Highlights of Recent Trends in Financial Markets

I. Overview

Financial market prices have been strong and stock exchange consolidation has continued.

Financial markets in major economies have been broadly strong after some weakening in the first part of the fourth quarter of 2005. Equity markets in the euro area have been buoyant over the past few months, and the strong upswing of Japanese markets in the fourth quarter was perhaps driven by prospects of the end of deflation. The US equity markets have grown at a somewhat slower pace than their G7 peers, but have recovered well from the adverse effects of the late-summer hurricanes. As part of a trend towards further stock market consolidation and demutualisation, the New York Stock Exchange became a listed company on 8 March after having acquired the electronic trading network Archipelago.

Global liquidity withdrawal has continued,…

Global liquidity withdrawal has continued as central banks have tightened their stance. In the United States the yield curve has flattened further over the past few months, as the increases in long-term benchmark yields did not keep pace with rising short-term rates. In Japan, the Bank of Japan announced an end to the policy of quantitative easing.

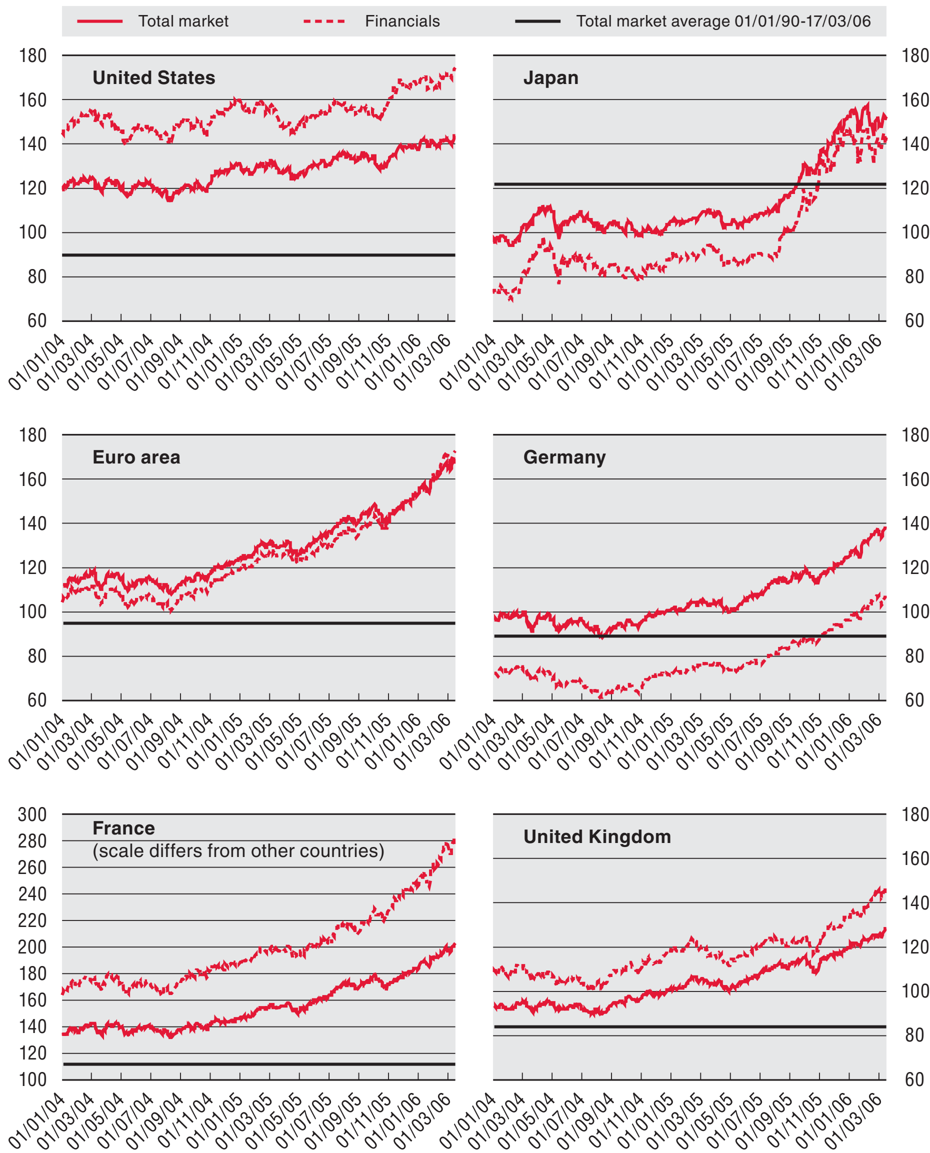
… but corporate spreads have remained low or stable.

Both in the United States and the euro area, high-yield corporate bond spreads remain far below their longer term averages and, in the euro area, have been compressed slightly over the past few months. Investment-grade spreads, by contrast, have moved sideways in the United States and the euro area.

© OECD 2006

Figure 1. **Major stock markets**

Total market and financial sector equity price indices, 1 Jan 1998 = 100



Note: Datastream indices. Daily data until 17 March 2006.
Source: Thomson Financial Datastream.

© OECD 2006

The equity market upswing also continued in emerging economies over the past few months, and some recent downturns related to investors' uncertainty about the extent of liquidity withdrawal by central banks proved to be short-lived. Emerging market bond spreads have risen slightly from relatively compressed levels, after the Icelandic stock market crash in February and some subsequent unwinding of carry trades.

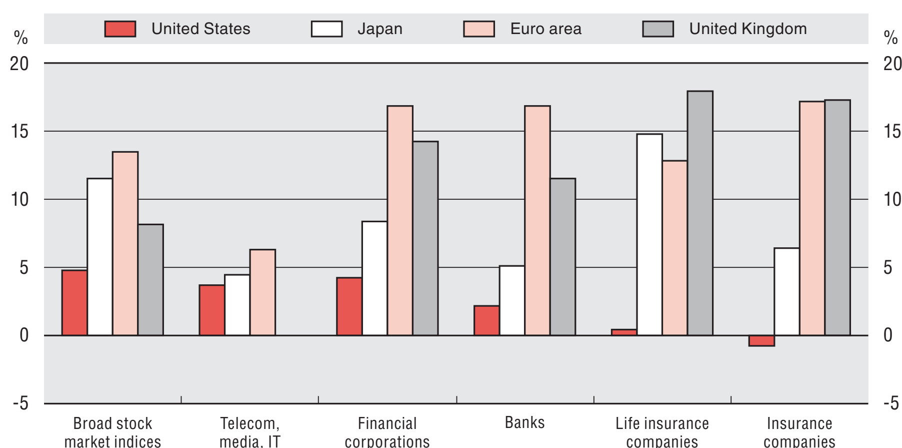
Emerging stock markets also continued their upswing, and EMBI spreads have only recently risen from compressed levels.

II. Equity markets

Major equity markets have shown a more upbeat performance over the past few months, continuing the overall upward trend that prevailed throughout 2005 (Figure 1). Indices dipped in November in the wake of some disappointing incoming macroeconomic and corporate data, but bounced back in December as a tightening in the ECB's policy stance in early December and lower-than-expected inflation outcomes in the United States provided some comfort that growth prospects remained on track (Figure 2 and Table 1).

Major equity markets have shown a strong overall performance…

Figure 2. **Recent sectoral stock market performance in major economies**
Percentage changes from November 2005 until March 2006



Note: Calculations based on monthly averages. Indices as specified in Table 1.
Source: Thomson Financial Datastream.

© OECD 2006

Table 1. **Overall and sectoral stock market performance in major 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.
Pct.chg. Dec-05-Mar-06	2.7%	2.3%	9.0%	8.6%	7.5%	9.3%	6.3%	6.7%
P/E Mar.06[b]	18.5	34.3	16.7	14.0	16.0	21.0	14.9	18.9
P/E avg. Jan.90-Mar.06[b]	21.3	48.3	16.2	16.9	15.2	19.1	17.1	19.0
	Telecom, Media, IT[a]							
Pct.chg. Dec-05 - Mar-06	2.0%	–2.5%	4.2%	5.3%	–0.4%	0.9%	1.7%	5.6%
P/E Mar.06	24.6	28.3	19.3	15.9	15.6	22.2	15.1	27.9
P/E avg. Jan.90-Mar.06	29.4	61.8	21.8	31.4	19.6	21.2	24.1	28.5
	Financials[a]							
Pct.chg. Dec-05-Mar-06	2.7%	0.2%	12.3%	11.5%	13.2%	13.6%	10.5%	6.2%
P/E Mar.06	15.5	36.0	15.8	12.2	15.5	23.1	14.5	16.3
P/E avg. Jan.90-Mar.06	15.4	62.5	15.8	19.1	12.5	20.4	16.6	13.7
	Of which: *Banks*[a]							
Pct.chg. Dec-05-Mar-06	0.3%	–2.0%	13.2%	12.9%	14.4%	14.0%	8.7%	7.3%
P/E Mar.06	13.4	41.1	15.9	11.6	13.3	22.0	12.5	16.5
P/E avg. Jan.90-Mar.06	14.3	96.3	13.3	13.7	10.8	16.3	14.2	13.0
	Insurance companies[a]							
Pct.chg. Dec-05-Mar-06	–0.7%	4.9%	9.1%	8.3%	9.2%	11.2%	12.7%	4.8%
P/E Mar.06	15.5	29.3	13.5	10.7	16.7	23.4	12.5	15.6
P/E avg. Jan.90-Mar.06	18.2	44.3	20.3	31.1	14.2	29.2	23.3	13.7
	Life insurance companies[a]							
Pct.chg. Dec-05-Mar-06	0.4%	6.7%	7.7%	15.7%	17.8%	8.5%	13.6%	4.5%
P/E Mar.06	12.5	74.4	11.8		13.0	22.3	12.9	16.3
P/E avg. Jan.90-Mar.06	14.9	n.a.	25.4			37.9	19.6	15.0

Note: Calculations based on monthly averages (March 2005 data are until 17 March only). 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.

a) Datastream indices. The Insurance index includes non-life insurance companies, insurance brokers and other insurance companies; it does not include life insurance companies.

b) From Datastream Total Market indices.

Source: Thomson Financial Datastream.

© OECD 2006

...and have grown well in Japan,...

In Japan, where the Nikkei rose more than 40 per cent in 2005, the growth of broad market indices had been particularly strong in the fourth quarter of 2005. The run-up in share prices was driven by data releases such as stronger-than-expected GDP growth and higher earnings forecasts, which fostered expectations of a sustained recovery, and data showing receding deflation. Inflation is now forecast to be slightly positive this year, a sign of the end to a long-lasting period of economic stagnation. Despite the sizeable gains last year, major equity markets and their sub-components seem not to be overvalued, judged at least on the basis of price-earnings ratios, which are below or close to their long-run levels (Table 1).

... backed by foreign as well as domestic demand from individual investors,...

This strong stock market growth in Japan was supported in part by foreign demand and increasing demand from individual investors, which accounted for 28 per cent of the total trading value on the three largest stock exchanges. About half of the purchases by individual investors were leveraged with loans based on market rates, and as some observers have noted the change in the Bank of Japan's policy stance with an outlook for rising interest rates may force some of these individuals to divest their stocks.

... despite a recent surge in volatility.

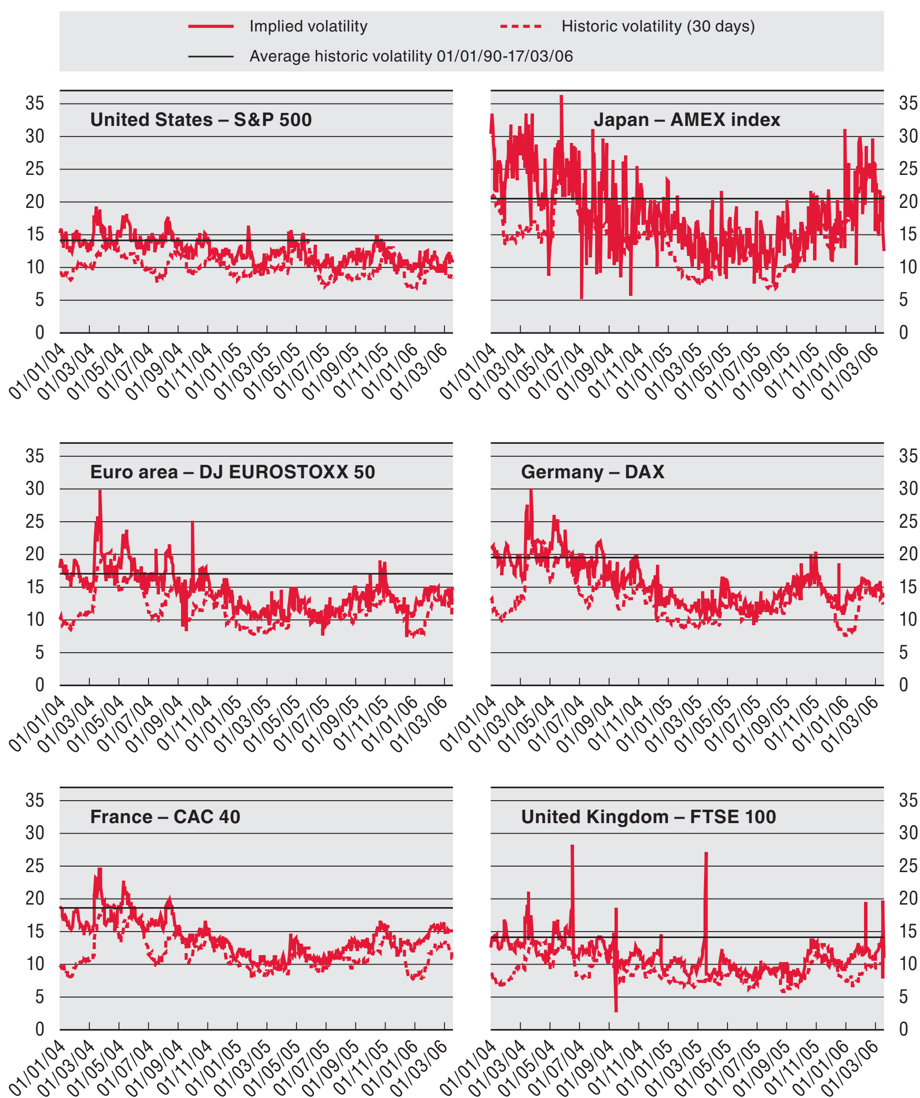
Volatility, both as implied by option prices and derived from the history of equity price variability, has remained low in all major markets but Japan (Figure 3). The sharp sell-off in the wake of an investigation into Livedoor, an internet company, in mid-January even led to an early closure of the Tokyo Stock Exchange (TSE), substantiating complaints about the inadequacy of TSE's trading system to deal with a surge in transactions. In response, the TSE announced in late March to double the previously planned IT spending and to implement a "next-generation" system over the coming years.

The financial sectors showed a relatively strong performance in Europe, where some reinsurers seem to have shrugged off hurricane losses.

Looking at the various segments of the stock markets, the financial sector showed the strongest gains in euro area markets and in the United Kingdom over the past few months. In both of these markets, the sectors' overall performance was boosted by the banking and insurance sub-sectors. Some of the major European reinsurers shrugged off heavy losses from last year's hurricanes by selling assets or through other compensating measures, while the US insurance sector has shown negative returns. However, the declines in US insurers' credit default

© OECD 2006

Figure 3. **Stock markets: implied and historic volatilities**
Vertical lines indicate date of previous meeting

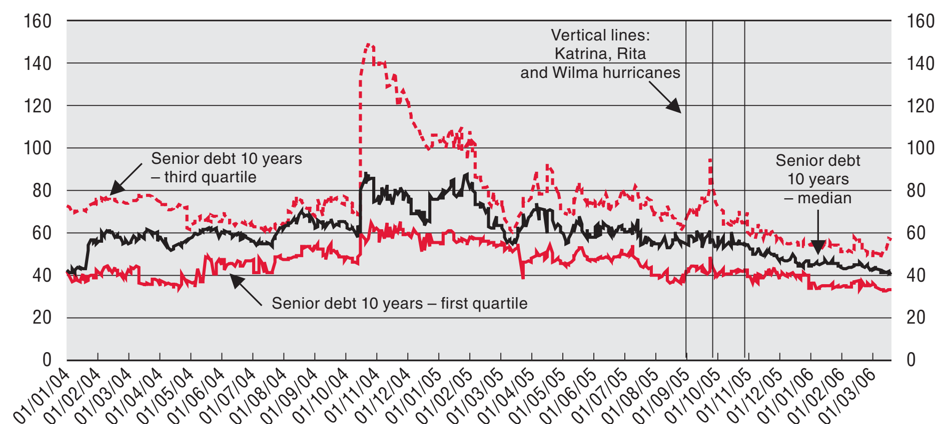


Note: Daily data until 17 March 2006. Historic volatilities are monthly volatilities calculated from daily data. Implied volatility can be interpreted as market expectation of risk (future volatility) and is derived from at-the-money call option prices (interpolated) using the Black-Scholes formula. The Cox-Rubinstein binomial method is used for American style options.
Source: Thomson Financial Datastream.

© OECD 2006

Figure 4. **Hurricane effects on US insurers**

Quartiles of credit default swap spreads of US insurers, senior debt 10 years



Note: Daily data until 17 March 2006. Quartiles measured over 10 biggest available credit default swap spreads of US insurers.

Source: Thomson Financial Datastream, OFDA/CRED International Disaster Database (*www.em-dat.net*), and OECD.

swap spreads over the past few months reflect a positive perception by investors of the sector's resilience (Figure 4).

US banks are coming under pressure from flattening yield curves and a cooling housing market.

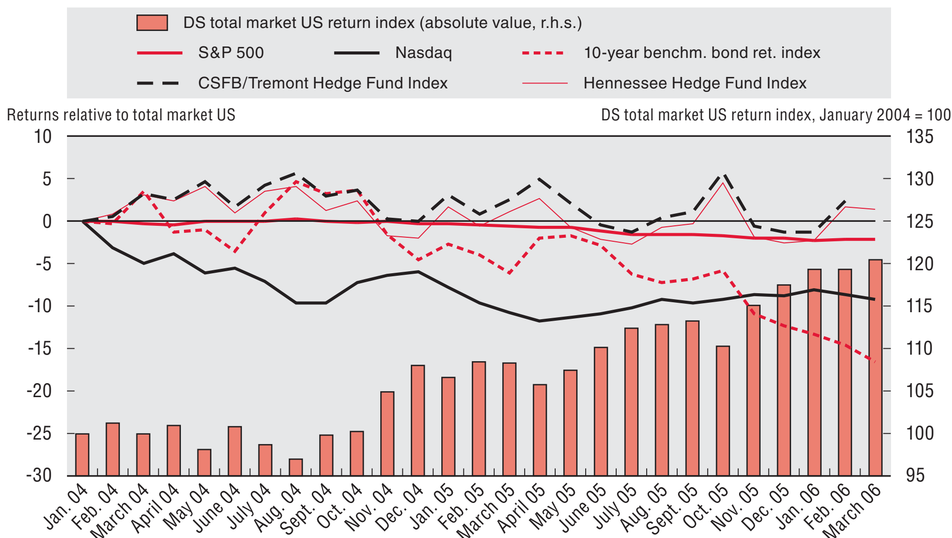
In the United States, where the overall stock market performance over the past few months has been weaker than the market performance of its G7 peers, banking sector stocks also fared relatively weakly. With rising interest rates and flattening yield curves, banks' profits have come under pressure, and while the sector has benefited from buoyant mortgage lending over the past few years, this source of income may ebb with a cooling housing market. At the same time, the increased extension of non-traditional mortgage products to sub-prime lenders may pose additional risk for some lenders.

The run on hedge funds has been slowing,...

As traditional equity investments have fared well over the last year, hedge funds may have lost some of their appeal as they tended to underperform the broader market indices in the fourth quarter of 2005 (Figure 5). While inflows into hedge funds continued strong and reached nearly USD 47 billion in 2005, they were lower than the USD 74 billion

© OECD 2006

Figure 5. **Relative performance of US securities and hedge funds**
Returns relative to broad market (DS total market index, Jan 2003 = 100)



Note: March 2006 data are based on averages until 17 March.
Source: Thomson Financial Datastream.

inflows attained in 2004. At the end of 2005, hedge funds are reported to have held about USD 1.1 trillion in assets, 13 per cent more than the year before. With somewhat lower returns, the dispersion of returns of various hedge funds strategies seem to have declined slightly. Lower volatility may have pushed some hedge funds into pursuing riskier strategies in search for "alpha". Should equity market volatility increase from current levels below long-term averages, this may help hedge funds diversify their strategies and again increase their average returns.

... while surveillance of the hedge fund sector has increased in the United States.

In the United States, effective end-January, the US Securities and Exchange Commission (SEC) has required hedge funds over a certain size (assets under management of over 25 million USD) and with a certain mobility of funds (holding period less than two years) to register as financial advisors (under the Investment Advisers Act of 1940) and report their business. While loopholes exist, this enhanced surveillance

© OECD 2006

may enable early warning procedures and foster greater financial stability.

The trend towards demutualisation of stock exchanges and consolidation of the sector has continued…

The global trend toward consolidation and demutualisation of stock exchanges has continued.[1] Such changes in the stock exchange landscape mark a more general trend dating back to the mid-1990s, arising from increasing globalisation and advances in information and communication technologies, which enhance competition in the area of the financial services provided by exchanges. The future structure for equities trading will be determined by the trade-off between economies of scale and network effects on the one hand and problems of monopolisation on the other.

…as the New York Stock Exchange acquired Archipelago and became a listed company in March.

The New York Stock Exchange became a listed company on 8 March, and the NYSE's completion of a merger with Archipelago, an all-electronic trading network, the day before marked a further step in the consolidation of the sector. Some recent M&A attempts, like the so far unsuccessful merger talks last year between Euronext (which operates exchanges in Paris, Amsterdam, Brussels and Lisbon as well as the Liffe derivatives exchange in London) and Deutsche Börse, as well as the unsuccessful offer by NASDAQ to acquire the London Stock Exchange on 9 March hint at further potential for consolidation of the sector.

III. Bond markets and interest rates

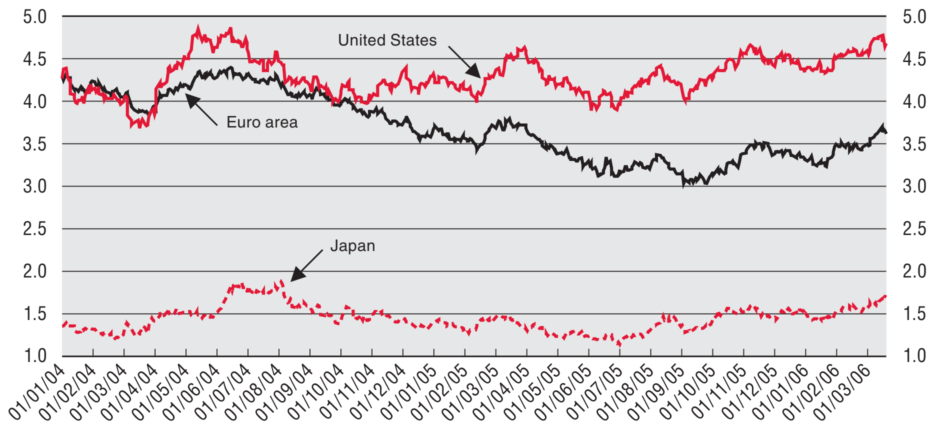
Long-term benchmark yields rose slightly, but yield curves have flattened with tightening monetary policy in the United States and elsewhere.

In major economies, benchmark bond yields have slightly risen from their low levels (Figure 6), driven by a positive economic outlook and by tightening monetary policy (Figure 7). In the United States the Fed lifted its target rate to 4.75 per cent on 28 March – its 15th consecutive step of the tightening round that began at the end of June 2004. However, the increases at the short end of the yield curve have been outpacing the increases in long-term rates and have rendered the yield curve flat if not inverted (Figure 8). In

1. Issues related to changes in the stock exchange landscape were also discussed at the November 2005 meeting of the OECD Committee on Financial Markets, and at previous meetings of the Committee. See also Schich, S., and G. Wehinger (2003), "Prospects for Stock Exchanges", *Financial Market Trends* 85, *October* 2003; pp. 92-117.

© OECD 2006

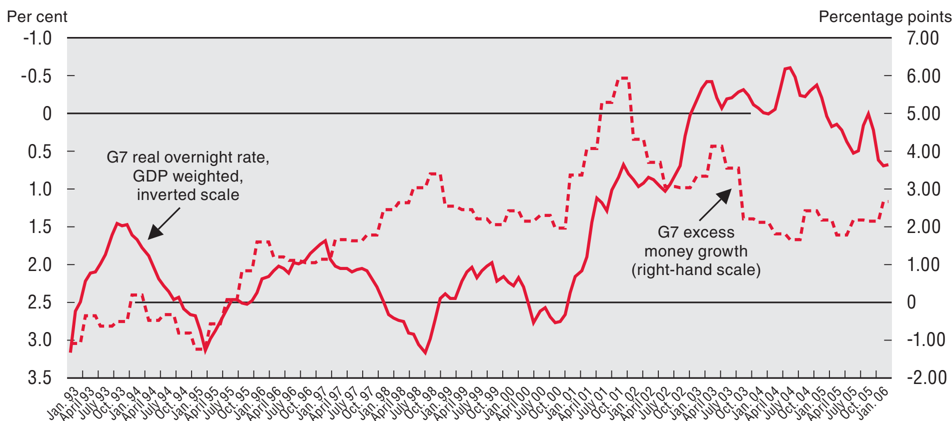
Figure 6. **10-year government benchmark bond yields**



Note: Daily data until 17 March 2006.
Source: Thomson Financial Datastream.

Figure 7. **Proxies for global liquidity developments**

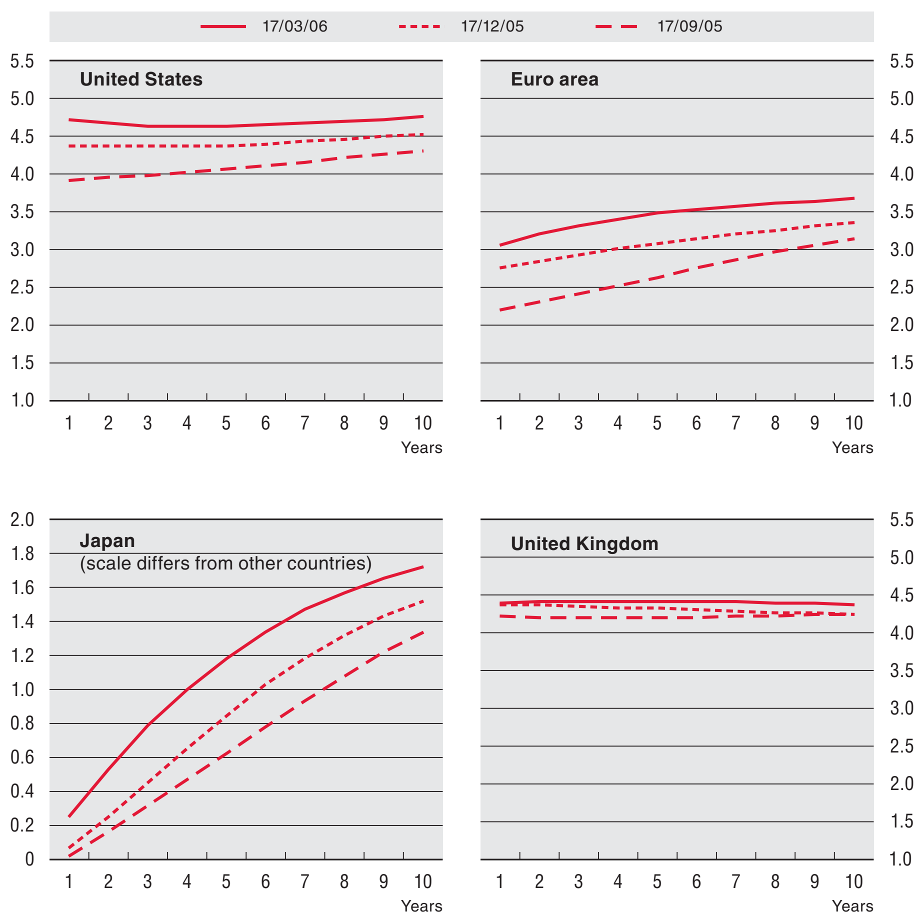
G7 real overnight rate, GDP weighted, inverted scale,
and actual money growth minus potential real GDP growth, in percentage points



Note: The global liquidity indicator based on real interest rate developments follows C. Borio and W. White (2004), "Whither monetary and financial stability? The implications of evolving policy regimes", BIS *Working Paper* No 147. The measure shows a weighted average of real overnight rates in G7 countries; for France and Germany, the Euro Overnight Index Average (EONIA) is used from 1999 onwards. The weights are based on USD GDP, and real rates are calculated by deducting three-month moving averages of year-on-year CPI changes from nominal overnight rates, including projected CPI changes in cases where most recent data have not yet been available. The other indicator focuses on G7 excess money growth (again as GDP-weighted average). Actual nominal money growth is the year-on-year growth of quarterly broad monetary aggregates; potential real GDP growth is corrected for trend velocity growth, *i.e.* it is a residual money growth measure derived from the quantity equation assuming zero inflation. Trend velocity growth is based on average velocity growth 1980-2002 in the respective economies, except for the euro area, where it is based on the mid-value of the range for velocity growth as assumed by the European Central Bank in deriving the quantitative reference value for monetary growth (0.75).
Sources: Thomson Financial Datastream; OECD, Main Economic Indicators and Economic Outlook Database; European Central Bank.

© OECD 2006

Figure 8. **Yield curves**



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

the euro area, following suit to its tightening step in early December last year – the first one after more than five years –, the ECB lifted its repo rate to 2.5 per cent on 2 March (becoming effective on 8 March). In making the change the ECB referred to upside risks to price stability from oil prices and, despite a disappointing fourth quarter GDP growth estimate, improving prospects from economic activity. Elsewhere, the Bank of England left its repo rate at 4.5 per cent (unchanged since the easing in August last year), while the

© OECD 2006

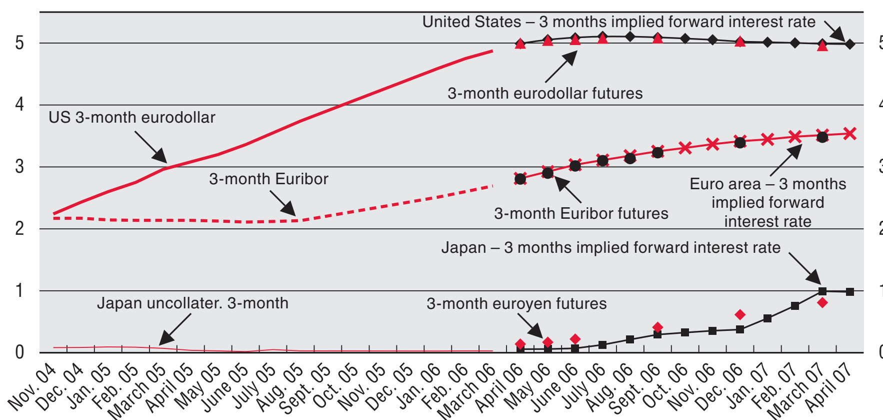
Bank of Canada raised its overnight rate target for the fifth time since last September to 3.75 per cent on 7 March, indicating that the Canadian economy is continuing to operate at its full productive capacity.

In Japan the BOJ announced the end of monetary easing, and while leaving interest rates at zero, investors expect short-term rates in Japan to increase later this year.

As price deflation continued to recede in Japan, the Bank of Japan (BOJ) ended its policy of quantitative easing. On 9 March it decided to change the operating target of money market operations from the outstanding balance of current accounts at the Bank to the uncollateralised overnight call rate. While at the same time it announced that it will encourage that rate to remain at effectively zero for the time being, investors expect – as implied by forward rates and futures – some upward movement in the course of the coming months (Figure 9). On the basis of similar measures for the US and the euro area, no further tightening is expected from the Fed, but investors see some further rate increases ahead by the ECB.

Figure 9. **Implied forward and futures short-term interest rates**

United States, euro area and Japan

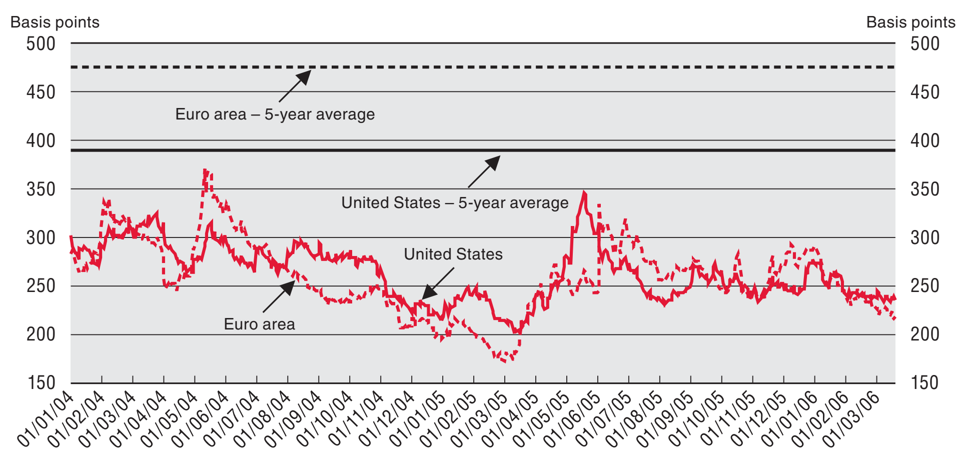


Note: Data as of 17 March 2006. Actual rates: United States: 3-months eurodollar middle rate; euro area: Euribor 3 month offered rate; Japan: uncollater. 3-month middle rate; monthly averages. Implied forward rates are derived from zero-bond yield curves. Eurodollar futures: 3-month (CME); Euribor futures: 3-months (LIFFE), euroyen futures: 3-months (TIFFE).

Sources: Thomson Financial Datastream, OECD.

© OECD 2006

Figure 10. **High-yield bond spreads**



Note: Daily data until 17 March 2006. Aggregate corporate high-yield bond yields minus aggregate corporate BAA bond yields (Lehman indices) for the United States; JP Morgan Maggie government spread of high yield credit, all sectors, all maturities, for the euro area.
Source: Thomson Financial Datastream.

High-yield corporate spreads remain compressed in the US and the euro area, but higher investment grade spreads in the Unites States indicate an ending upgrading cycle.

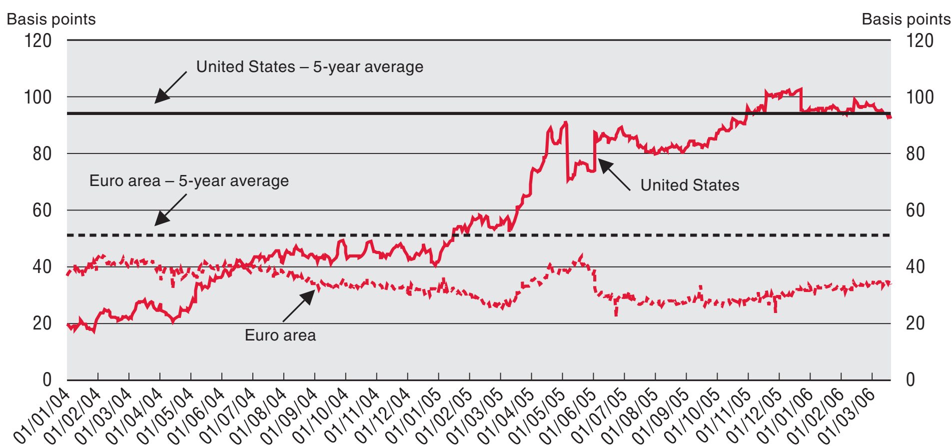
Spreads of high-yield corporate bond yields over those of BAA bonds have remained significantly below their longer-term averages in both in the United States and euro area and have even become further compressed over the past few months (Figure 10). While spreads of investment-grade bond yields over benchmarks have moved sideways in the United States and the euro area, they have remained at their 5-year average level in the United States (Figure 11). This higher spread level may mirror prospects that the cycle of upgrades may be coming to an end as easy financing through low interest rates is running out and corporate balance sheets may come under pressure. This may soon also show up in high-yield spreads, as surveys are indicating that many market participants expect corporate default rates in the high-yield segment to rise in 2006 and even further in 2007.

US bond issuance decreased slightly in 2005,…

Bond issuance in the United States has picked up strongly in the last quarter of 2005, with a substantial issuance by the financial as well as the government sector (Figure 12). However, owing to weak issuance in the previous quarters, total issuance in 2005 at USD 1 030 billion was slightly below the USD 1 088 billion of 2004. The biggest contribution came from the financial sector, with total bond issuance of USD 659 billion.

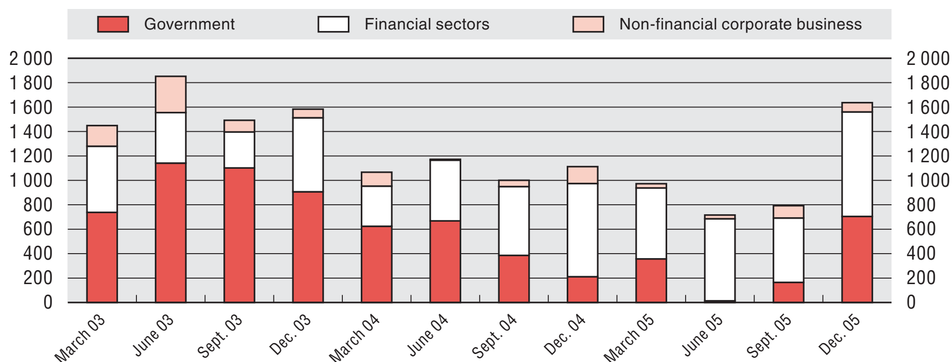
© OECD 2006

Figure 11. **Investment-grade corporate bond spreads**



Note: Daily data until 17 March 2006. Aggregate corporate BAA bond yields (Lehman indices) minus government benchmark bond yields for the United States; JP Morgan Maggie government spread of investment-grade credit, all sectors, all maturities, for the euro area.
Source: Thomson Financial Datastream.

Figure 12. **Net issuance of US bonds**
In 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.

in 2005, up from the USD 538 billion in 2004. Government issuance declined from USD 472 billion in 2004 to USD 310 billion in 2005, and issuance of corporate bonds slowed from USD 78 billion in 2004 to USD 61 billion in 2005.

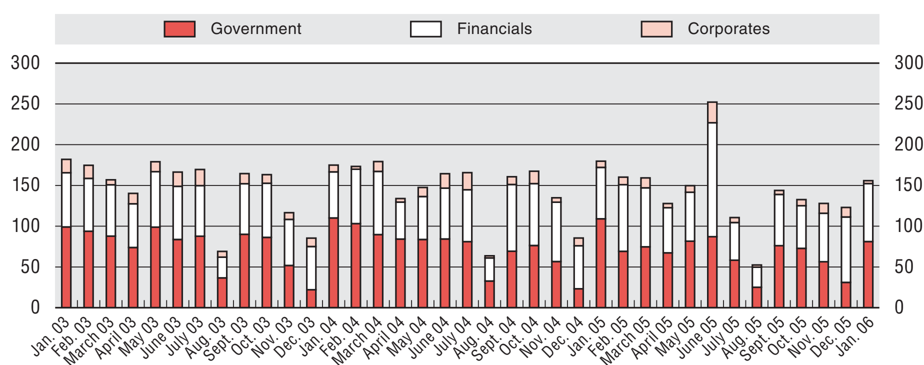
© OECD 2006

Issuance of euro-denominated bonds also declined on net in 2005 to a total of EUR 1719 billion as compared to EUR 1751 billion in 2004, mainly owing to lower issuance of government bonds (Figure 13). The latter declined from EUR 894 billion in 2004 to EUR 809 billion in 2005. On March 8 the German government issued its first inflation-linked bond, yielding about 5 basis points more than a comparable French issue.

... and so has euro-denominated issuance,...

Figure 13. **Euro-denominated bond markets: volumes issued by type of issuer**

In billions of euros



Note: Issues of a maturity of 1 year or more. “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 *Cédulas hipotecarias*, etc.

Note that, according to information from the European Commission, the surge in issuance by financial institutions and by non-financial corporations in June 2005 seems to be mainly related to the implementation deadline of 1 July 2005 for the new EU Directive on prospectuses, which will require most companies to update their borrowing programmes before returning to the market.

Source: European Commission (DG ECFIN).

With increasing demand from long-term investors, the share of longer-term euro-denominated bonds in total issuance has risen. In 2005, 55 per cent of bonds were issued in maturity segments of 7 years and above, up from 47 per cent in 2004. This trend has continued in January 2006, with 30 per cent of the issuance at maturities of 11 years and above. In February, the US Treasury reintroduced a 30-year bond after a gap of more than four years. Expected changes to regulations for US pension funds to improve duration matching (similar to UK regulations) foster expectations of higher demand for such longer-dated bonds in the future. In the same month, the European Investment Bank introduced

...but the share of longer maturities segments where demand is strong has increased.

© OECD 2006

a 30-year bond, becoming the first supra-national issuer in the long-term segment. Early in March, the UK government achieved its lowest yield ever on the sale of a 30-year inflation linked bond, highlighting the strong demand for longer-dated issues among pension funds and other long-term investors. The 0.91 per cent real yield of the issue was substantially lower than the 1.65 per cent on the last issue of these bonds in April 2005, but was up from market levels prevailing in mid-January when pension funds' uncertainty about the supply of ultra-long term bonds drove down the yield on the 30-year inflation-linked bonds to 0.69 per cent, and that on the 50-year inflation linker to 0.38 per cent.

Also the ABS segment has increased, and strong corporate issue lies ahead on both sides of the Atlantic.

Fuelled by strong housing markets in Europe, the issuance of asset-backed securities (ABS) increased over 70 per cent, from EUR 95 billion in 2004 to EUR 165 billion in 2005, and, based on scheduled issues, can also be expected to remain strong this year. Taking advantage of the still favourable prices to borrowers, European companies have scheduled further issues for the coming months, and many of them will include a change-of-control clause to protect investors from leveraged buyouts (LBOs). Investors' demand for such protection, giving them the right to sell the bond back at par to the company if in consequence of a takeover its credit is downgraded to speculative grade status, has risen as private equity firms have increased their capacity for ever-bigger LBOs. In the United States, a rise in takeover activity is spurring corporate issuance of ABS, which has reached its highest levels since 2001.

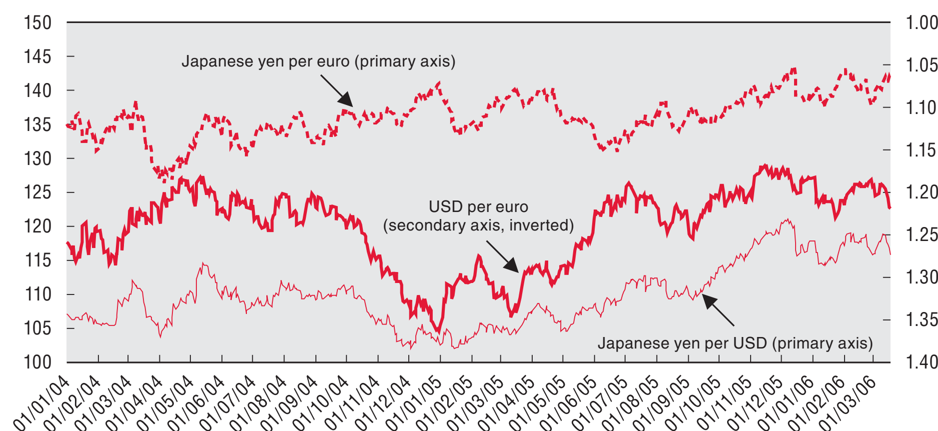
IV. Foreign exchange markets

Uncertainty about expected interest rate differentials and structural weaknesses led to fluctuations in the relative values of the dollar, euro and the yen.

Structural weaknesses apparent in macroeconomic data releases had interrupted the upward trend of the US dollar against the euro at the end of November, but it regained some strength at the end of January when the Fed's tightening fostered a more optimistic outlook and increased the interest rate differential between the US and the euro area, in particular at the shorter end of the yield curve (Figure 14). The yen had gained some strength ahead of the expected change in BOJ's policy stance towards tightening, but signals by the Bank that it intended to retain interest rates at zero increased investors' uncertainty. While there is only anecdotal evidence, some market observers expect that carry trades in

© OECD 2006

Figure 14. **Major exchange rates**



Note: Daily data until 17 March 2006.
Source: Thomson Financial Datastream.

which investors have borrowed at very low Japanese interest rates to acquire other, higher yielding assets elsewhere are likely to phase out. In the course of the unwinding of such positions, capital flows into Japan have already risen and are expected to rise further.

Asia still invests strongly in US assets, but net inflows from Japan turned negative recently.

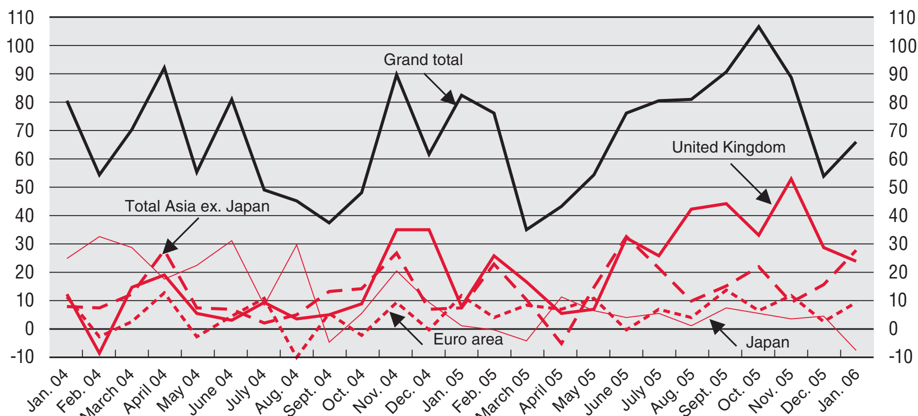
Such developments are also mirrored in data on net inflows into the United States, which show that despite an increase in total net inflows in January (USD 66 billion as compared to 53.8 in the previous month), the balance with Japan turned negative in that month, after having been at relatively low levels throughout 2005 (Figure 15). Inflows from other Asian countries, however, largely compensated for the drop in Japanese inflows. In January, net inflows from Asia, excluding Japan, stood at USD 26.6 billion, 11.7 of which came from China. Net inflows from the United Kingdom further dropped in January, after they had already decreased in December as compared to the November peak. However, with London being a financial hub, there is no straightforward geographical interpretation of UK flows from these data (TIC, as compiled by the US Treasury).

OPEC demand for US assets has increased.

With higher oil prices, a trend of OPEC countries investing their oil surplus in US assets ("petro-dollar recycling") seems to have firmed over the past few months (Figure 16).

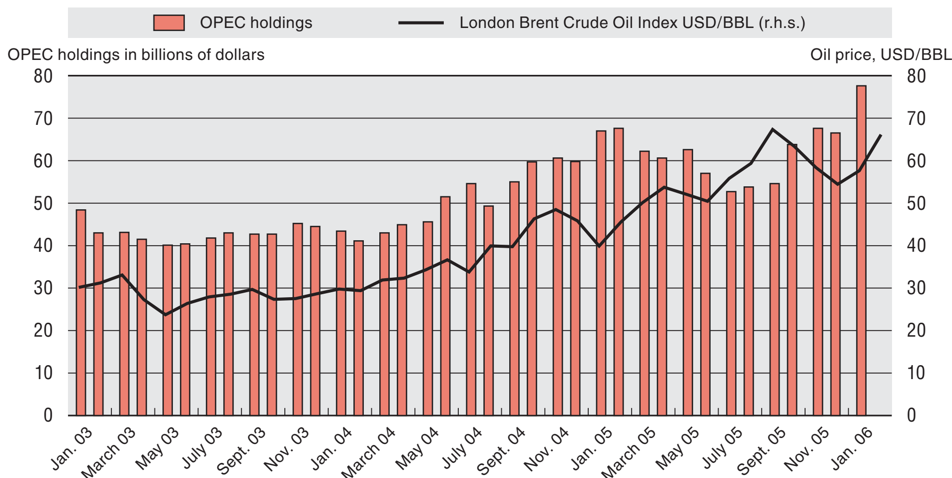
© OECD 2006

Figure 15. **Net portfolio flows into US by region**
Billions of US dollars



Note: Net portfolio flows are net purchases of assets by foreigners from U.S. Residents (gross purchases-gross sales).
Source: US Treasury, Treasury International Capital (TIC) Reporting System.

Figure 16. **OPEC holdings of US assets**
Total holdings of US assets by residents of OPEC countries,
in billions of US dollars and oil price in USD/BBL, monthly average



Source: US Treasury, Treasury International Capital (TIC) Reporting System; Thomson Financial Datastream.

© OECD 2006

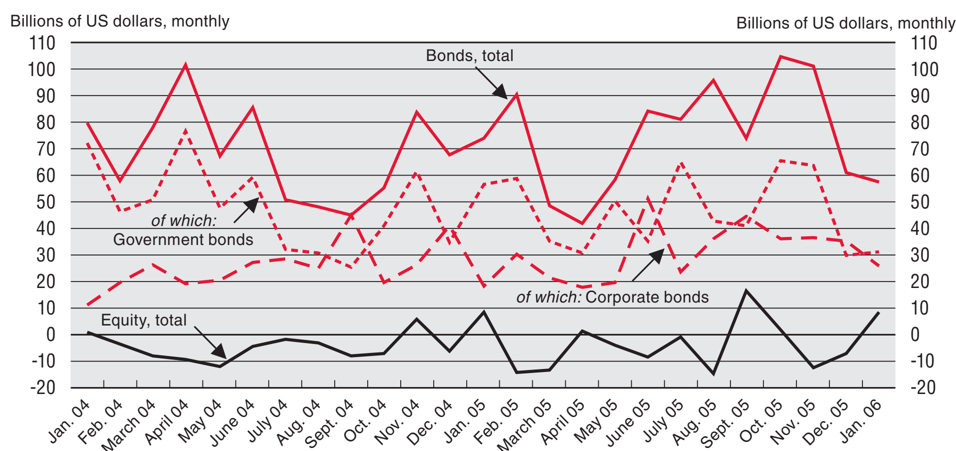
In January, OPEC countries' holdings of US assets increased to USD 77.6 billion, up from USD 66.5 billion in December and the high of USD 67.6 billion in November. So far, however, this is still only a small share of 3.5 per cent of overall foreign holdings of USD 2 187.6 billion in January. Japan, with a share of over 30 per cent, is still the major holder of US assets.

US government bonds are still favoured by foreign investors, but seem to have lost some of their attraction recently, with a net income balance in decline.

Most of the foreign investments in US assets are still in bonds, predominantly government bonds, but stocks have gained investors' interest more recently (Figure 17). Net inflows in bonds dropped to USD 57.6 billion in January, continuing a downward trend from the USD 104.5 billion peak in October 2005 owing to a decline in government bonds, while corporate bonds held relatively steady. Net inflows in the stock category rose to USD 8.4 billion, up from the negative balance in the two previous months. The overall negative balance in stock inflows into the US in 2005 (USD –47 billion) was rather due to high net purchases of equity abroad by US residents (USD 126.9 billion) than to still positive net foreign purchases of US stocks (USD 79.9 billion).

Figure 17. **Net portfolio flows into US by category**

Billions of US dollars



Note: Net portfolio flows are net purchases of assets by foreigners from U.S. Residents (gross purchases - gross sales). Bonds comprise US and foreign bonds; government and corporate bonds as shown here are US bonds only; equity comprises US and foreign equity.
Source: US Treasury, Treasury International Capital (TIC) Reporting System.

© OECD 2006

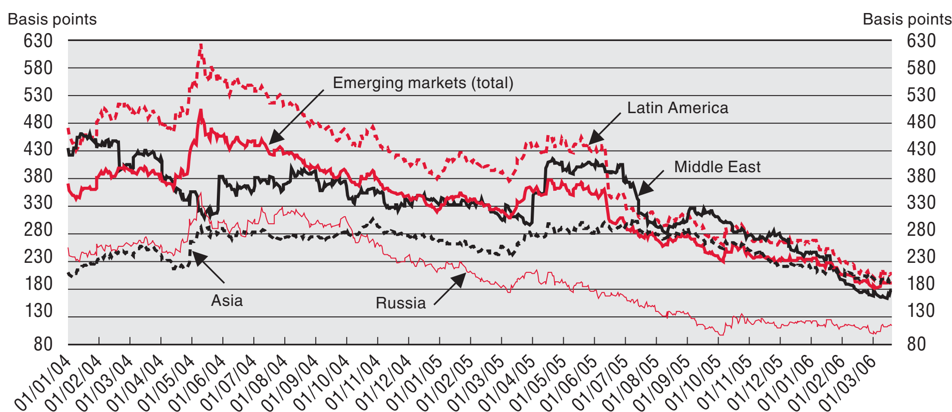
These trends in 2005 are also reflected in the fact that the asset income balance in the US current account declined by USD 28.8 billion , from USD 36.2 billion in 2004 to USD 7.4 billion in 2005, with negative balances in the second and fourth quarter. Overall, the US current account deficit reached a record of USD 805 billion in 2005, up by 20 per cent from 2004, now standing at 6.4 per cent of GDP, but was still slightly lower than total US net capital inflows of USD 867.9 billion in 2005 (TIC data).

V. Emerging markets

EMBI spreads continue at low levels as capital flows to emerging economies reach record highs.

Emerging market spreads have generally remained low (Figure 18). These developments have been driven by still relatively high liquidity, improving fundamentals in emerging market economies, and favourable growth in industrial countries. Inflows of capital into emerging markets have been strong in 2005, with total net private capital flows at a record of USD 358 billion, up USD 40 billion from 2004, and well above the previous record of USD 324 billion in 1996.

Figure 18. **Emerging market bond spreads**



Note: Daily data until 17 March 2006. JP Morgan EMBI Global blended spreads over US benchmark bond yields. EMBI Global covers US dollar denominated Brady Bonds, Eurobonds, Traded Bonds and local market debt instruments issued by sovereign and quasi-sovereign entities.

Note also that, according to information from JP Morgan, the strong drop from 10 to 13 June 2005 in the Latin American and, consequently, in the emerging markets total index is due to an intra-month rebalancing triggered by the Argentina debt exchange. As a result of the rebalancing, Argentina defaulted debt (with spreads of 5000 b.p. and above) was partially replaced with performing debt with much lower spreads.

Source: Thomson Financial Datastream.

© OECD 2006

The recent Icelandic stock market crash had some repercussions on emerging markets.

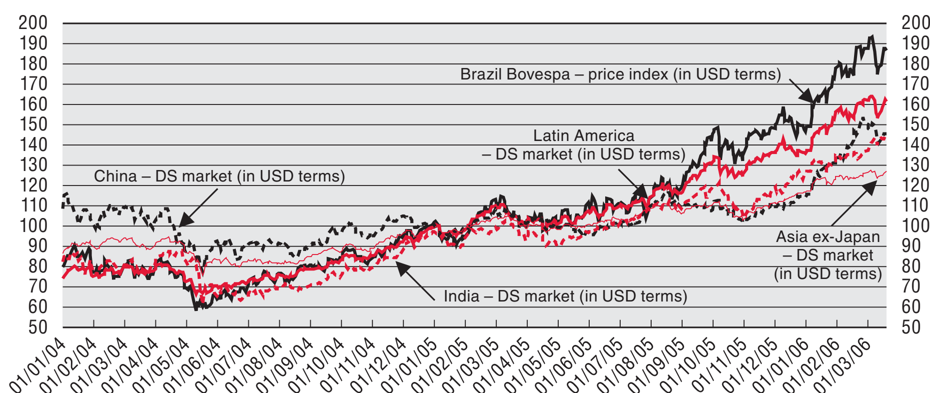
More recently, EMBI spreads tightened somewhat in the wake of the Icelandic stock market crash on 22 February. Against a background of a global liquidity withdrawal, this equity market collapse had spill-over effects among various asset classes and also hit emerging market bonds as investors reconsidered some of their emerging market exposure and some traders exited carry trades. The collapse was caused by a downgrading of Iceland by Fitch in its outlook over fears about an unsustainable Icelandic current account deficit similar to imbalances evident before the 1997 Asian crisis. So far, however, these contagion effects were only temporary – also, as according to market observers the apparent spill-over was mainly caused by traders trying to close their profitable emerging market positions to compensate for Icelandic losses.

Emerging stock markets have been buoyant...

After all, underlying fundamentals in emerging markets remain strong and emerging equity markets have continued their upswing over the past six months (Figure 19). Some recent drops in mid-March coincided with the BOJ's decision to change its monetary policy stance and were partly linked to the uncertainty around its new interest rate policy – and the uncertain interest outlook in the United States and the

Figure 19. **Stock market performance in selected emerging economies**

Equity price indices, 3-Jan-05 = 100, in US dollar terms



Note: Daily data until 17 March 2006.
Source: Thomson Financial Datastream.

© OECD 2006

euro area in general. The subsequent unwinding of hedge fund positions in particular in Brazil, where the real fell sharply, sent some shock waves to emerging stock markets, but they seem to have been only temporary.

...in particular in Brazil, owing to successful macroeconomic policies,...

Brazil again outperformed the sample of other emerging market indices, owing to investors' continued confidence in the positive outlook, with the current account being in surplus and the government still generating primary budget surpluses – despite growing expenditures. Like many other emerging market debtors, Brazil has also bought back part of its international debt which has also improved its rating (from BB- to BB for Brazil's long-term, foreign-currency sovereign debt). Its USD 6.6 billion buyback of Brady bonds announced later in February is to be concluded by mid-April and should save USD 350 million in interest payments (which would have to be paid through 2010).

... and also in China which has undertaken further steps in financial sector liberalisation...

China, which has taken some further steps towards financial sector liberalisation, also experienced strong stock market growth. In mid February, China announced its decision to harmonise accounting and auditing practices in line with international standards. Also in February, China's four largest banks signed up to trade foreign exchange via Reuters electronic trading system, giving them access to around 40 spot currency pairs, whereas previously they could trade non-renminbi currency pairs only via the China Foreign Exchange Trade System, a dealer-to-bank platform with less liquidity than Reuters.

... and India, where the economy is booming and plans for future full convertibility of the rupee are being discussed...

In India, with the economy and stock markets booming, the central bank has lifted interest rates over fears of overheating. Credit demand has surged recently, as foreign capital has increased liquidity and has driven down interest rates. Investors' outlook on the Indian economy and expectations of economic reforms moving forward may also reflect a plan by the government to consider withdrawing remaining currency controls announced by the Indian prime minister in mid March. Such a plan to make the rupee fully convertible had already existed in 1997 but was shelved in the wake of the devaluation of the Thai baht and the ensuing Asian Crisis. This time, the intended schedule would be to start a

© OECD 2006

mechanism to achieve full convertibility of the rupee in 2008, which would allow Indian residents to invest more freely overseas – above the current limits of 500 million USD per company per year – and give large companies easier and cheaper access to foreign debt.

…as well as in Russia where a financial sector reform package has recently been approved.

Stock markets are also booming in Russia, where they have shown a strong performance in 2005 after underperforming world markets in 2004. In mid February a reform package was approved which should improve market infrastructure, lower regulatory barriers to access to capital markets, and make financial reporting more transparent.

© OECD 2006