

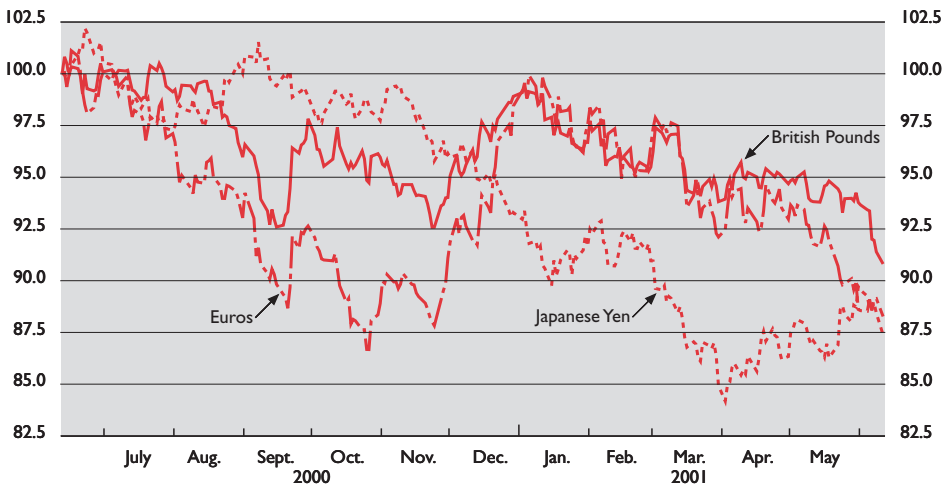
## Highlights of Recent Trends in Financial Markets

### I. Foreign exchange markets

In foreign exchange markets, much interest once again focuses on the bilateral exchange rate between the US-dollar (USD) and the European euro (EUR).<sup>1</sup> Following its recovery in late 2000 the latter has been on a near-linear declining trend *vis-à-vis* the dollar since January (Figure 1). In mid-June, the euro traded at around 0.85 to the dollar, its lowest level since November 2000.

*A renewed  
weakness  
of the euro...*

Figure 1. **Comparative Daily Exchange Rates: Relative to US Dollar**



Source: OECD.

**... seems to reflect  
the macroeconomic  
outlook.**

Analysts have offered a host of explanations for this renewed weakness of the euro, including the continued flow of portfolio investment from the euro-zone to the United States and reductions in the liquid balances of enterprises and households as the date for converting banknotes draws nearer. These factors may all have exerted a certain downward pressure on the euro, and so may the remaining political uncertainties about the European project as well as occasional market misinterpretation of the ECB's intentions. However, it would appear that the main factor influencing the USD/EUR rate remains the perceived growth prospects in the two economies. The rapid strengthening of the euro from October through December 2000 coincided with the deterioration of the outlook for the US economy at the time. The decline of the currency in the first half of 2001 took place on the background of a trickle of bad news, leading to recurrent downward revisions of the growth prospects in the major European economies.

**Relative stability  
of the yen...**

After declining steadily *vis-à-vis* the dollar for almost 15 months, the Japanese yen (JPY) regained some ground in April and May 2001. In early June the yen was trading at around 120 against the dollar. However, the relative stabilisation of the yen, attributed by analysts to an increasing confidence in the new government of Japan, was rattled when macroeconomic data released in the second week of June raised fears of an imminent recession. Also, since April the yen has strengthened significantly *vis-à-vis* the euro, which, given the depressed state of domestic demand, gave rise to some publicly voiced concerns on the part of policy makers.

**... and a correction  
of sterling.**

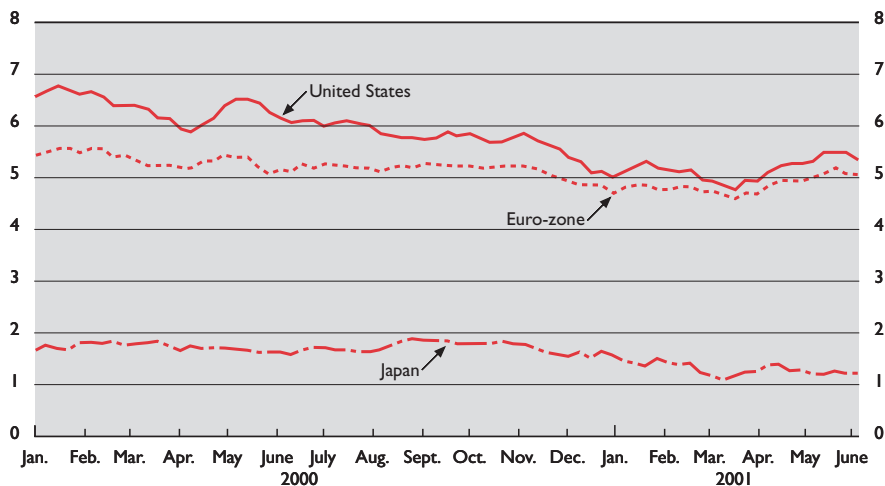
Finally, following the British election result the pound sterling dipped sharply on market expectations that the re-elected government will seek to link the currency closer to the euro.

## II. Interest rates

**Lower official  
interest rates...**

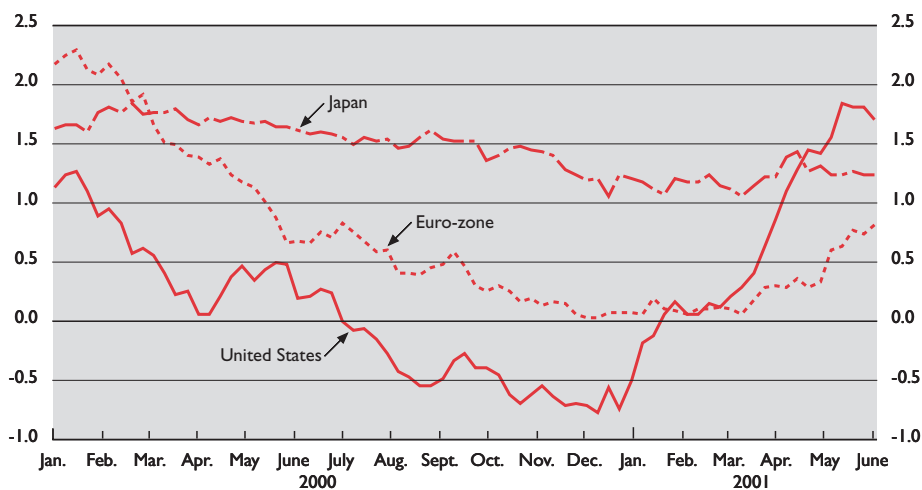
A general decline in long-term interest rates over the last year (Figure 2) was largely driven by the effects of reduced official rates. Judged by evidence from derivatives markets, markets had expected the US monetary authorities to lower Federal Fund rates, but they were somewhat unprepared for the speed and magnitude of the cuts. This is further supported

**Figure 2. Long-term interest rates: 10 year government benchmarks**



Source: Reuters, Federal Reserve Board.

**Figure 3. Yields gaps: 10 year bonds minus 3 months treasury bills**



Source: Reuters, Federal Reserve Board.

by the fact that the yield gap on dollar denominated securities went from being negative at the end of 2000 to be internationally high in early June 2001 (Figure 3). Likewise, financial analysts had not fully predicted the lowering of official interest rates in Japan and the euro-zone in early 2001, which was to some extent seen as a reversal of previously held positions.

*... but long-term yields nudged up...*

The declining trend in long yields was, however, reversed in the second quarter of 2001. The slight increase in rates was attributed by market participants to a host of factors, including, notably, a partial reversal of earlier fears of a shortage of government bonds. Moreover – as pointed out by the ECB in its Monthly Bulletin, June 2001 – market participants' expectations and uncertainty regarding longer-term inflation may have increased in the first half of the year. This argument is supported by evidence from the French and US markets for index-linked government bonds, where the ten-year break-even inflation rate rose by 20 and 60 basis points, respectively, between March and June. It may, however, also be argued that the increase in yields reflects a correction from the relatively low levels observed in the first quarter of 2001, at a time when safe haven flows from volatile equity markets may have boosted bond prices.

*... and converged across the Atlantic.*

As regards the cross-border linkages between market rates, the average euro-zone 10-year government bond yield stood at around 5.2 % in early June – less than 20 basis points below US levels. This may serve as an illustration of a more general tendency in the first half of 2001 for euro-zone and US bond yields not only to converge, but also to display a similar pattern of short-term movements.

In Japan, 10-year government bond yields stood at around 1.3 % in early June, which was little changed from the levels prevailing in March and April. The announcement of structural reforms by the government may have helped yields withstand the data releases confirming the ongoing weakness of the Japanese economy.

*The discount on lower-grade bonds increased further.*

While the cyclical weakening has exerted downward pressures on government bond rates in most economies, the same does not apply to the yields on lower-grade bonds. On the contrary, the heightened uncertainties and generally scarcer liquidity has led to a significant widening of yield

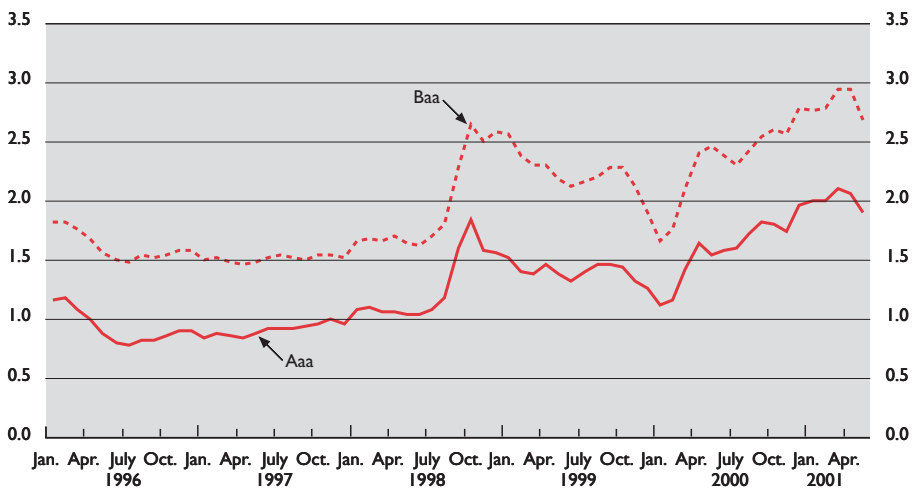
differentials between emerging market and corporate bonds on the one hand, and treasuries on the other. Markets' increasing differentiation between classes of debtors is illustrated by the recent developments in US corporate bond markets. The yield differential between Aaa corporates and treasuries has widened by 80 basis points since January 2000, whereas the differential between Baa-rated corporate bonds and treasuries went from 170 to 270 basis points (Figure 4).

### III. The pricing of equity

From the first quarter of 2000 to the first quarter of 2001 equity prices in the major OECD area stock markets generally declined significantly (Figure 5). It has been argued that the losses represented the deflation of a world-wide equity price bubble rather than a correction reflecting underlying fundamentals.<sup>2</sup> Even so, the developments in individual financial markets have also been influenced by more "traditional" factors such as (real) interest rates and macroeconomic

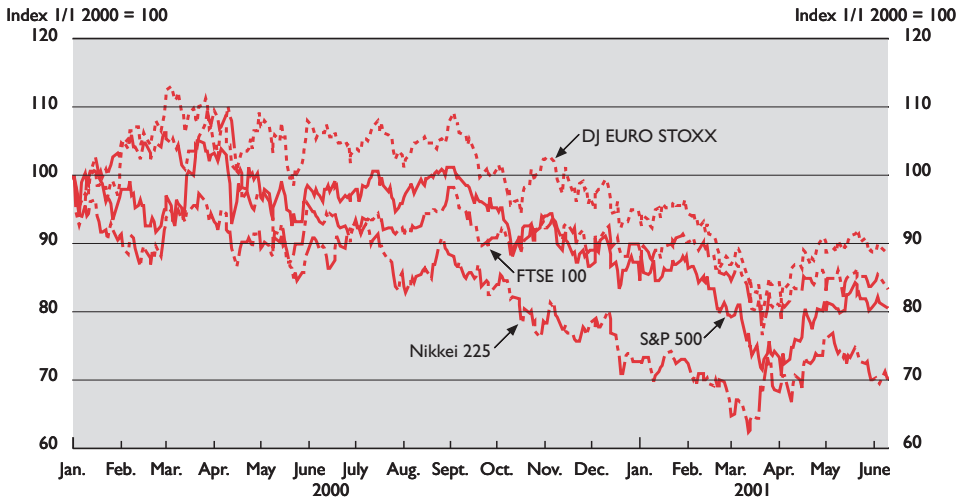
*Equity prices  
are on a declining  
trend...*

Figure 4. *Interest rate differentials: US corporate bond minus treasury yields*



Source: Federal Reserve Board.

Figure 5. *Main stock indices in selected countries*



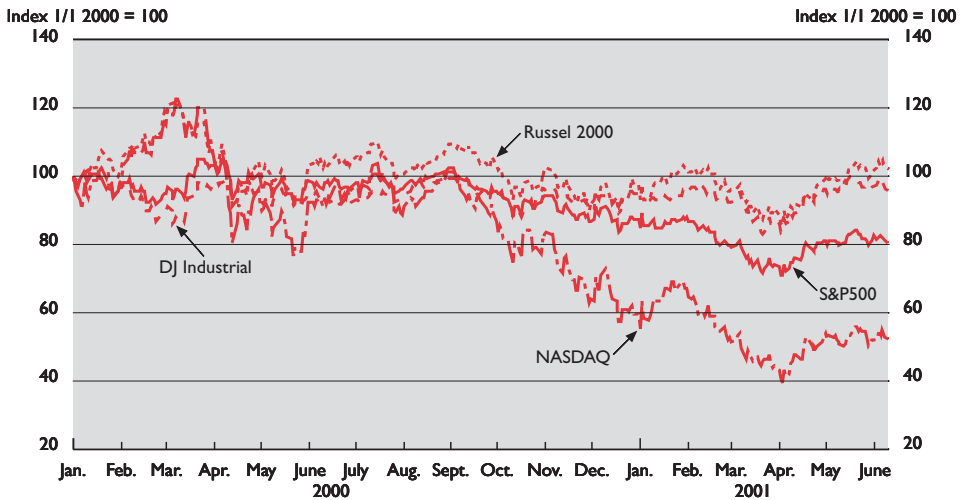
Source: Datastream.

growth. For example, the correction of Japanese stock prices – which is particularly striking when compared with the levels that were briefly attained in April 2000 – has been sharper than in any other large economy. This was clearly linked with the deterioration of the macroeconomic outlook in Japan in late 2000 and early 2001. Until early 2001, when the consensus forecasts were still for a US slowdown and continued growth in Europe, US stock market indices generally fell by more than the ones in the United Kingdom and the euro-zone.

*...particularly  
as regards tech  
stocks...*

The equity price correction that has taken place over the last 15 months particularly affected technology-related and other “new economy” stocks. In the United States, the technology-heavy NASDAQ index has lost 60 per cent of its value since March 2000 (Figure 6). In mid-June the index was hovering around 2,000, down from more than 5,000 15 months earlier. On the other hand, the stocks of more traditional industrial and service enterprises appear to have regained investor confidence. In mid-June, the enterprises included

Figure 6. Selected US stock indices



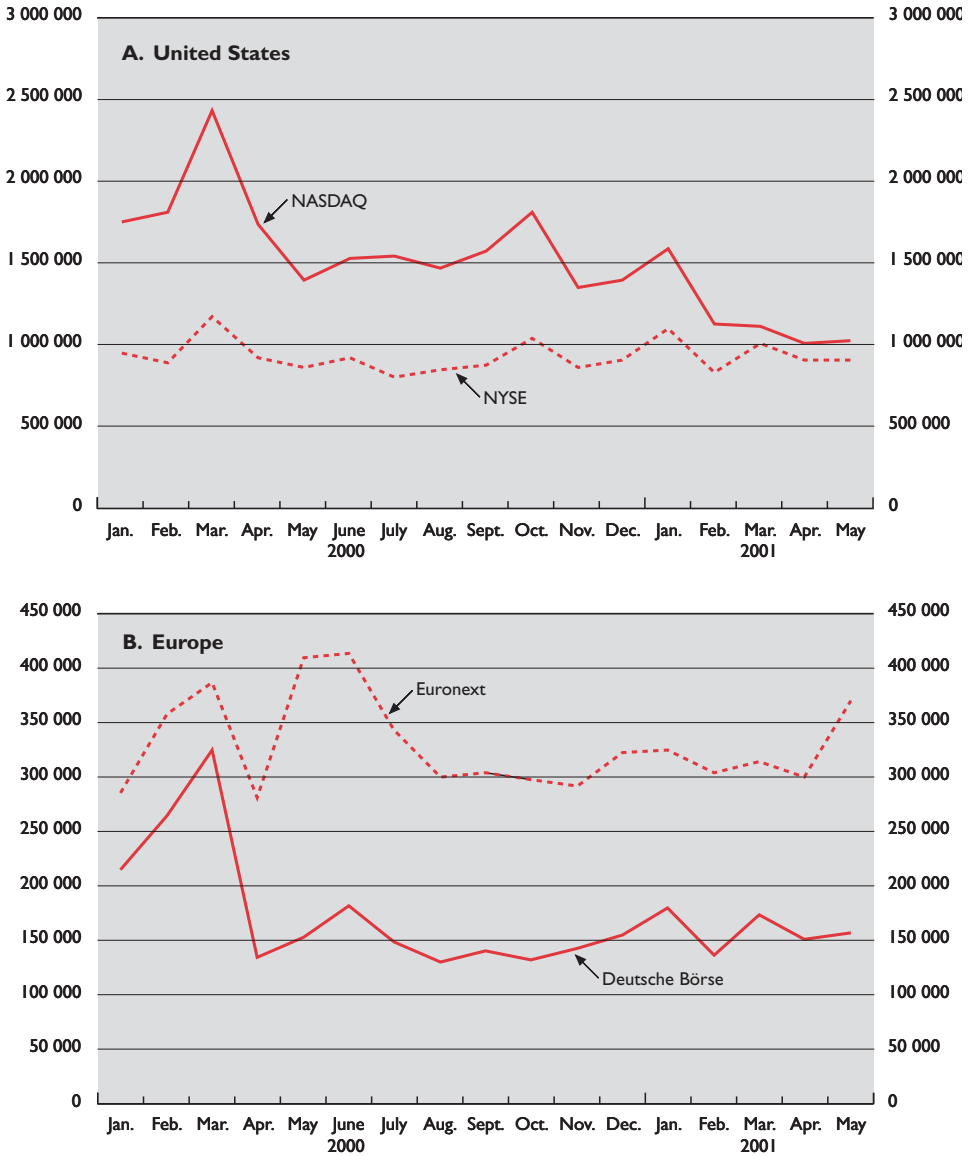
Source: Datastream.

in the Dow-Jones Industrials index traded at around the same average prices as they did in early 2000, and so did the small and medium-sized companies of the Russel 2000 index. Indeed, as a possible illustration of what analysts have termed “the revival of the old-economy stocks”, the latter two indices have been closely shadowing each other for most of 2001. This seems to indicate that investors’ focus has shifted toward value-investment in companies with an established earnings record and relatively predictable outlook, and away from the high-tech entities that dominate NASDAQ and to a certain extent also Standard & Poors indices..

A significant downturn in the turnover of technology-related stocks in the course of 2000 was subject to much press coverage. However, using NASDAQ as an indicator of the technology sector, this point appears to have been overemphasised. Between March 2000 and March 2001, the turnover actually declined by less than the concurrent drop in market prices (Figure 7, Panel A). The trading on the New York stock exchange market, by contrast, remained largely constant

*...amid small changes in traded volumes.*

**Figure 7. Trading volumes on selected stock markets**  
 Million US\$



against a background of limited price variations in the “old economy” stocks. In Europe, innovator markets held out well during the decline in stock prices. For example, the turnover in Euronext stocks was virtually the same in the first half of 2001 as a year earlier (Figure 7, Panel B)

The second quarter of 2001 brought a partial reversal of the medium-term declining trend in prices. The major indices grew by some 5 % to 10 % from mid-March through May, particularly in the United States where fears of a sharp economic downturn abated and the decisive reductions of official interest rates boosted stock prices. While the macro-economic news in Japan remained discouraging (in early June, preliminary GDP figures even triggered fears of recession), the main stock indices nevertheless recovered some ground as a new government perceived as reform-minded took office. Even so, the Nikkei 225 stood at a comparatively low level just above 13.000 in mid-June.

*The trend was partly reversed in 2001: Q2.*

Stock market movements in the euro-zone and the United Kingdom have been remarkably similar in recent quarters. This may be seen at somewhat surprising given the differences in cyclical positions, especially earlier in 2001 when most observers expected a steep UK slowdown to coincide with brisk growth in the continental economies. Some market participants have attributed this to an increasing importance of institutional investors and other index-based position takers, while others have pointed out that the financial market integration that followed the introduction of the euro does not stop at the borders of the euro-zone.

#### **IV. Securities issuance**

Anecdotal evidence suggests that the modest turnaround in equity prices lent support to a resumption of initial public offerings (IPO) of stocks in the second quarter of 2001. Among the most well-published cases, the Spanish retailer Zara's IPO in the second half of May was subscribed 53 times, and shares in the coal producer Peabody Energy went to a 30 % premium when they started trading in New York. Moreover, the partial privatisation of Statoil of Norway was so well received by markets that the expectation was a sell-off of 20 to 25 % of the company by the second half of June – well

*Stock offerings have resumed...*

ahead of earlier predictions. Characteristically, most the success stories were concentrated among “old economy” companies with strong balance sheets and a well-documented earnings profile. However, other companies such as Vodafone and the electronic broker Instinet also undertook successful offerings in the primary market.

*... but they remain below earlier levels.*

Notwithstanding the improvements in market conditions, the total amount of stock IPOs in the first half of 2001 was a relatively limited USD 35 billion, or about half of what was brought to the market during the same months of 2000. Meanwhile, demand remains potentially strong, as illustrated by the fact that institutional investors are reported to retain very important liquid positions while they seek opportunities to invest in long-term assets. For example, European pension funds reported cash holdings at an all-time high share of 4.5 % of total assets.

*The euro-zone market for debt securities is strong...*

The issuance of debt securities within the euro-zone remained buoyant in early 2001. Figures from the ECB show that the annual growth of the amount of outstanding debt securities issued by euro-zone residents grew by 7.5 % in the first quarter of 2001 – that is, at a rate virtually unchanged from 2000. The issuance by the private sector, particularly financial institutions, was particularly strong with annual growth rates close to 9 %. In a development rather different from what was seen in the United States, one of the main driving forces for corporate debt securities issuance was a narrowing of spreads between high-quality corporate bonds and government bonds since the beginning of the year.

*... to the benefit of US investment banks.*

On a related issue, European banks appeared to be losing market shares in the buoyant market for underwriting euro-denominated bonds. True, Deutsche Bank remained the most active underwriter in the first half of 2001, but second through fifth ranks were claimed by US investment banks (Table 1). By contrast, at the introduction of the euro in 1999, the top four underwriters in the market were all European. The shift in market shares has been attributed by analysts to an increasing tendency for borrowers with large funding needs to issue very sizeable bonds in multiple currencies. To be successful, banks increasingly need to be

Table 1. **International euro-denominated debt issuance**

Rank 2001* (99)	Bookrunner	Amount (£n)
1 (1)	Deutsche Bank	33.9
2 (8)	Saloman Smith Barney	23.4
3 (11)	JP Morgan	20.5
4 (7)	Merrill Lynch	19.1
5 (5)	Morghan Stanley Dean Witter	18.5
6 (4)	ABN Amro	18.1
7 (9)	Credit Swiss First Boston	17.6
8 (2)	Dresner Klein Wasserstein	16.8
9 (6)	UBS Warburg	15.3
10 (18)	Barclays Capital	15.0

\* Jan. 1 to May 16, 2001

Source: *Capital Data Bondware*.

able to distribute bonds in the United States, Europe and Asia. Finally, the US banks' longer experience of debt financing in their sophisticated domestic corporate bond markets is also quoted among the success factors.

## V. Banks in East Asia

### a) Japan

The sluggish domestic demand in Japan has made it notoriously difficult for Japanese banks to perform a necessary clean-up of their balance sheets, notably by disposing of bad loans. Based on individual loan analysis, non-performing loans (NPL) of the banking sector are officially estimated to be some JPY 35 trillion yen. On the other hand, independent analysts, on the basis of macroeconomic estimates that focus on the role of asset price deflation, point to a figure closer to JPY 100 trillion (about 20 % of GDP). At the same time, loan loss reserves are much lower than estimates of either bad loans or NPL: according to one study they are in the range of 40 % to 60 % as opposed to some 160 % in the United States.<sup>3</sup>

The major banks have increased loan provisions and write-offs in fiscal year 2000, as a result of which seven major banks reported losses. However, while they wrote-off JPY 4.4 trillion in the six months to March 2001, JPY 3.4 trillion of new bad loans appeared. Of 121 regional banks, more than 25 have

*Continued  
problems  
with bad loans...*

*... despite  
provisioning  
and write-offs.*

reported losses for fiscal year 2000 mainly due to bad loan disposal. They have been issuing new capital in part to strengthen balance sheets ahead of April 2002 when the blanket deposit guarantee ends, but the rise in bad debts has also been an important consideration. Bad loans have increased by some 13 % due to increasing failures among corporate borrowers and falling land and stock prices. Moreover, some observers have aired concerns that regional banks may have under-provisioned for NPL in the past, so that, if major banks step up disposals, they will be badly affected. Concerns such as these made the Financial Service Agency announce the creation of a high-level team to monitor the bad-loans problems. Also, there were press reports of a joint United States-Japan initiative in this area.

**Troubled  
profitability...**

The evident under-provisioning (and under-recognition) of bad and doubtful debts is attributed by most analysts to the low profitability of the banking sector. At the time of re-capitalisation, it was expected that interest rate spreads (interest rates on lending minus those on funds procured through deposits and other means) would increase. However, for most of the major banks the ratio has declined, ending fiscal year 2000 at just 0.58 % and for one major bank it was as low as 0.32 %. According to some observers, banks have tended to lower contracted interest rates to provide financial assistance to firms requiring close monitoring and have not been able to price for risk. This could explain that an extraordinary proportion of loans earn a return below the prime rate.

**... and balance  
sheet risks...**

In addition to non-performing loans, the banking sector is also saddled with a balance sheet structure that makes it vulnerable to shocks. Low demand for loans and ample liquidity have meant that banks have become big investors in government bonds with holdings rising from JPY 46 trillion in March 2000 to JPY 73 trillion a year later.<sup>4</sup> This means that government bonds represent about a tenth of banks total assets, double the level two years ago and considerably higher than their equity portfolio. With long term rates at historical lows, banks are faced with significant risks of falling bond prices and so have concentrated recent buying at the shorter end of the spectrum.<sup>5</sup> Nevertheless, analysts still estimate that the average maturity of banks' holdings could be as long as five to six years.

Regional and city banks have extensive equity holdings. Shareholdings by the city banks amounted to JPY 28 trillion at book value in September 2000 while their net worth amounted to only JPY 16.7 trillion. 40 % of unrealised stock gains have up till now been classified as tier I capital although continuous selling and repurchasing over the years has reduced the level of unrealised reserves which will in any case disappear from September 2001 as mark to market is fully introduced. The level of stock holdings makes the banking sector vulnerable to movements in stock prices.

*... such as vulnerability to equity prices.*

#### **f) China**

In the light of China's progress toward a WTO membership that will ultimately lead to stiffer competition from foreign financial institutions in national financial markets, the health of the Chinese banks has become an issue of some concern. As is the case with China's enterprises more generally, the national banks appear to be burdened by problems, that have been attributed by analysts partly to an accumulated "stock" of burdens arising from past distortions and partly to ongoing weaknesses in governance and operating capabilities.

*As China prepares for WTO membership...*

The profitability of Chinese banks has declined steadily over the last ten years and is now quite low. By 1999 (the last year for which comparable data are available), profits before-tax of the four largest state owned commercial banks (SOCB) ranged between slightly negative as a ratio to total assets for the Agricultural Bank of China to 0.33 % for the China Construction Bank

*... the low profitability of banks raises concerns.*

According to most analysts, the low level of profits is partly attributable to inefficiencies and excessively high costs in bank operations. While aggregate data are scarce, there is much evidence at the individual bank level of substantial inefficiencies and accompanying excessive costs in operations.<sup>6</sup> The SOCB and to a lesser extent other commercial banks also have substantial amounts of excess staff. Bank costs are further inflated by the relatively high turnover tax rate (8 per cent) imposed on their lending.

*The problem is attributed to inefficiencies...*

Another apparent reason for the decline in profitability of four largest SOCB is the marked drop in their net interest margins in relation to total assets. This decline has occurred despite the fact that authorities have induced an increase in loan

*... and a drop in interest margins.*

spreads over deposit rates as they have reduced the overall level of regulated interest rates. Part of the reason appears to be a decline in the ratio of total loans to assets, due in part to banks' efforts to cut back on credits to many of their traditional enterprise customers in order to avoid new problem loans. The marked rise in loans classified as non-performing has contributed to the relative decline in net interest income by lowering the amount of interest accrued.

**Non-performing  
loans remain  
high...**

The actual level of non-performing loans (NPL) is subject to discussions, but they appear to have grown quite sharply since 1997, at which time the profitability of state owned enterprises deteriorated and a large number of loans originally made during the 1993-1995 investment boom came due and were not repaid. Official figures together with outside estimates suggest that recognised NPL, based on the traditional classification system, were between 15 and more than 20 % for the four SOCB in 1999. The official figures suggest that nearly all of the NPL of the SOCB were carved out by the transfer of nearly 20 % (around USD 169 billion) of their loan portfolio to the bank asset management companies created in 1999 and 2000 (Table 2). However it is widely recognised that official figures based on traditional accounting systems substantially understate the true level of NPL as they would be classified under international standards. Bank officials and outside experts estimate that remaining NPL of the SOCB were on the order of at least 10 % to 20 % of their total loans in late 2000.

**... and they could  
even be  
understated.**

A recent announcement by the Bank of China (one of the SOCB) disclosing that its actual NPL stand at almost 29 % of total assets was well received by market analysts as an indication of an increasing degree of openness among Chinese

Table 2. **The Asset Management Companies and NPL (billions of Yuan)**

Bank	Asset Management Company	NPL Absorbed	NPL Disposed
Bank of China	Xinda	267.4	18.8
China and Commercial Bank	Huarong	373.0	38.0
Industrial and Commercial Bank	Great Wall	407.7	7.9
Agricultural Bank of China	Dongfang	345.8	-

Source: *South China Morning Post*, February 19, 2001; *China Daily*, February 19, 2001; *Mingpao*, February 17, 2001; *Xinhua News Agency*, January 12, 2001.

banks. Further, Bank of China is expected to seek stock market listing in the fourth quarter of 2001. At the same time, the bank plans to merge its branch in Hong Kong, China with 10 sister banks operating in the territory, a process that could make it the second-largest financial institution in Hong Kong, China.i

***A recent trend toward increased openness.***

## Notes

1. A senior European central banker even referred to the euro's current levels as "a great mystery" (*Financial Times*, Saturday, 16 June 2001).
2. The BIS 71st Annual Report argued this point. Among the evidence quoted is the fact that, prior to the correction, price-earnings multiples had risen in unison to unprecedented levels across a number of national stock markets.
3. See M. Fukao, "Japan's lost decade and weaknesses in its corporate governance structure", mimeo, Keio University, May 2001.
4. For the city banks, JGB holdings jumped 120 per cent to 41.8 trillion Yen.
5. According to the Japan Security Dealers Association, the largest banks made Yen 23 trillion net purchases of short term bonds in FY 2000 and one trillion of longer term bonds.
6. See the study by the Chinese Academy of Social Sciences, 2000; and Wong, Richard, "Competition in China's Banking Industry, Part II", *China Online*, October 2000.