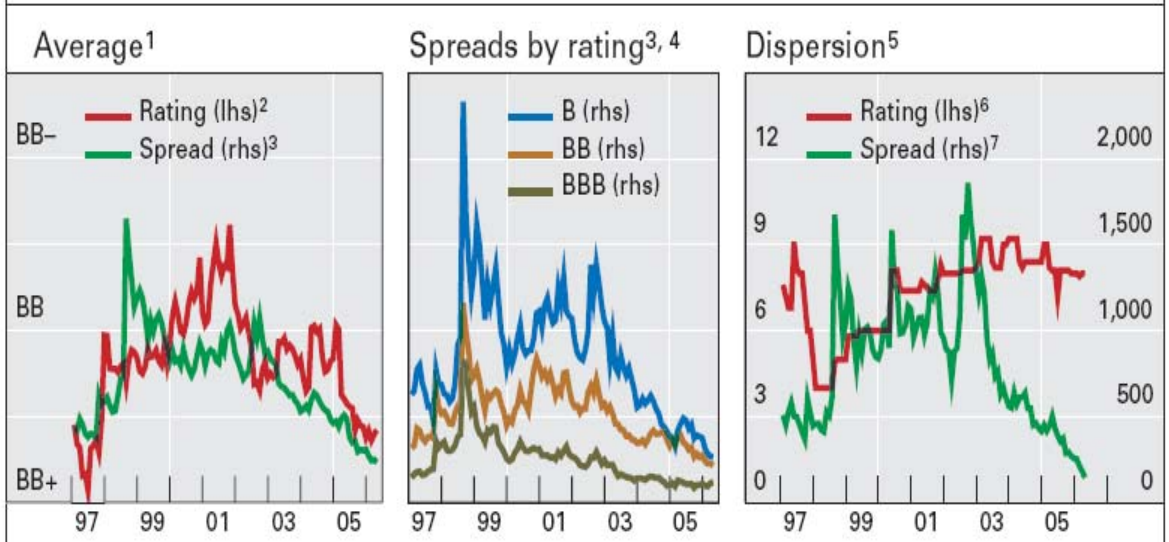
- The spreads on yields between the US and the emerging markets have declined to historical low levels
- The volatility of exchange rates and interest rates exhibits a downward trend

Figure 1.11 Emerging-market bond spreads, 1997–2004

Source: J.P. Morgan Chase.

Emerging market bond spreads and credit ratings

Month-end data

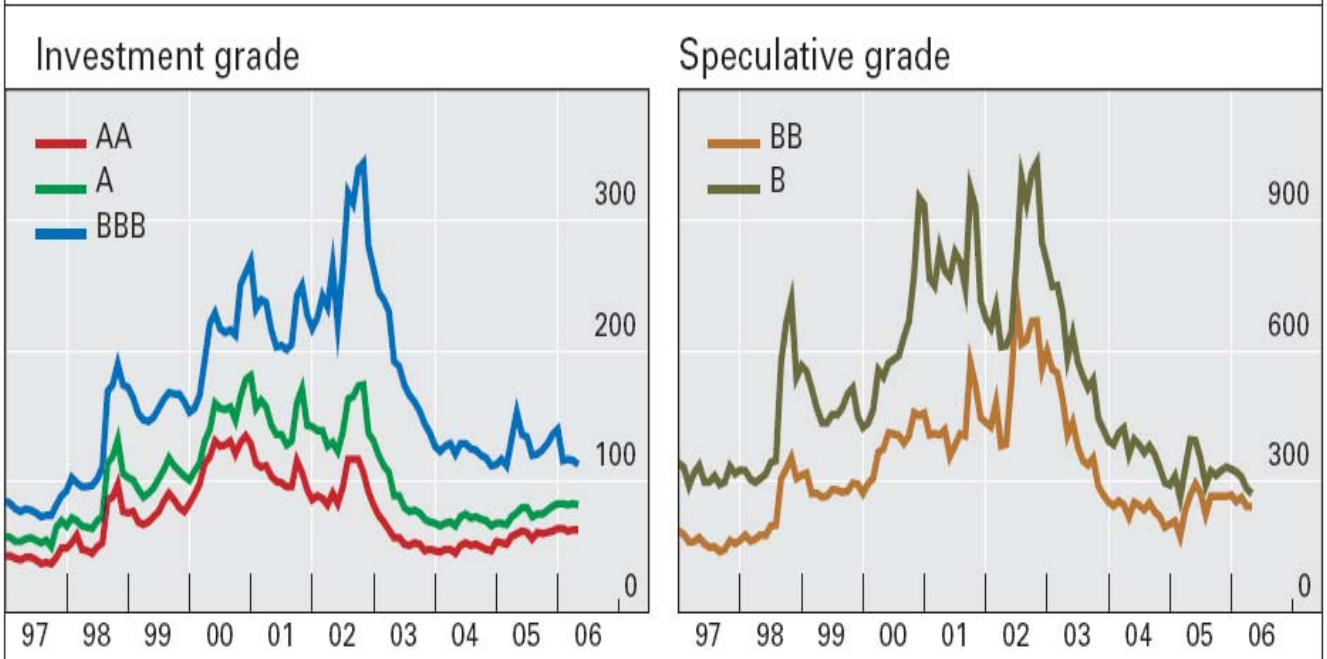


[1] Average rating is calculated using the same weights for individual sovereigns as applied to the spread. [2] Credit rating for all constituents of the JPMorgan Chase EMBI Global Diversified (EMBIGD) index; based on long-term foreign currency ratings from Standard & Poor's. [3] Sovereign stripped spread over US Treasury yields, in basis points; prior to 1998, the index spread is approximated using data for individual sovereigns. [4] Trimmed average spread for B, BB and BBB-rated constituents of the EMBIGD; the highest and lowest spreads on any given date are excluded from the average. [5] Difference between 90th and 10th percentiles. [6] In number of notches. [7] In basis points.

Sources: Datastream; JPMorgan Chase; Standard & Poor's; BIS calculations. Graph VI.16

Corporate bond spreads

Month-end, in basis points[1]



[1] Option-adjusted spreads over government bond yields; Merrill Lynch US dollar corporate bond indices.

Sources: Bloomberg; Merrill Lynch.

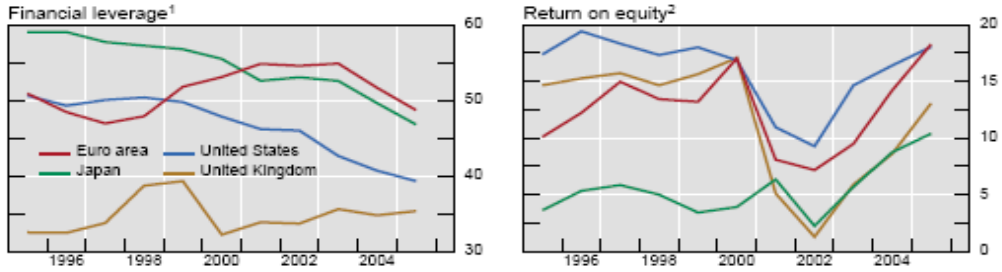
Graph VI.12

Profitability

In all economies considered, ROE declined after 2000, reached a trough in 2002, and then recorded a rapid recovery in all areas, in a range of 8 to 12 percentage points (Graph 4.3, right-hand panel).

Graph 4.3

Financial leverage and return on equity of listed companies



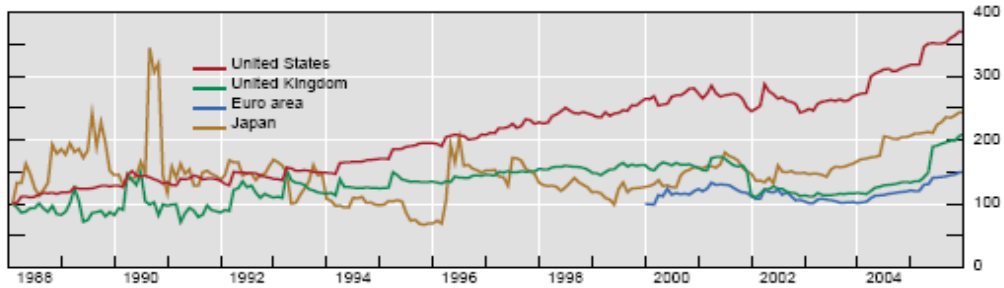
[1] Ratio of financial debt and equity, calculated at book value; sample of non-financial companies that represent approximately 90% of the market capitalisation of their respective markets. Observations with negative equity are excluded. [2] Return on equity is the ratio of net profits to end-of-year equity, calculated at book value. Observations with negative equity are excluded.

Sources: Thomson Financial; Worldscope.

Since ROE is a backward-looking indicator, whereas asset price volatility may be closely tied to expected profitability, Graph 4.4 reports the expected earnings per share over the last decade for the major industrial regions. The data show that expected profitability has increased very rapidly since the beginning of 2004 and that it now stands at its highest level in the period considered.[31]

Graph 4.4

Expected earnings per share of listed companies[1]



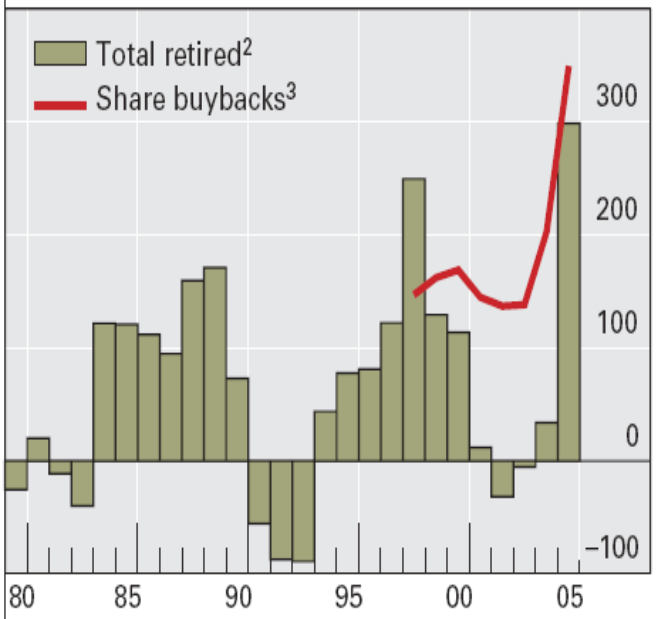
[1] January 1988 = 100 (for the euro area, December 1999 = 100). Two-years-ahead expected net income for the companies included in the S&P 500 for the United States and the respective MSCI indices for the other countries.

Source: IBES.

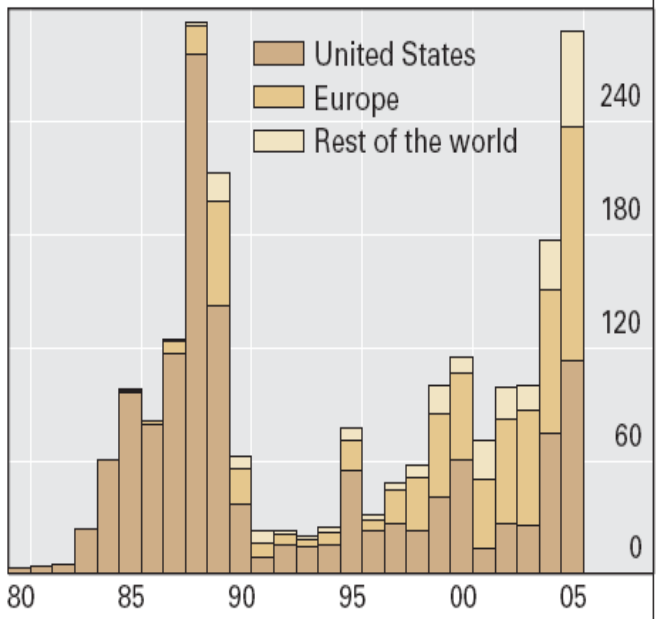
Shareholder-friendly actions

In billions of constant US dollars[1]

Equity retired



Leveraged buyouts[4]

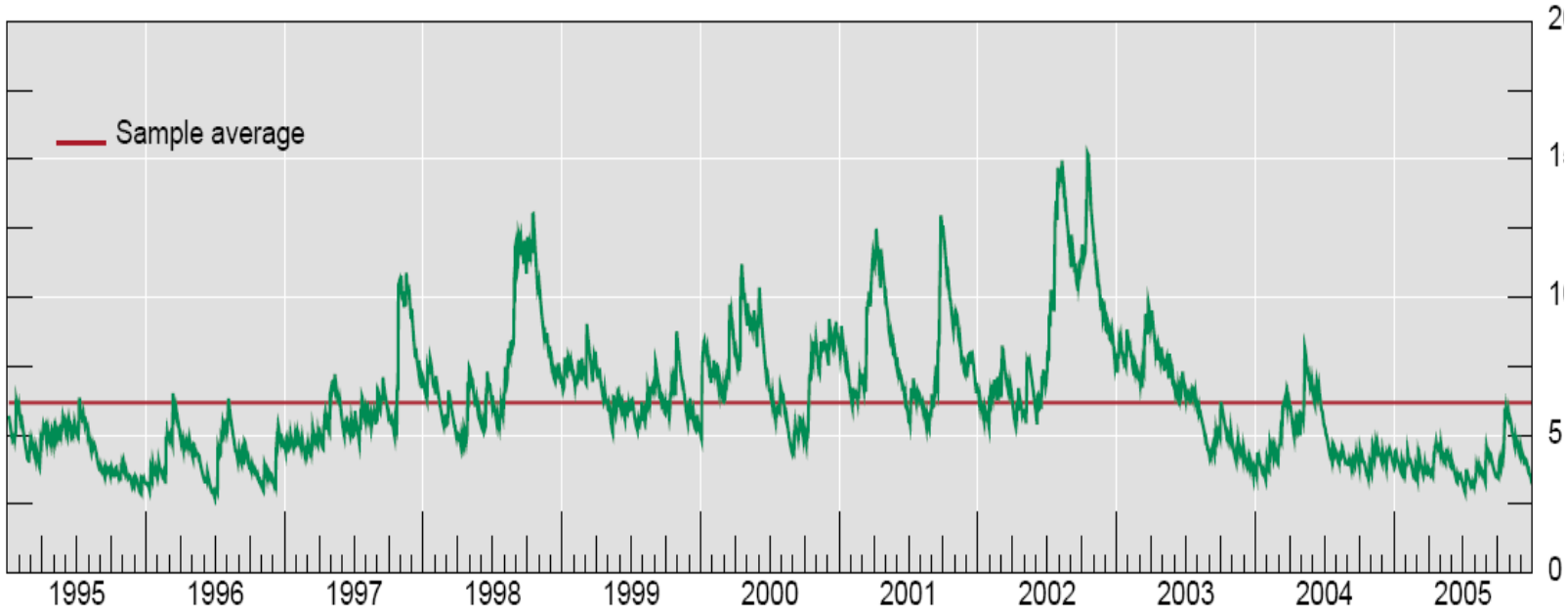


[1] Nominal amounts, converted to constant 2005 dollars using the US GDP deflator. [2] US corporations, net of new equity issued. [3] Gross buybacks by S&P 500 companies. [4] Announced value of all deals, including net debt; based on the date of the announcement and the residency of the target firm.

Sources: Standard & Poor's; Thomson Financial SDC Platinum; national data; BIS calculations. Graph VI.8

Graph 2.1

Global volatility indices[1]

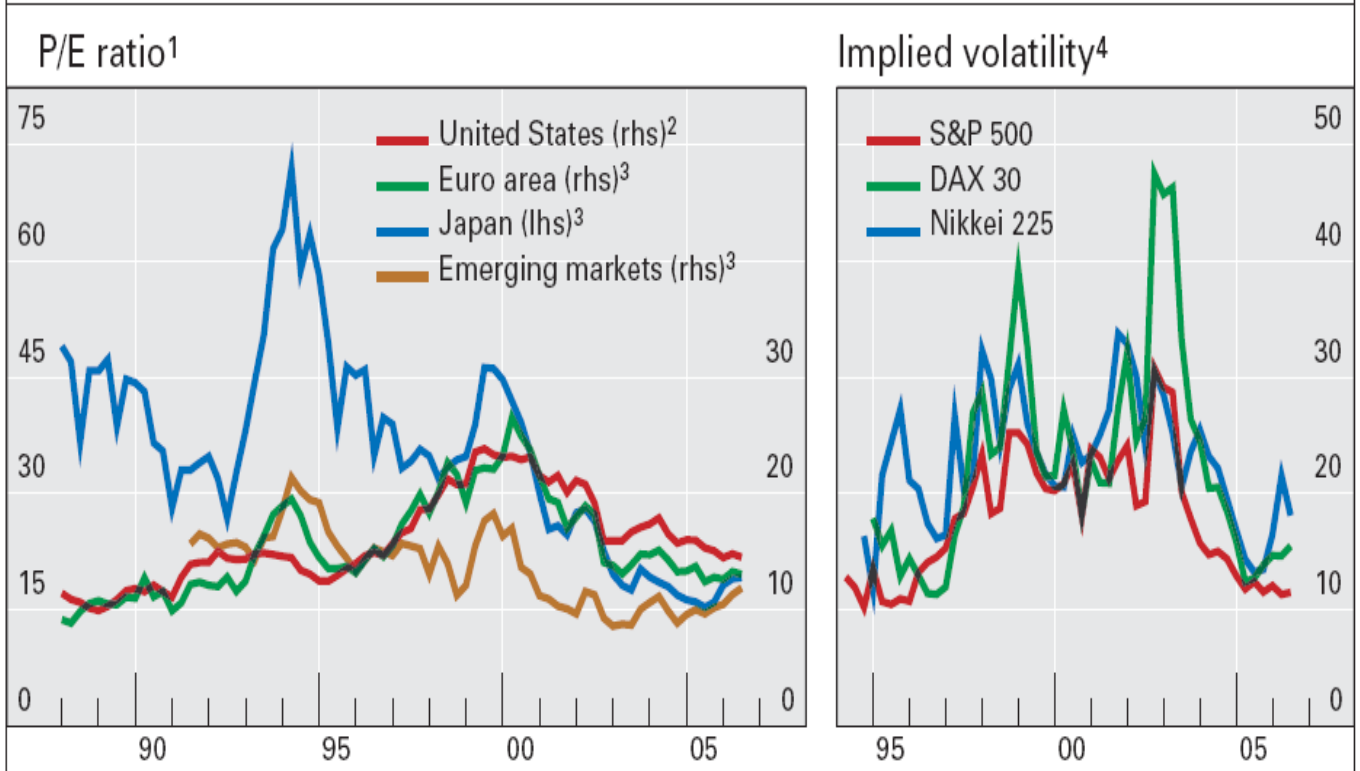


[1] Annualised daily volatility of an equally weighted bond-equity international portfolio including the FTSE globa stock index and the EFFAS global bond index; in per cent.

Sources: EFFAS; FTSE.

Valuations and volatility in equity markets

Quarterly averages



[1] Based on consensus forecasts of one-year-ahead operating earnings. [2] S&P 500. [3] MSCI index. [4] Derived from the price of at-the-money call option contracts on stock market indices.

Sources: I/B/E/S; Morgan Stanley Capital International; national data. Graph VI.10

B/ Dancing on a volcano !

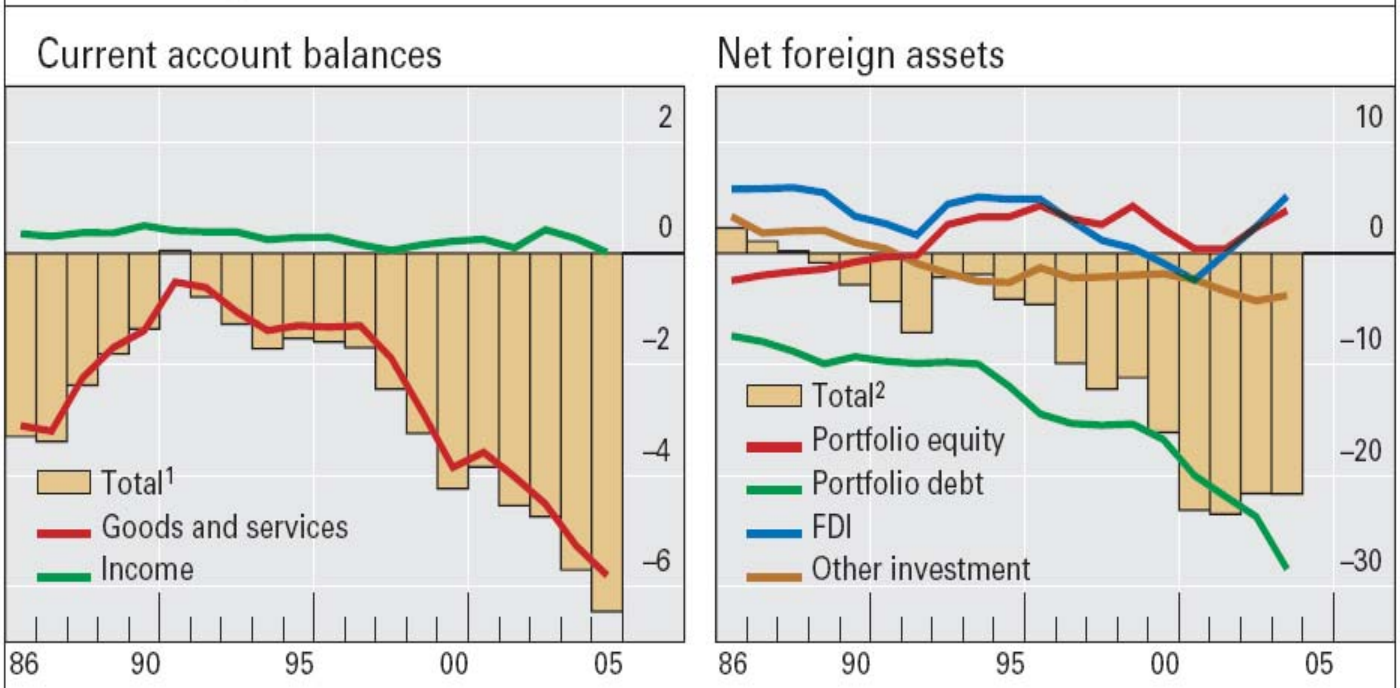
- The « new Bretton Woods » view is fallacious : the international growth regime is not sustainable for economic & social and ecological reasons
- Existing BoP imbalances are not sustainable
- LDC debt and financing is not sustainable
- Large exchange rate misalignments
- Huge accumulation of reserves & excess liquidity in the world economy
- Excessive risk taking from short-sighted investors

The « new Bretton Woods » fallacy

Bretton Woods **1944 - 1971**	**« New Bretton Woods »** **since the Asian crisis (1997)**
Fixed & adjustable exchange rate system	Large currencies are floating Pegged regimes for LDC
Small BoP imbalances US BoP surplus	Large BoP imbalances Huge US deficit LDC financing DC
Capital controls = > Small size & relative stability of capital flows	Financial deregulation Washington Consensus => Increasing & destabilizing role of capital flows
Dollar monopoly Hegemonic stability	Increasing role of the euro Currency competition => exchange rate instability

US current account balances and net foreign assets

As a percentage of GDP



[1] Also includes current transfers. [2] Also includes reserve assets.

Sources: IMF; national data.

Graph V.7

Annual changes in official foreign exchange reserves

In billions of US dollars

	2000	2001	2002	2003	2004	2005	*Memo: Amounts outstanding (Dec 2005)*
	At current exchange rates						
Total	158.8	110.5	356.0	620.0	720.3	421.7	*4,170.8*
Industrial countries	59.6	3.1	112.3	218.5	195.5	–22.3	*1,292.2*
United States	–0.9	–2.3	4.8	5.9	3.0	–4.9	*37.8*
Euro area	–9.4	–10.7	7.9	–27.8	–7.3	–13.4	*167.3*
Japan	69.5	40.5	63.7	201.3	171.5	4.5	*828.8*
Emerging Asia	52.5	76.0	173.9	263.9	363.4	249.9	*1,821.6*
China	10.9	46.6	74.2	116.8	206.6	209.0	*818.9*
Hong Kong SAR	11.3	3.6	0.7	6.7	5.0	0.7	*124.3*
India	5.3	8.0	21.7	30.6	27.5	5.9	*131.0*
Indonesia	2.0	–1.2	3.7	4.0	–0.0	–1.9	*32.8*
Korea	22.2	6.6	18.3	33.7	43.7	11.8	*210.0*
Malaysia	–1.0	1.0	3.7	10.2	21.9	4.3	*69.7*
Philippines	–0.2	0.4	–0.2	0.3	–0.5	2.8	*15.8*
Singapore	3.4	–4.8	6.5	13.6	16.5	3.8	*115.3*
Taiwan, China	0.5	15.5	39.4	45.0	35.1	11.6	*253.3*
Thailand	–1.9	0.4	5.7	2.9	7.5	2.0	*50.5*
Net oil exporters[1]	31.9	16.4	18.5	51.2	68.5	83.1	*351.8*
Mexico	4.2	9.2	5.5	7.8	5.0	10.2	*73.0*
Russia	15.8	8.3	11.5	29.1	47.6	55.1	*175.9*
Venezuela	0.9	–3.8	–0.8	7.5	2.3	5.6	*23.5*
Middle East[2]	11.0	2.7	2.2	6.8	13.5	12.2	*79.5*
Latin America[3]	2.1	–0.3	4.2	30.6	21.1	25.4	*217.2*
Argentina	–1.7	–9.9	–4.1	2.7	4.9	4.7	*22.7*
Brazil	–2.3	3.2	1.7	11.7	3.6	0.8	*53.5*
Chile	0.5	–0.6	0.8	0.4	0.3	1.2	*16.7*
CEE[4]	18.8	12.6	36.6	51.1	69.0	70.2	*335.1*
	At constant end-2004 exchange rates						
Total allocated	230.3	54.5	216.0	341.0	355.7	249.8	*2,890.0*
Dollar reserves	100.9	40.1	84.5	263.7	271.3	132.6	*1,869.8*

[1] Economies with net oil exports exceeding 0.5 million barrels per day. [2] Excluding Iran and Iraq. For Saudi Arabia, excluding investment in foreign securities. [3] Countries shown plus Colombia, Mexico, Peru and Venezuela. [4] Central and eastern Europe: Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Russia, Slovakia and Slovenia.

Sources: IMF; national data. Table V.1

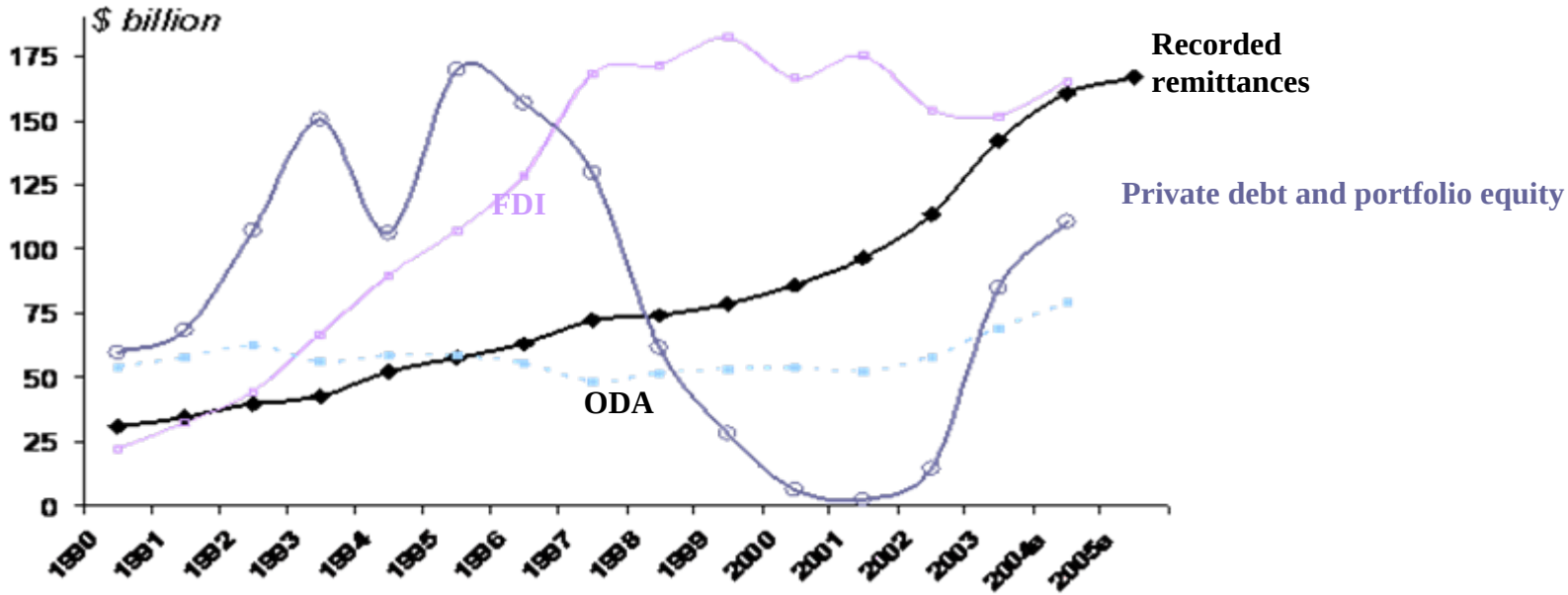
Real misalignments against the dollar in 2004 in percent

Computation from a BEER model *

Overvalued currencies		Undervalued currencies	
Australia	- 2.3	Argentina	49.4
Great Britain	- 19.7	China	49.0
Mexico	- 11.5	Indonesia	47.9
Turkey	- 11.9	India	24.3
Eurozone	- 8.9	Japan	11.7
		South Korea	29.0

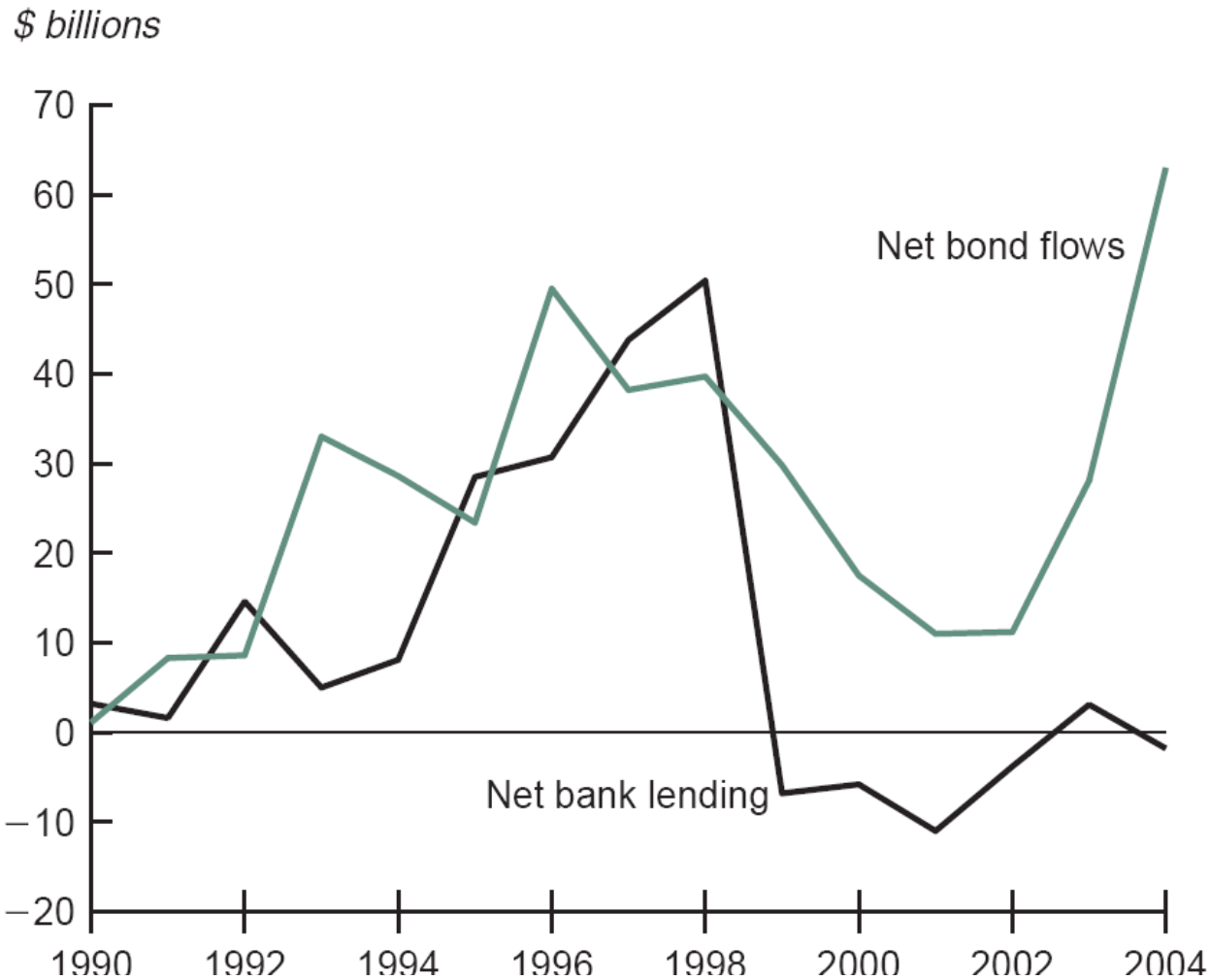
*** Benassy & Mignon (2006)**

Instability of financial flows going to developing countries (1990 – 2005)



Source: World Bank

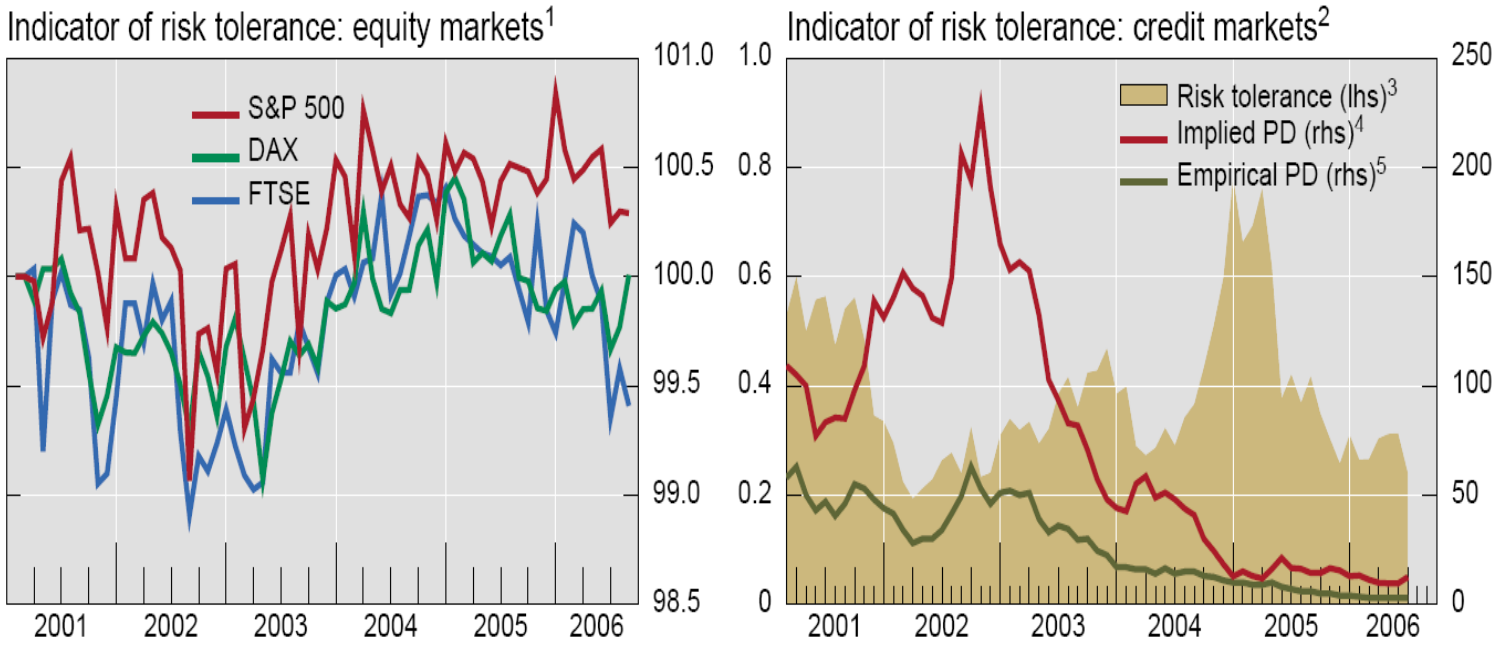
Figure 1.9 Net private debt flows to developing countries, 1990–2004



Increased risk-taking from short-sighted investors

- Due to excessive confidence, investors are increasing their risk positions, as they did on the eve of the 1997 – 98 Asian crisis
- This is shown by the fast growth of derivative markets due to speculation

Equity and credit market-based risk tolerance indicators



[1] Derived from the differences between the left tails of two distributions of returns, one implied by option prices, the other based on actual returns estimated from historical data. Indexed to Jan 2001 = 100; an upward movement indicates an increase in risk tolerance. [2] Based on the 125 constituents of the DJ CDX.NA.IG.3 CDS index; monthly averages. [3] Ratio of empirical (ie physical) probabilities of default (PD) to implied (ie risk neutral) PD. [4] PD implied by one-year CDS spreads, assuming a constant recovery rate of 40%. [5] One-year PD estimated by Moody's KMV, based on balance sheet information and asset price volatility.

Sources: Bloomberg; CME; Datastream; Eurex; LIFFE; Markit; Moody's KMV; BIS calculations.

Table 5.1

OTC and exchange-traded derivatives: notional amounts outstanding

Billions of US dollars, end-of-period data

	1998	2001	2005
Interest rate, currency and equity contracts			
OTC contracts[1]	80,309	111,178	270,100[2]
Exchange-traded contracts	13,975	23,774	57,811
Credit default swaps (CDS)			
Outstanding OTC contracts	na	919	12,430[2]

[1] No data are available before 1998, ie the start date of the OTC Survey. [2] For 2005, end-June.

Sources: ISDA; BIS (2004a).

Concluding remarks

- The international monetary & financial system certainly is not under control, but rather exhibits large imbalances and important potential sources of instability
- This system leads to growing inequality among & within countries
- Investors confidence is high now as it was just before the Asian crisis

- There is an urgent need for radical reforms (IMF) and the introduction of strong public regulations (capital controls to start with)
- Existing regulatory systems are insufficient and have perverse effects (Basle II)
- In fact, financial reforms would not be enough : there is a need for an alternative model of globalization giving a high priority to the supply of global public goods : health, education, water and financial stability