Highlights of Recent Trends in Financial Markets

I. Background

Financial markets reflect optimism about the economic recovery…

Both bond and equity markets have been strong recently. Stock markets have continued to rise over the past few months, reflecting the on-going economic recovery and general optimism about the economic outlook. Credit quality has improved, downgrades by rating agencies have moderated, and in Japan, big corporations have significantly reduced their debt. Bond yields have risen from their lows in mid-2003, and while corporate spreads and emerging market spreads have edged up in the most recent weeks, they remain fairly low by historical standards. The positive outlook is also reflected in improved consumer and business confidence indicators in most of the major economies; although some of them had fallen recently, this does not yet mark a trend.[1] For the time being, monetary policies in major areas are supportive of the upswing and, in particular in the United States, some stimulus is also coming from the fiscal side. Policy rates are likely to remain low, as the US economy has yet to show significant improvement in employment and in Europe growth remains sluggish. In Japan, easy monetary conditions are also expected to continue.

… the speed of which, however, differs among the major economies…

The optimism financial markets in all major economies have shown has occurred against the backdrop of marked differences in performance in the real economy. Fourth quarter growth in the US slowed from the robust third quarter figures, but at an annualised rate of four per cent was quite respectable by historical standards, consistent with the general picture of a recovery well underway. The latter is underscored by the fact that corporate balance sheets have become stronger and corporate profits are high. In Japan as well, recent data suggest that the economy may be on a firmer path to recovery.[2] By contrast, growth in many Continental European countries remains somewhat sluggish. In that context, recently released figures for several European countries suggest that growth remains below expectations, as the strong euro has put some pressure on exports while household spending remains scant.

... and to which downside risks remain.

The outlook for financial markets depends importantly on how remaining imbalances are unwound. Among the more important factors is the adjustment in the exchange value of the US dollar. Thus far, the downward adjustment of the dollar has been orderly, if uneven in the rate of adjustment across major currencies. The outlook for oil prices also bears watching, more so in the wake of the further cuts in production decided at the OPEC meeting early in February. Gold prices and prices of other commodities, which have been rising to peak levels, may reflect some of the uncertainty in the markets. As reflected in forward rates and futures prices, increases in interest rates are expected further in to the recovery. This may generally put strains on balance sheets of highly indebted firms and households and may also affect profits of those financial institutions that have relied on the growth in credit during a period of historically low rates.

Corporate governance still remains to be improved.

Corporate governance also remains important. Declines in investor confidence in the wake of major financial scandals have had a depressing effect on financial asset values in the recent past. In response, policymakers have taken various steps to improve corporate governance and restore the confidence of investors. These efforts may be having the desired effect, as evidenced by the absence of major repercussions on financial markets of recent corporate scandals like the case of the Italian multinational Parmalat.[3] Although news of the scandal raised some fears that the Italian corporate sector as a whole would face higher financing costs as a result, investors thus far seem willing and able to discriminate among risks and so no significant effect on the broader markets has been observed. Even so, this incident shows that audit quality and audit oversight remain on the agenda as key issues for national governments, supervisors and international fora.

II. Equity markets

While difficult to assess, stock market valuations…

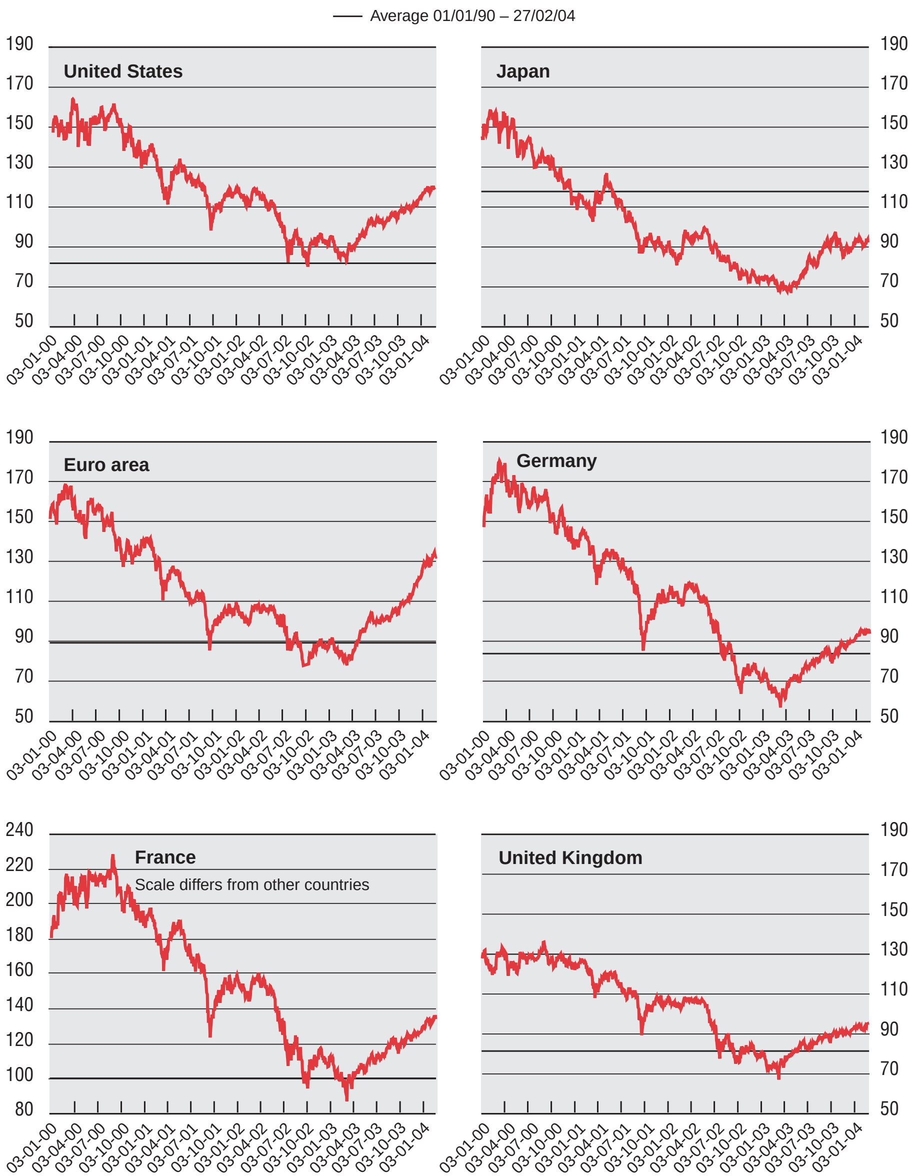
Equity prices have continued to rise over the past few months on most major exchanges (Figure 1). The upswing that began in March of last year now seems to be on a solid footing. In general, these figures reflect the positive economic prospects and increased optimism on the part of investors, which have left their safe-haven investments in the search for higher returns.[4] Supporting this development is the fact that volatility has continued to decline in all major stock markets – less significantly, however, in Japan (Figure 2). However, despite the recent price gains – which were in the range of ten per cent for broad market indices in the United States, the Euro area and Canada over the past three months – none of the major stock markets has yet recouped the losses incurred since the peak in early 2000 (and late 1999 for the United Kingdom, Table 1). In Japan and in the euro area as a whole, markets are still around 45 to 50 per cent below their peak values. In the United Kingdom equity prices are currently more than 30 per cent below their peaks, while in the United States and Canada, markets are still some 20 per cent below their peaks. However, since those peaks can be regarded as exceptional, it is perhaps not too surprising that there is still a long way to go to move back to those levels.

… are closing in on historical averages.

As earnings have risen strongly, price-earnings ratios of the corresponding indices are now only slightly above their averages since 1990 in the United States, and have fallen below those averages in Japan, the euro area, the United Kingdom and Canada. Earnings, which picked up strongly in the second half of last year, are expected to remain buoyant, which should further lower the price-earnings ratios and bring them closer to previous averages in particular in the United States. There, earnings hit records in the fourth quarter of 2004, growing 28 per cent on average for S&P 500 companies, and are expected to grow by 14 per cent throughout 2004.[5] Earnings derived from price-earnings ratios in the United States are now back at their peaks of 2000 and are about 50 per cent above their average since 1990.[6] In Japan by comparison, respective levels for earnings are 35 per cent below their averages since 1990, and only six per cent and five per cent below in the euro area and the United Kingdom respectively.

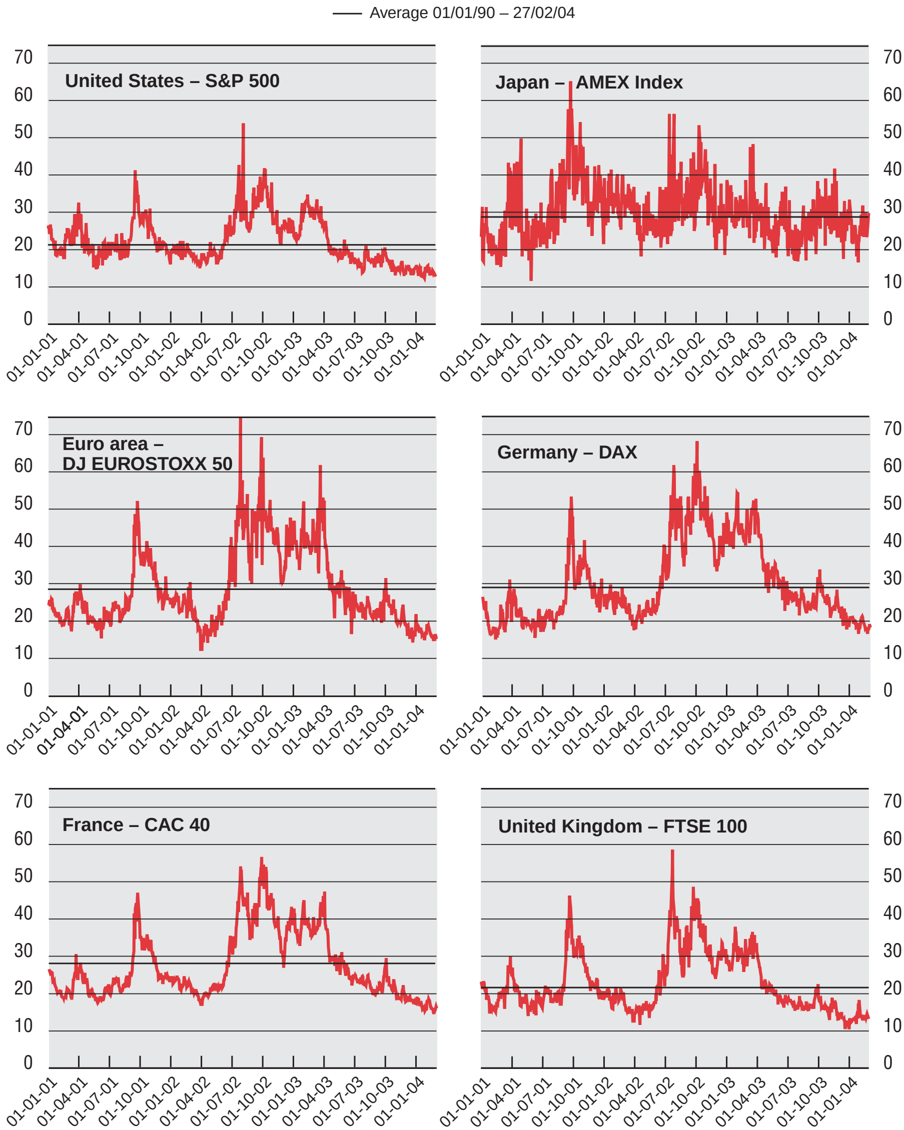
Figure 1. **Major stock markets**

Total market equity price indices, 1 Jan 1998 = 100



Note: Datastream Total Market Indices. Daily data until 27 February 2004.
Source: Thomson Financial Datastream.

Figure 2. **Stock markets: implied volatilities**



Note: Daily data until 27 February 2004. Implied volatility can be interpreted as market expectation of risk (future volatility) and is derived from at-the-money call option prices (interpolated) using the Black-Scholes formula. The Cox-Rubinstein binomial method is used for American style options.

Source: Thomson Financial Datastream.

Table 1. **Sectoral Stock market performance in G7 economies**

	United States	Japan	Euro area	Germany	France	Italy	United Kingdom	Canada
	Broad stock market indices							
	WILSHIRE 5000	NIKKEI 225	DJ EURO STOXX	DAX 30	CAC 40	MILAN MIBTEL	FTSE 100	S&P/TSX COMP.
Peak month	Mar-00	Mar-00	Mar-00	Mar-00	Aug-00	Mar-00	Dec-99	Aug-00
Trough month	Feb-03	Apr-03	Mar-03	Mar-03	Mar-03	Mar-03	Mar-03	Oct-02
Overall decline[2]	–43.7%	–79.3%	–59.5%	–68.1%	–59.0%	–51.1%	–46.0%	–43.7%
from peak m.-Feb.04	–21.0%	–46.4%	–43.8%	–48.0%	–43.9%	–38.1%	–34.0%	–20.6%
from Oct.03-Feb.04	10.4%	–0.9%	12.6%	16.2%	11.1%	8.2%	3.6%	13.3%
P/E at peak[3]	30.3	83.6	26.1	22.5	22.2	34.3	25.9	23.8
P/E Feb.04[3]	22.4	38.4	15.3	12.8	16.6	16.3	16.5	18.0
P/E avg.Jan.90-Feb.04[3]	21.5	51.1	16.5	17.7	15.2	19.4	17.5	19.2
P/E avg.90-94[3]	17.6	48.7	14.2	17.4	12.5	17.8	15.4	19.2
	Telecom, Media, IT[1]							
Peak month	Mar-00	Feb-00	Mar-00	Mar-00	Mar-00	Mar-00	Mar-00	Aug-00
Trough month	Oct-02	Apr-03	Sep-02	Oct-02	Oct-02	Mar-03	Sep-02	Oct-02
Overall decline[2]	–75.9%	–78.4%	–79.5%	–86.8%	–85.3%	–72.6%	–80.7%	–83.7%
from peak m.-Feb.04	–63.3%	–71.6%	–60.7%	–76.7%	–73.8%	–64.1%	–72.8%	–70.6%
from Oct.03-Feb.04	8.3%	–9.1%	25.0%	16.1%	9.2%	14.1%	11.8%	23.7%
P/E at peak	53.7	180.7	70.1	69.9	68.0	62.3	77.8	54.3
P/E Feb.04	33.7	46.8	23.2	21.1	21.8	20.5	20.7	27.8
P/E avg.Jan.90-Feb.04	29.5	66.6	22.2	33.8	19.8	21.2	25.2	29.0
P/E avg.90-94	21.2	49.7	14.3	28.6	13.0	13.6	14.8	27.1
	Banks[1]							
Peak month	Jan-01	Oct-99	Jan-99	Aug-00	May-02	Nov-00	May-02	Apr-02
Trough month	Oct-02	Apr-03	Oct-02	Mar-03	Oct-02	Oct-02	Mar-03	Oct-02
Overall decline[2]	–28.1%	–88.7%	–49.3%	–67.7%	–36.1%	–54.5%	–32.7%	–29.9%
from peak m.-Feb.04	11.9%	–55.5%	2.2%	–41.8%	–5.4%	–35.8%	–14.8%	21.1%
from Oct.03-Feb.04	8.0%	–7.3%	22.8%	13.3%	14.3%	7.3%	1.6%	7.4%
P/E at peak	18.3	429.9	20.4	15.5	11.2	18.4	16.8	16.4
P/E Feb.04	14.6	81.7	12.5	7.6	11.4	13.8	14.6	15.6
P/E avg.Jan.90-Feb.04	14.3	104.5	13.3	13.8	10.7	16.3	14.5	12.7
P/E avg.90-94	11.3	64.4	10.6	13.4	9.5	11.0	14.5	12.5
	Insurance companies[1]							
Peak month	Dec-00	Apr-99	Jan-01	Nov-00	Nov-00	Nov-00	Dec-00	Jan-99
Trough month	Feb-03	Mar-03	Mar-03	Mar-03	Mar-03	Oct-02	Mar-03	Oct-02
Overall decline[2]	–31.8%	–73.7%	–62.3%	–76.1%	–68.9%	–51.6%	–69.0%	–29.6%
from peak m.-Feb.04	–2.8%	7.6%	–33.6%	–64.0%	–47.8%	–36.8%	–61.7%	4.7%
from Oct.03-Feb.04	17.4%	–0.3%	24.1%	12.4%	16.8%	12.3%	7.6%	13.8%
P/E at peak	32.1	43.1	21.5	35.1	18.9	31.9	11.7	17.0
P/E Feb.04	18.9	24.2	10.1	7.2	25.3	18.9	20.4	14.7
P/E avg.Jan.90-Feb.04	18.8	47.7	22.1	35.3	13.7	31.0	25.1	13.5
P/E avg.90-94	13.9	49.3	24.7	47.7	11.4	33.6	29.2	12.2

1. Datastream indices.
2. Per cent decline of the respective equity price index, measured from peak to trough.
3. From Datastream Total Market Indices.

Note: Calculations based on monthly averages. Earnings per share, the denominators of the price-earnings ratios, are based on the latest annualised rate reflecting the last financial year or derived from an aggregation of interim period earnings. For France, the current earnings per share are a forecast provided by local sources. For the United Kingdom, the earnings are calculated by a rolling 12 months method of analysis based on interim, final and annual accounts.

Source: Thomson Financial Datastream.

Technology stocks are recovering and present a generally positive outlook.

Technology stocks have also continued their upward movement in the major markets. Over the past four months, the pace of the tech stock pickup in the United States was slightly higher than the broad market and about twice as fast in the euro area (Table 1, where a somewhat broader TMT – telecom, media and information technology – sector is shown). In Japan, where the main market lost almost one per cent over the past four months, the tech sector lost nine per cent of its equity market value. It is also evident that the technology stocks are still further below their peaks than other market segments. In the euro area as a whole, the sector is now about 60 per cent below its peak. However, this compares favourably with the performance of tech stocks elsewhere, including markets in major euro area countries. In Germany and France, for example, the technology sector is still over 70 per cent more cheaply valued than at its peak in 2000. The same is true of the technology sectors in Japan, the United Kingdom and in Canada. The recent rebound has been supported and re-enforced by major mergers, especially in the TMT sector.[7] However, some see these mergers not as a sign of growth, but of cost-cutting by firms with growth effects that are not immediate.

Financial sector indices have been rising strongly as well…

Equity indices of financial institutions also continued to rise over the past few months in all major markets except Japan (Table 1), where the banking sector is now more than 50 per cent below its late-1999 peak. The Japanese insurance sector, by contrast, has recovered quite well and is now almost eight per cent above that previous peak. In comparison, banks in the United States are faring twelve per cent better than at their peak early in 2001, but US insurance companies are still some three per cent below their peak of 2000. In the euro area, where the decline during the downturn was relatively large (mainly in Germany and France) as compared with other major markets, the gains over the past four months were the highest among major markets, climbing more than 20 per cent for both the banking and insurance sectors. While this upswing lifted the level of the euro area banking sector slightly above its peak of January 1999, the insurance companies are still over thirty per cent below their highs (of January 2001), with non-life insurers faring better than life-insurers and reinsurance companies.

... and financial institutions have come back into shape...

In most cases, the downturn of the financial sector was less pronounced than that of the broader market, but a steeper decline set in later in the cycle of the overall equity market slump.[8] With the decline in equities, institutions had begun to put more weight on fixed-income assets, but the recent upswing in the stock market, which has helped to strengthen balance sheets again, may well reverse this trend. The end-of-year results reported by major banks and insurance companies are noteworthy in this regard. In Japan, despite the decline of the banking sector index, it seems that larger banks have made substantial progress in cleaning up their balance sheets, and ratios of non-performing loans are improving, although more needs to be done. The revaluation of equities has also helped to strengthen balance sheets and to narrow funding gaps of corporate defined-benefit pension funds, which in some cases had gapped sharply during the market downturn.

... but the changing interest landscape may bear risks.

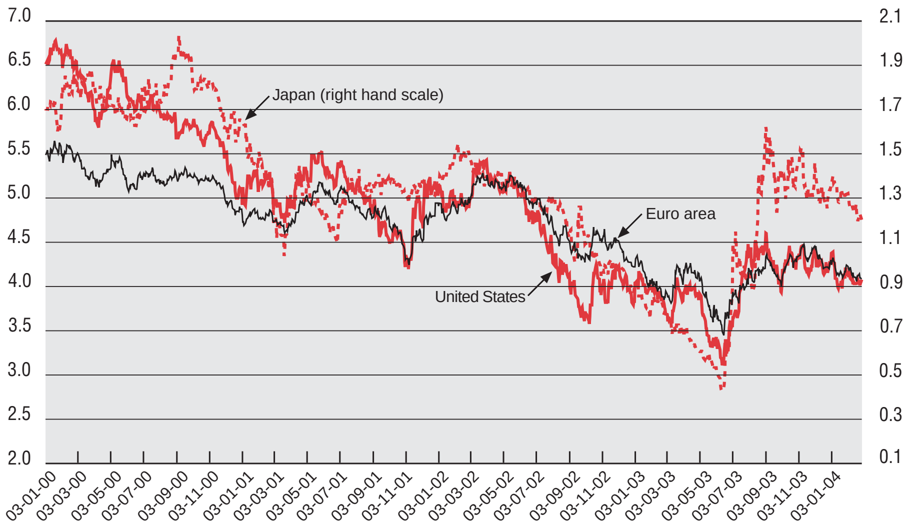
Looking ahead, it is not sure whether the climate for financial institutions will remain as favourable as it has been recently. The steep rises in equity markets may taper off to a more normal pace, and short-term interest rates are unlikely to remain at their current lows. If yield curves become flatter, this may cut into the profits of those institutions which largely depend on the yield spread. Higher interest rates would also lead to a retrenchment of mortgage lending and mortgage refinancing. This business has been very profitable during the period of falling and historically low interest rates, especially for banks in the United States and the United Kingdom. On a more positive note, for insurance companies in the United Kingdom and Japan, rising interest rates along with further increases in equity prices could help to close the still existing mismatches between current and guaranteed yields.

III. Bond markets and interest rates

Financing conditions on bond markets remain favourable...

Bond yields, which had dropped to historical lows in the middle of last year, have since partially retraced the declines, but remain low by historical standards. The yields of 10 year government bonds are now hovering slightly above four per cent in the United States as well as in the euro area, and above one per cent in Japan (Figure 3). This

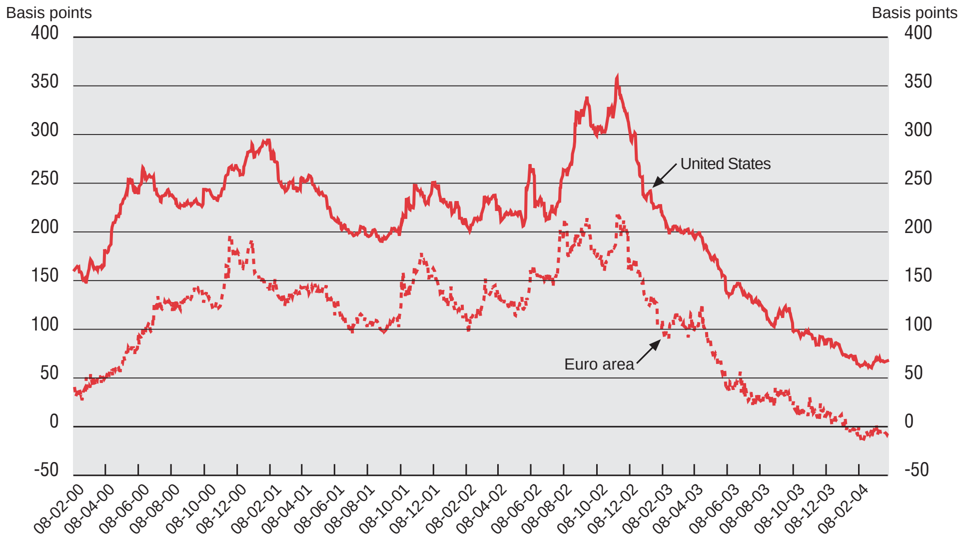
Figure 3. **10-year government benchmark bond yields**



Note: Daily data until 27 February 2004.
Source: Thomson Financial Datastream.

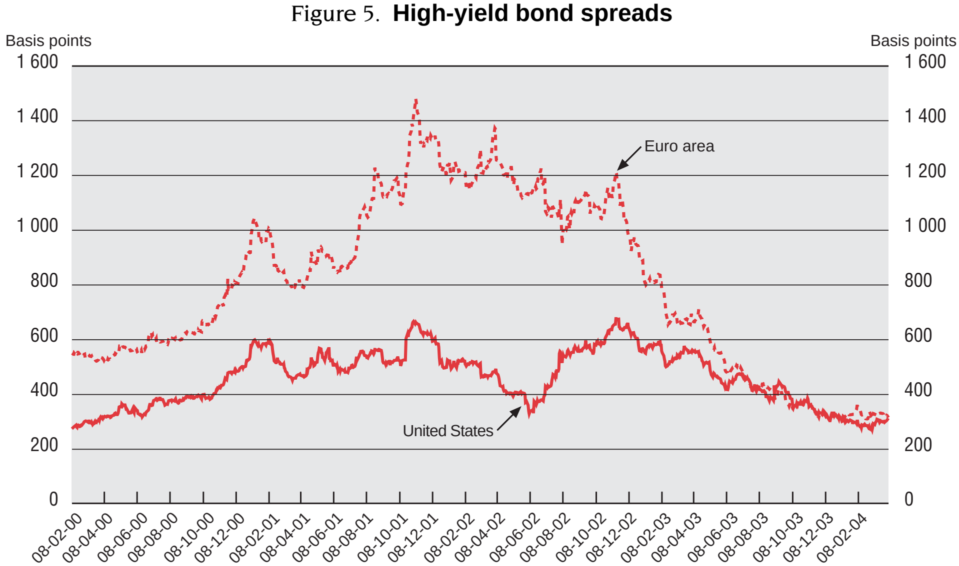
somewhat partial disconnect between stock and bond markets also reflects the still relatively ample liquidity searching for higher yields. The latter, in conjunction with the increased confidence of investors, has also led to further declines in corporate spreads over the past few months. Investment-grade as well as high-yield spreads in the United States and the euro area declined to historical lows in the second half of January, where they virtually remained thereafter (Figure 4 and Figure 5). These favourable financing conditions, combined with the expectations that they may not last much longer, contributed to a pickup in issuance. In Europe, according to some observers, the junk bond market has become riskier as companies with lower investment ratings have come to the market. Last year, 18 per cent of speculative-grade issues were rated single-B-minus or below, compared with 8 per cent the year before.[9] The market is still buoyant and yields of European high-yield bonds reached historical lows in January, as spreads over higher rated bonds have continued to narrow considerably. In Italy, even though one might have expected the Parmalat scandal

Figure 4. **Corporate bond spreads**



Note: Daily data until 27 February 2004. Aggregate corporate BAA bond yields (Lehman indices) minus 10-year government benchmark bond yields.
Source: Thomson Financial Datastream.

Figure 5. **High-yield bond spreads**



Note: Daily data until 27 February 2004. Aggregate corporate high-yield bond yields minus aggregate corporate BAA bond yields (Lehman indices).
Source: Thomson Financial Datastream.

to frighten investors away from the Italian market, recent Telecom issues were sold at reasonably low rates.

... and issuance especially of government bonds remains high.

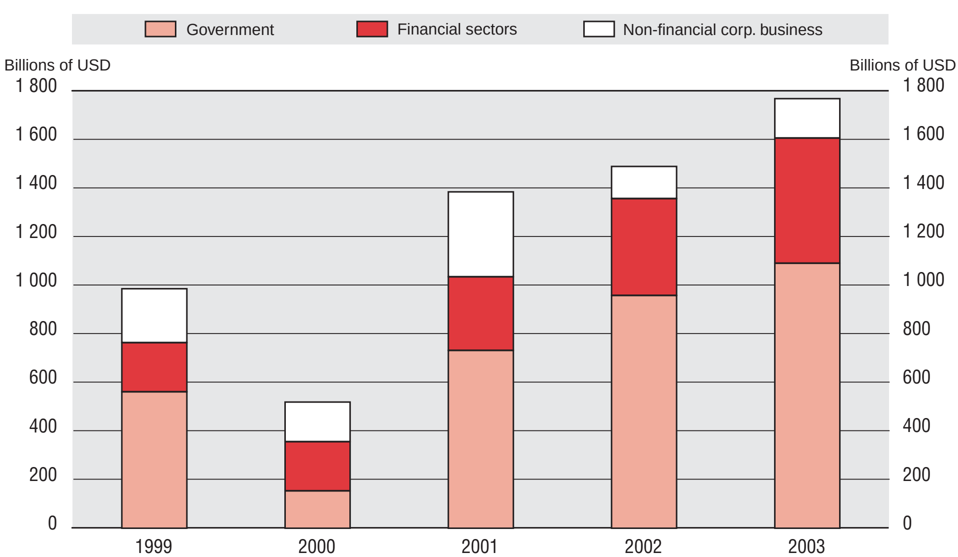
Government issuance also has increased over the past year, particularly in the United States, reflecting the financing needs of the US government[10] (Figure 6 and Figure 7). Asian governments have been major purchasers of these securities and now hold an estimated one-quarter of outstanding marketable US Treasury securities. Issuance by financial as well as non-financial corporations has also increased over the course of the last year, led by issues denominated in euro.

Policy rates remain low...

At the short end of the yield spectrum, major central banks have kept their policy rates low, as inflationary pressures have not yet been seen as jeopardising any targets for price increases in the near future. The low rates have added support to the economic upswing. In the US, the Federal Funds target rate has remained at its historical low of one percent

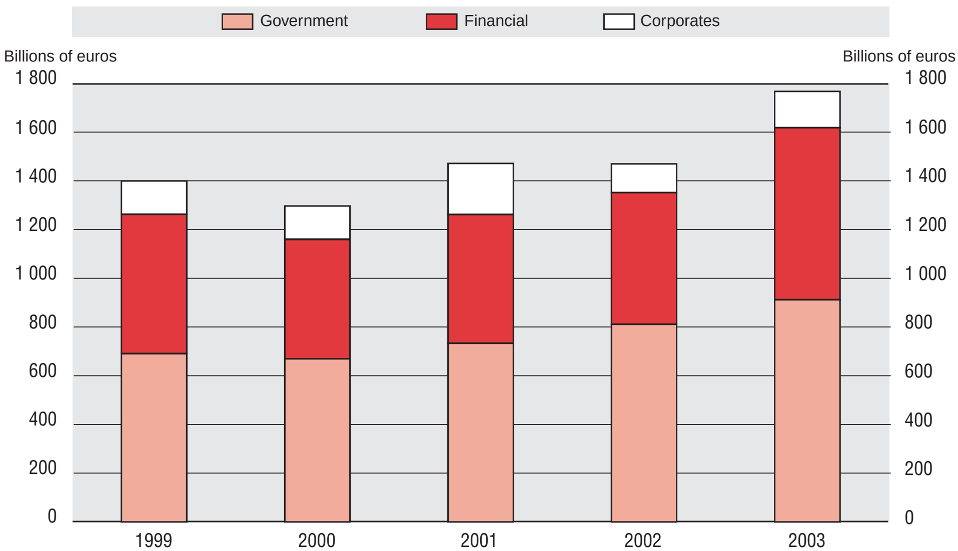
Figure 6. **Net issuance of US bonds**

Billions of US dollars



Note: Government includes Treasury, Municipal and Agency Securities.
Source: US Federal Reserve Board, Flow of Funds Accounts of the United States.

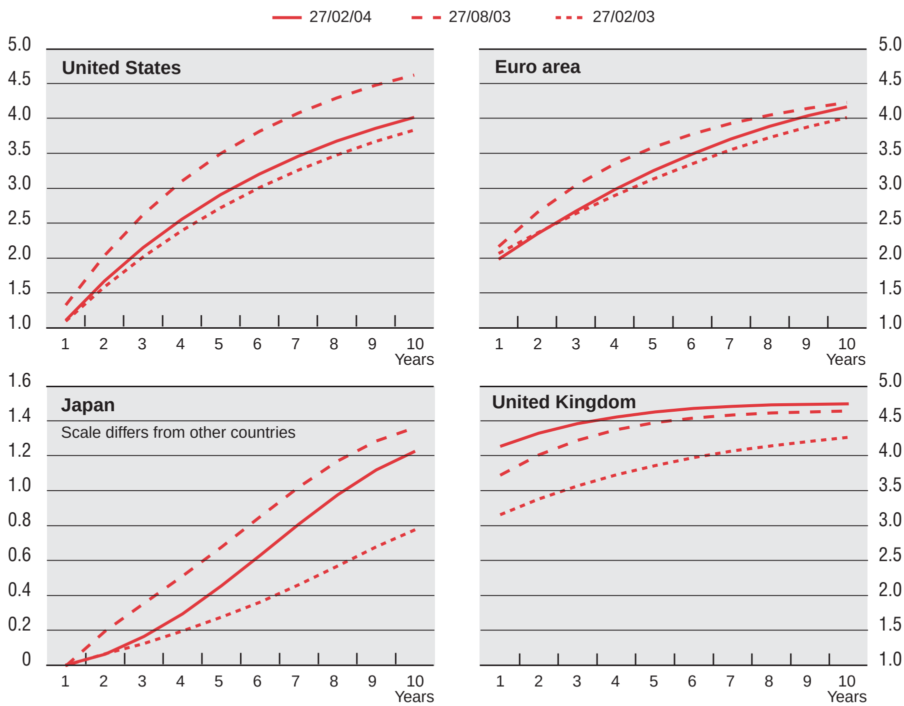
Figure 7. **Euro-denominated bond markets: volumes issued by type of issuer**
In billions of euros



Note: "Government" comprises bonds of agencies, central governments, municipals, regions, cities, and supra-nationals. "Financial" comprises asset-backed securities, financials' bonds, and Pfandbriefe. The latter includes Pfandbrief-style paper issued in EU-countries, like for instance French Obligations foncières, Spanish Cedulas hipotecarias, etc.
Source: European Commission (DG ECFIN).

since late June 2003, and additional easing of monetary conditions has occurred with the steep decline of the dollar. The European Central Bank (ECB), which had lowered its main refinancing rate to two per cent in early June 2003, has not changed its rate since. However, the rising euro has in effect tightened monetary conditions. The Bank of Canada lowered its target for its overnight rate in two steps of 0.25 percentage points, on January 20 and on March 2, to 2.25 per cent. Besides low pressures on core inflation and a larger-than-expected output gap, the appreciation of the Canadian dollar, which had effectively tightened monetary conditions, was one of the main arguments given for this move. While rates at the short end moved, yield curves had remained relatively steep, reflecting a generally positive outlook (Figure 8). Among major central banks, only the Bank of England raised its repo rate by 0.25 percentage points to four per cent early in February,

Figure 8. **Yield curves**



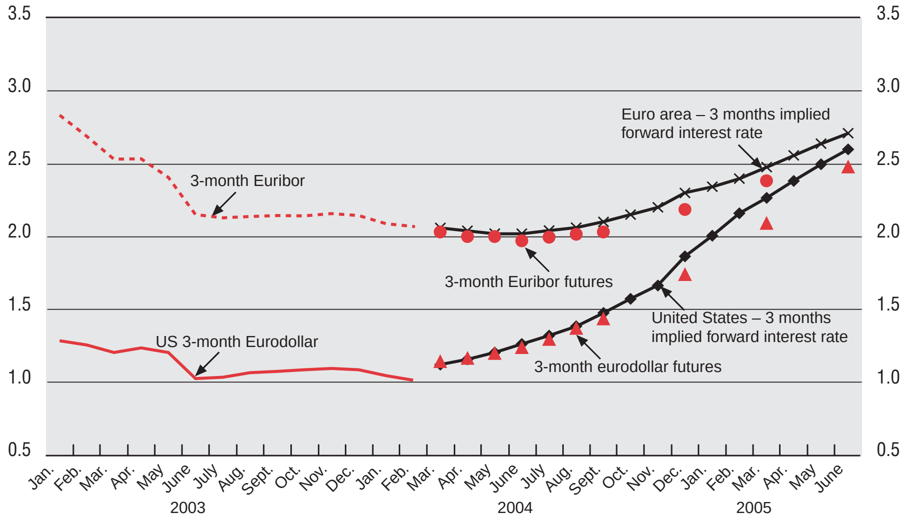
Note: Monthly averages of daily data.
Source: Thomson Financial Datastream.

arguing that output growth in the United Kingdom had been above trend in the second half of last year, and expected continued growth was likely to pick up gradually over medium term.

... but are expected to rise in the near future.

In the near future, market participants expect short-term rates to rise in the major economies. According to information in implied forward rates and futures contracts, a rise in short-term rates is expected some time in the second quarter of this year in the United States, and somewhat later this year in the euro area – in line with the lag in the economic recovery there vis-à-vis the US economy (Figure 9). For the United Kingdom, markets give a high probability to short-term rates rising again in the first quarter of this year. Canadian short-

Figure 9. **United States and euro area – implied forward and futures interest rates**



Note: Data as of 27 February 2004. Actual rates: United States: 3-months eurodollar middle rate (bid, 11a.m. London); euro area: Euribor 3 month offered rate; monthly averages. Implied forward rates are derived from zero-bond yield curves. Eurodollar futures: 3-month (CME); Euribor futures: 3-months (LIFFE.).
Sources: Thomson Financial Datastream, OECD.

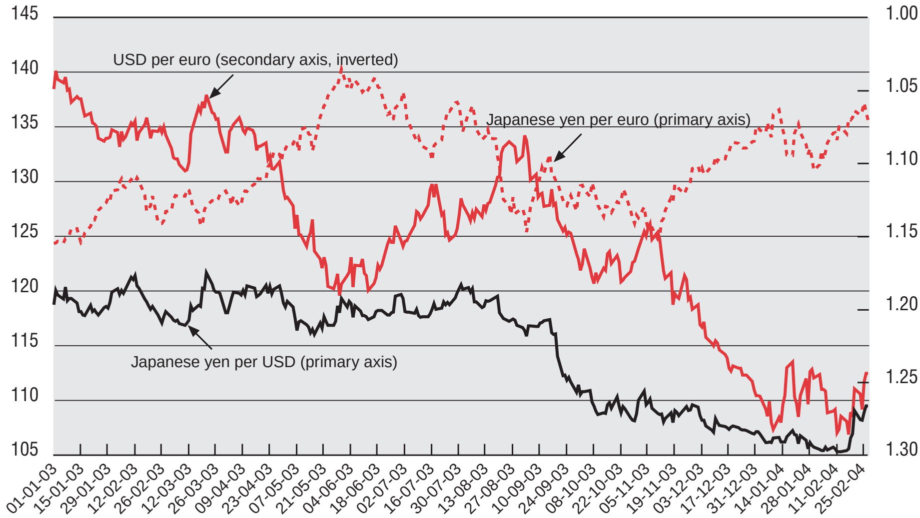
term rates are not expected to turn around before the end of the year. In Japan, due to the extremely low rates, interest rate data are more difficult to interpret. However, futures contracts and implied forward rates give some indications that markets expect rates starting to pick up slightly this year, and more strongly during the next, reflecting the outlook on the Japanese economy which has become significantly more positive.

IV. Foreign exchange markets

The dollar continues to decline…

Last year, the US dollar fell about 15 per cent on a trade-weighted basis and about 20 per cent against the euro, and this trend continued through the first two months of this year (Figure 10). By November 2003, the euro had re-gained its starting value (of January 1999) against the dollar, and reached all-time highs around mid-February, while volatility

Figure 10. **Major exchange rates**



Note: Daily data until 27 February 2004.
Source: Thomson Financial Datastream.

of the euro-dollar exchange rate has increased markedly. The yen, which had appreciated against the dollar from mid-September to mid-October last year, continued this trend somewhat until mid-February, when it rapidly fell back to its December level.

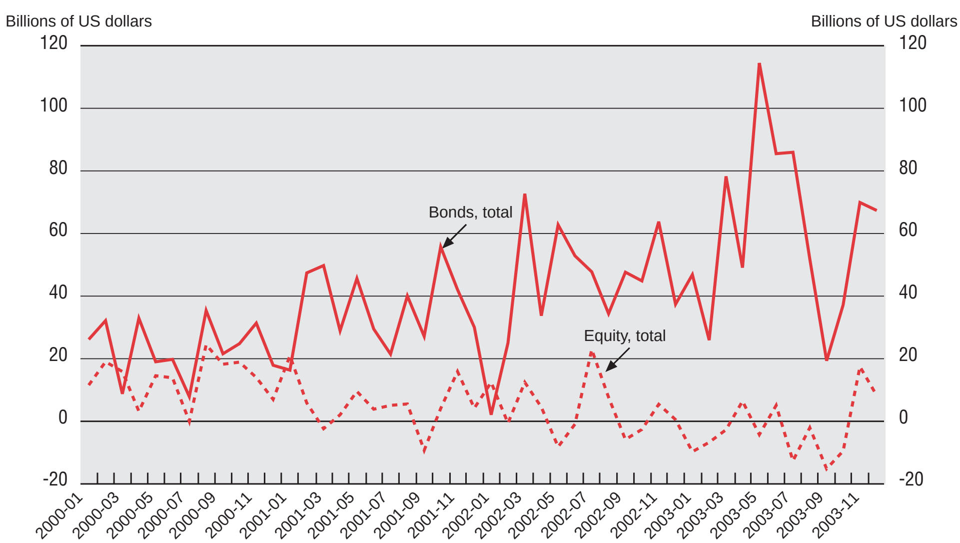
… and volatility has increased…

This reversal and the further decline of the dollar came shortly after the last G-7 meeting held on 7 and 8 February. The concluding statement of the meeting recorded that excess volatility and disorderly moves were undesirable, while more flexibility was desirable for currencies that currently "lack such flexibility". The former has been interpreted by some observers as implying that a further appreciation of the euro vis-à-vis the dollar was undesirable and would eventually evoke interventions by the central banks concerned, and the latter was taken by some observers as a hint to Japan and other Asian countries to allow their currencies to appreciate against the dollar. Apparently markets have been testing the validity of these statements, as indicated by the increased volatility.

... but the dollar remains attractive for investors.

Many market observers had predicted that a fall of the dollar would be necessary given the steep rise in the US current account deficit, although the timing was highly uncertain. However, so far, the dollar's decline has not led to a major reversal of the current account deficit, which has reached about 5 per cent of GDP. Investors' confidence in US assets is still high, nonetheless, and capital inflows into the US have remained strong. That said, the December 2003 figure of USD 75.7 billion was slightly lower than the one for November (USD 87.5 billion), and those net inflows declined for bonds as well as for equities (Figure 11). Nevertheless, these flows are still largely sufficient to finance the US current account deficit, for which an estimated USD 45-50 billion of capital inflows per month are needed. So far, the dollar has dropped mainly vis-à-vis the euro, while the yen and other Asian currencies have only slightly appreciated or maintained their exchange values to the dollar. While the impact of the strong euro is already felt by certain exporters of the euro area, until now exports of the euro

Figure 11. **Net portfolio flows into US by category**
Billions of US dollars



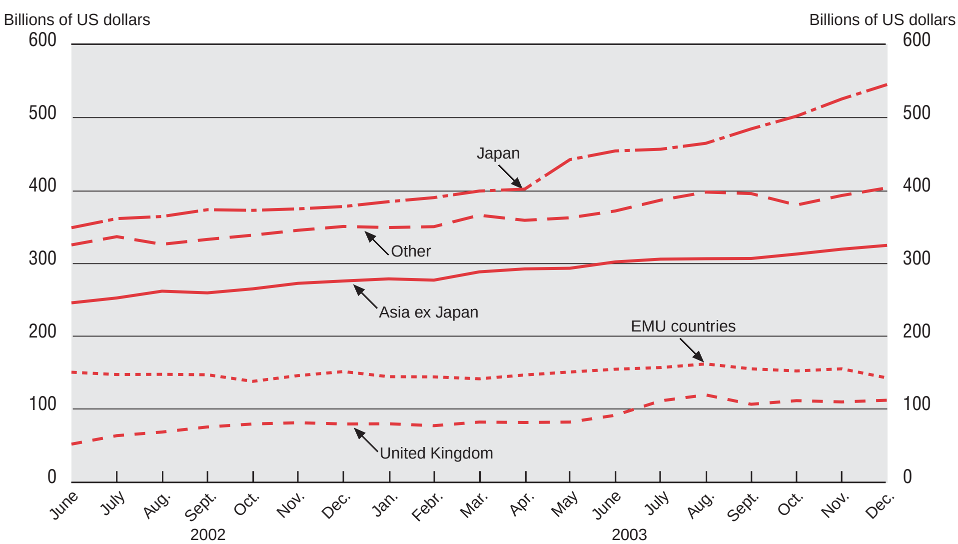
Source: US Treasury, Treasury International Capital (TIC) Reporting System.

area have been affected to a lesser extent than expected. Even though they dropped between 4 and 8 per cent from the third to the fourth quarter of 2003,[11] most of the companies had fared better than investors anticipated.

The brunt of the adjustment is still borne by the euro.

So far, the major Asian currencies have not, or at least not significantly, depreciated against the dollar. To maintain these valuations, Asian central banks have repeatedly intervened in foreign exchange markets over the past two years. As a consequence, their foreign-exchange reserves have risen by about USD 750 billion to about USD 2 trillion, mostly held in dollars (in addition to private holdings of US government paper, Figure 12). As the current account surplus of the euro area is expected to be around USD 50 billion this year and the cumulated surplus of the Asia Pacific region is USD 238 billion, there is some indication that further exchange rate adjustments will have to be borne also by the

Figure 12. **Major foreign holders of U.S. Treasury securities**
Billions of US dollars



Note: Holdings are end of month values. EMU countries for this chart are Germany, Italy, France, Belgium, Luxembourg, Netherlands, Spain, and Ireland.
Source: US Treasury, Treasury International Capital (TIC) Reporting System.

latter economies should the United States reduce its deficit of USD 585 billion.[12] For the time being, a further adjustment of the dollar may also be delayed by hedging activities. There are some signs of an increase in foreign exchange derivative trading, especially in dollar-euro, which indicate that a part of exporters' losses has been offset by their short forward positions against the dollar.[13] However, this impediment to the dollar adjustment may be only a minor one, as most hedging contracts are short-term and, given the current high volatility, long-term hedging would be too expensive for most companies.

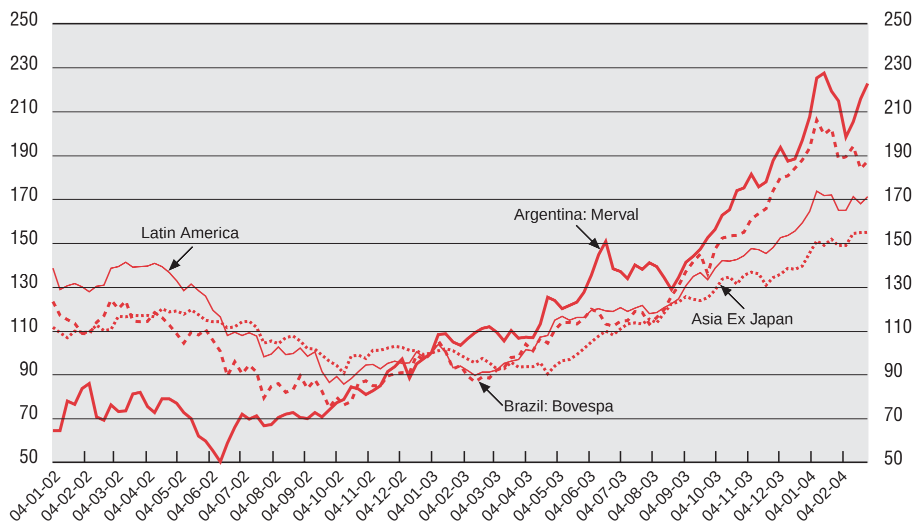
V. Emerging economies

Emerging markets prospects are on the upside…

Last year, emerging market assets were among the top performers (Figure 13). As volatility in emerging markets has subsided, many investors, in particular U.S. pension funds, have been adding emerging market assets to their portfolios in search of diversification and higher returns. Emerging

Figure 13. **Stock market performance in selected emerging economies**

Equity price indices, 3-Jan-03 = 100



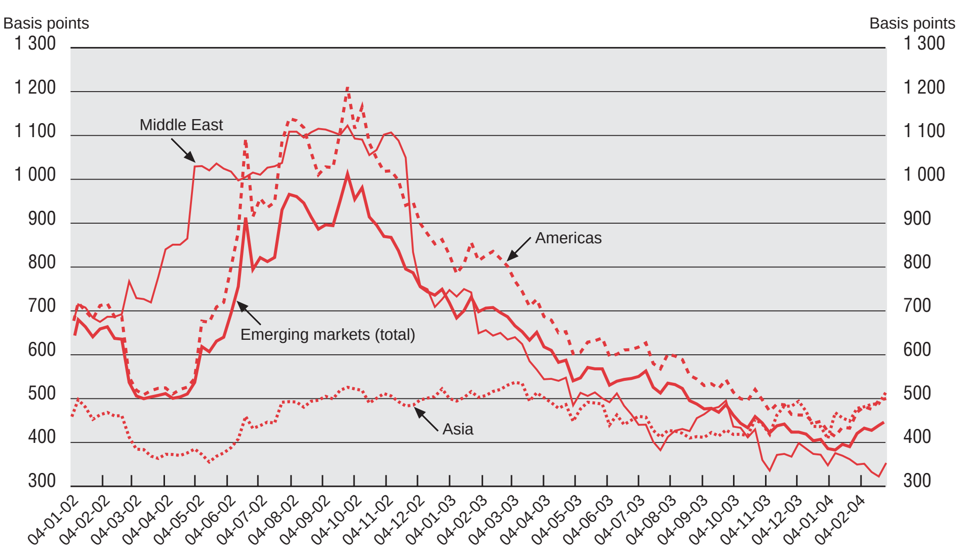
Note: Weekly data until 27 February 2004.
Source: Thomson Financial Datastream.

market debt returns were reported in the range of 30 per cent, as compared to 2.2 per cent for US treasuries. This trend may well increase, the more so as economic prospects in the developing regions look bright and reform of stock exchanges and stricter accounting rules add to a more favourable risk rating. The favourable demand conditions – and expectations of rising US interest rates – were also met by a surge of emerging market issuance in January. Despite this strong supply, the spreads of emerging market bond indices (EMBI) over US government paper have come down to historical lows, and have risen only slightly very recently (Figure 14).

… in Asia,…

This positive performance owes much to the developments in Asia, which was the fastest growing region in 2003 (excluding Japan). The Asian economies are also becoming more integrated and their growth is now relying less on external demand, which may be helpful when exchange rate adjustments become necessary in the future.

Figure 14. **Emerging market bond spreads**



Note: Weekly data until 27 February 2004. Lehman indices, redemption yields minus 5-year US government bond index yield.
Source: Thomson Financial Datastream.

...especially in China,...

The regional growth was boosted mainly due to the Chinese economy, which grew at an annual average of about 8 per cent over the last three years. However, the buoyant economy is to be contrasted to the very fragile situation of the Chinese financial system, with banks burdened by high levels of non-performing loans. The government programme to support cleaning up those banks' balance sheets which has recently been started could provide some relief. It is also noteworthy that sterilisation policies to neutralise the inflationary pressures of the dollar inflows are becoming less effective, reflected by creeping inflation and growing money and credit.[14]

... as well as in Latin America.

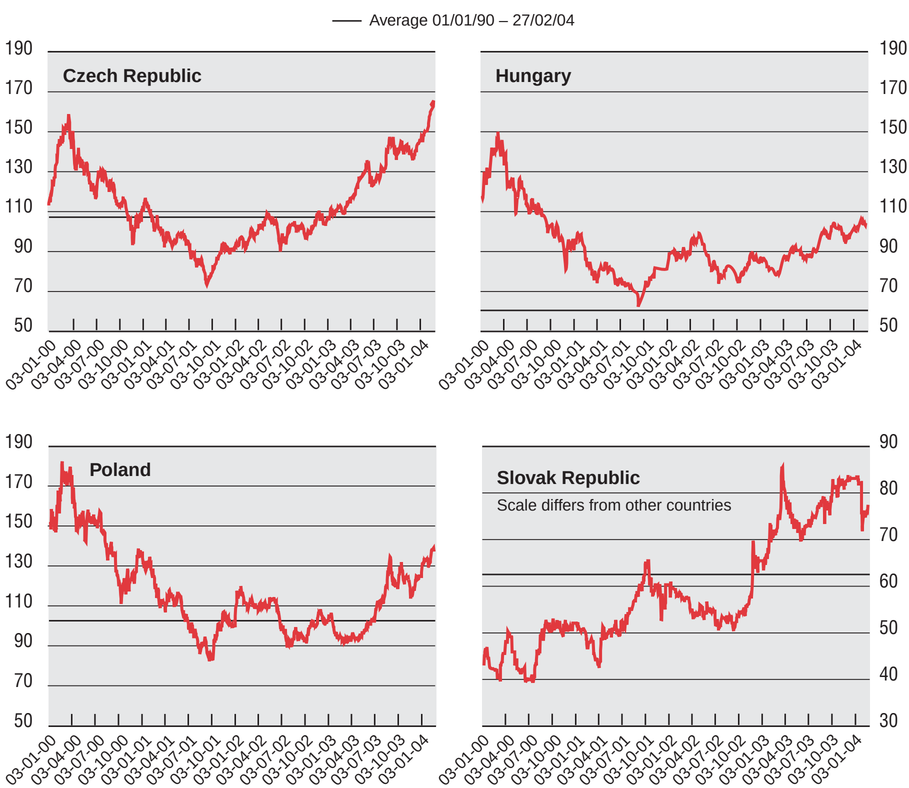
The positive performance of Latin American economies – the region is expected to grow about 4 per cent in 2004 – has been helped by the recovery of the US economy, high commodity prices and favourable foreign financing conditions. In Argentina, whose debt is estimated at over USD 160 billion, debt re-negotiations are paving the way for a recovery from the financial collapse and debt default of 2001, although the government's recent tough play on creditors, who lost up to 90 per cent of their investments,[15] could delay Argentina's re-admittance to the global capital markets and cut off necessary funding. In Brazil, where the government is rather successfully reforming the economy, debt is to a large extent tied to the US dollar and to international interest rates. While this enhances investor confidence, it makes the economy vulnerable to instability in foreign exchange markets and rising interest rates. Both the Argentinean (Merval) and the Brazilian (Bovespa) equity indices fell significantly over the past weeks, but are still at high levels, far above their troughs in 2001 and 2002, and are still outperforming the overall Latin American index (Figure 13).

VI. Enlargement of the European Union

Prospects of EU accession have enhanced financial markets in Eastern Europe...

On 1 May 2004 ten countries will become new members of the European Union,[16] four of them (Hungary, Poland, the Czech and the Slovak Republic) being Members of the OECD. As far as financial markets are concerned, acceding countries still face some challenges, but capital market reforms during the run-up to EU membership and enhanced confidence of investors have brought more stability and prosperity to their financial markets. Over the last months, developments on stock markets of major acceding countries have already been very much in line with developments on the US and the EMU markets (Figure 15). While too much optimism on the side of investors could lead to overheating in the new EU member countries, extreme developments seem very unlikely as any impact will be attenuated by expectations of stabilising policies enforced by EU membership. Acceding countries can thus expect further benefits

Figure 15. **Major CEEC stock markets**
Total market equity price indices, 1 Jan 1998 = 100



Note: Daily data until 27 February 2004. Datastream Total Market Indices; for Slovak Republic: Nomura Index.
Source: Thomson Financial Datastream.

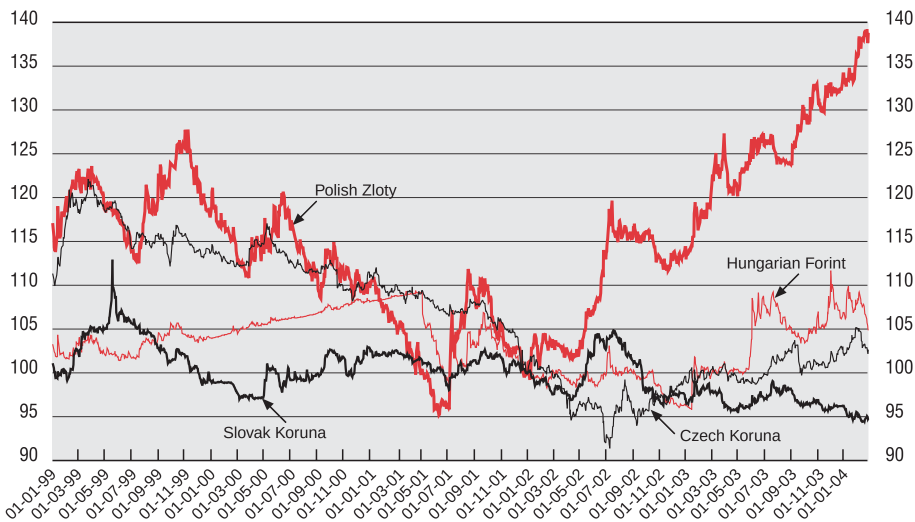
from increased financial stability and enhancement of their financial sector and institutions.

… and made exchange rates of acceding countries more stable…

For most acceding countries, currencies have become more stable during the pre-accession period (Figure 16), with positive effects also for the real economy. Many of them have already tied their exchange rates to the euro, but some still allow for larger adjustments.[17] While further stability for these currencies can be expected once they enter the EU, none of these countries will automatically become members of the European Monetary Union (EMU).[18] EMU membership will depend on the speed of convergence in each of the countries. However, as laid down in the accession documents, the new Member States will be "committed to striving towards the eventual adoption of the euro"[19] and at some point join the Exchange Rate Mechanism II (ERM II).[20] The euro can only be adopted after the Maastricht convergence criteria have been fulfilled.[21] While some countries have experienced strong appreciation of their currencies

Figure 16. **Exchange rates of selected countries acceding the EU**

Against the euro, indices, Jan. 2002 = 100



Note: Daily data until 27 February 2004.
Source: Thomson Financial Datastream.

due to capital inflows, and have overcome the instabilities related to those capital flows by adjusting policies and institutions, others will still be exposed to such developments (brought about by freer access to capital markets and investors' optimism).

… but more adjustments will be necessary.

While major steps in the reform of financial market institutions have been undertaken in acceding countries (also to mention the reforms toward making their central banks independent from government influence), many of them have still some way to go to fully catch up with the other EU countries. For example, the banking sectors in many of the acceding countries still remain below the EU average. While in the former group the ratio of private sector bank credit to GDP is still typically in a range of 30 to 40 per cent, this ratio is around 100 per cent in the latter. However, the experience of Ireland, Portugal, Spain or Greece, the credit ratio of which had been similarly low a decade ago or so, shows that the catch-up process can be enhanced by EU membership, and will be further amplified by a future EMU membership, when, for example, the issuance of euro-denominated paper becomes possible for the new members. Reforms of pension systems towards more privately managed funds will further help the development of financial markets, enhancing their depth and liquidity.

Notes

1. While on the rise in January, however, the Conference Board's Consumer Confidence Index for the United States weakened significantly in February 2004, and the same is true for European consumer confidence indices. Furthermore, the German ifo-index for business confidence dropped in February, reflecting expectations of a less favourable business climate over the next half year.
2. Figures released in mid-February show that GDP in Japan grew at an annualised rate of 7 per cent from the third to the fourth quarter 2003, and 2.7 per cent over the whole year 2003.
3. The Parmalat group comprises some 250 companies in more than 30 countries and represents about 8.5 per cent of the total Italian stock market capitalisation. The case involved fraudulent accounting, forgeries, conspiracy to commit fraud and other criminal activities. Its accumulated losses are currently estimated in the order of 14.5 billion euros, more than one per cent of Italian GDP, and some major banks are involved.
4. According to a global poll, 30 per cent of the individuals interviewed are expecting to invest more in the stock market in 2004, and only 7 per cent expect to invest less (The Economist, 2003, T*he World in* 2004, The Economist Newspaper Ltd). These figures are from an online survey, conducted from 12-15 September 2003, drawing on 1,702 responses from around the world, with nearly half the respondents from North America, 22 per cent from Asia-Pacific, 21 per cent from Europe and 10 per cent from the rest of the world.
5. According to an estimate by Thomson First Call.
6. These calculations are based on the Datastream Total Market Price index and the respective price-earnings ratios. The average of the implicit earnings (the inverse of the price index divided by the price-earnings ratio) since 1990 is about 30 for the United States, and the current (mid-February 2004) value is about 45.
7. For example, Cingular Wireless, which won the bidding for and AT&T Wireless, offered USD 41 billion, a takeover premium of more than 25 per cent. Furthermore, Comcast has been, although so far unsuccessfully, envisaging a takeover of Disney.
8. Times became especially difficult in 2002, when buffers had thinned out, which had already been put to a test by heavy losses from terrorist attacks and natural disasters.
9. Standard & Poor's, as cited in Wall Street Journal Europe, January 26, 2004, p. M1.
10. The US budget has slumped from a surplus of about one and a half per cent of GDP in 2000 to a deficit estimated at around five per cent of GDP for 2004, and expected to stay high over the years to come (OECD Economic Outlook database; figures refer to government net lending).

11. According to a J.P. Morgan Chase estimate.
12. Figures are from the February 2004 Consensus Forecasts. For the euro area, the current account surplus estimate is USD 35.4 billion for 2003 and 49.7 for 2004; for the Asia Pacific region (comprising Japan and eleven other countries of the region) the figures are USD 234 billion in 2003 and 238 in 2004, and for the United States USD –549 billion for 2003 and –585 for 2004.
13. Testimony of Chairman Alan Greenspan, Federal Reserve Board's semiannual Monetary Policy Report to the Congress Before the Committee on Financial Services, U.S. House of Representatives, February 11, 2004.
14. Some indication of a change in regime (such a change also being driven by problems of an underfunded social security system) may be that the government is currently considering to let some social security funds and some insurance companies to invest outside mainland China, although the amounts under consideration are low (USD 480 to 610 million or 3-4 per cent of the social security system's total reserves) and will initially be allowed in Hong Kong only.
15. The Argentinean president Kirchner had offered the country's private creditors fresh bonds at a 75 per cent discount, and pricing in unpaid interest and the riskiness of the new bonds, bondholders face a devaluation of 90 per cent.
16. The member states of the European Union and the candidates for membership agreed in December 2002 on the admission of ten new member states to the Union. The accession treaty was signed in April 2003. The acceding countries are Cyprus, Malta, Hungary, Poland, the Slovak Republic, Latvia, Estonia, Lithuania, the Czech Republic and Slovenia.
17. Estonia and Lithuania have adopted currency board regimes, the strictest form of a currency peg.
18. However, the acceding central banks will, as of 1 May 2004, already become members of the European System of Central Banks.
19. ECB (2003), *Policy position of the Governing Council of the* ECB *on exchange rate issues relating to the acceding countries* (18 December).
20. The ERM II is a multilateral arrangement of fixed, but adjustable, exchange rates with a central rate and a standard fluctuation band of ±15 per cent and replaced the European Monetary System created in 1979. It was established by the resolution of the European Council of 16 June 1997 order to link the currencies of EU Member States outside the euro area to the euro.
21. Those criteria were initially set up for the current EU member states' adoption of the euro, and impose limits regarding public finances, inflation, interest rates and exchange rate stability (minimum period of participation in ERM II).