1 Evolution of financial markets

1.1 International financial market

1.1.1 Introduction

In the period extending from early 2001 to the midpoint of the following year, the international financial system was subjected to a rare sequence of highly adverse shocks that generated enormous impacts on its structure, operations and profitability. Despite this, when viewed as a whole, banking institutions in all parts of the world demonstrated considerable resilience to the unfavorable scenario and were not only profitable but managed to remain sufficiently capitalized. This fact in itself was enough to ward off systemic events in the majority of the different national markets. However, this does not mean that localized banking crises did not occur, particularly in Japan and Argentina.

The shocks faced by the international financial market originated in the real sector of the economy, which was marked by a worldwide recession in 2001 led by the United States, with very slow recovery in the pace of economic growth forecast for this year and next. Parallel to this, the period was marked by the end of the American stock market bubble, in a process that rippled out from telecommunications, media and technology companies (TMT) to the rest of the market. The loss of financial wealth impacted business capitalization, banking guaranties, indebtedness levels and consumption trends.

Among other negative factors, mention should be made of accounting frauds followed by bankruptcies and debt composition agreements involving large United States corporations. The announcements were
made in the context of an already depressed market and provoked highly negative impacts on investor confidence in corporate information and in regulatory agencies and, consequently, on their willingness to invest. Investments were further discouraged by a steady stream of announcements of lower-than-expected profit levels, pushing United States stock market indices to record lows.

The impact of the financial environment in the industrialized countries on the so-called emerging economies, particularly in Latin America, was evident in the downturn in net voluntary private capital flows and in the sharp increase in loan spreads. The localized downturn in international credits generated greater risk aversion on the part of foreign investors and cutbacks in exposure levels in what are termed high risk countries. Basically, this movement was caused by the demands of prudential regulations and national supervisory entities.

Finally, one should cite the negative impacts on the international growth outlook caused by rising tensions between the United States and Great Britain, on the one hand, and Iraq, on the other, as evinced in the recent upturn in the per barrel spot and futures prices of petroleum.

1.1.2 Recent international financial market evolution

The current scenario and outlook for the international financial market indicate a process of deterioration in the early part of the year. The unfavorable scenario was particularly evident in the downturn in net private capital inflows to the emerging economies and in financing operations with below investment grade debtors. The outlook for the international capital market during the remainder of this year and next year indicates low levels of global liquidity and lesser access to financing for adversely rated debtors. From the point of view of recovery of capital flows to emerging markets, a factor of decisive importance will be the still uncertain reduction in risk aversion among international investors and this, in turn, will certainly depend on a rise in their confidence levels, cutbacks in the risk exposure of their balance sheets and investment portfolios and
continued implementation or adoption of solid and sustainable economic policies in the countries targeted for capital investments.

With regard to projections of international capital flows to the developing countries, these forecasts have been substantially revised to reflect the deteriorating world economic scene. According to the April and September 2002 IMF World Economic Outlook (WEO), total net capital flows to these countries are expected to be less than originally expected both in the current year and next year. For 2002, projections were revised downward from US$83.9 billion to US$66 billion and, for the following year, from US$85.2 billion to US$71.9 billion. In the cases of Latin America and the Caribbean, the revised figures moved from US$49.5 billion to US$26.1 billion and from US$47.6 billion to US$41.1 billion in 2002 and 2003, respectively.

The evolution of the international financial market can be noted in the figures released by the Bank for International Settlements (BIS)\(^1\). In the second quarter of this year, international banking assets abroad – encompassing bank assets in countries different from that of the institution’s home offices plus the assets of their branches abroad, including those maintained with local residents in local currency – registered a slight 1.5% rise, after being adjusted for the effects of the dollar rate of exchange in relation to the currencies in which the loans were referenced. While the developing countries of Asia, Europe, Africa and the Middle East turned in growth in their international loan stocks, Latin America closed with a negative result as a consequence of increased perception of risk in the region and the statistical impact of second quarter depreciation of local currencies, particularly in Brazil and Mexico. Though it does not represent an effective cutback in credit lines or reduction in the rolling of matured operations, this latter effect does, in any case, reflect a situation of lesser exposure in the balance sheets of international banks.

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The stock of international banking assets held in Latin America came to US$491.9 billion at the end of the second quarter of 2002, reflecting a reduction of US$36.2 billion (6.9%) in comparison to the previous quarter, and to US$70.4 billion (12.5%), when viewed against the end of 2001. With this result, the region’s participation in total banking assets held in developing countries dropped from 39.8% and 41.4% to 36.9% in the same periods. Among the countries of the region, the sharpest drop in international credits in 2002 occurred in Argentina (US$31.8 billion, 43%) due to accounting write-offs, the banking system’s shift to the peso and cutbacks in exposure levels.

The stock of international banking assets in Brazil came to US$123.9 billion in June 2002, for a reduction of US$18.5 billion, or 13% in the year. Viewed in terms of final risk maintained in Brazil, BIS highlights the concentration of this position in the banking sectors of the United States, Spain and Holland which, taken together, account for 54.5% of total loans to the country. It should also be noted that individual exposure levels represent 0.5%, 1.5% and 0.9% of the total international assets of each of the national banking systems in the order cited above.

At the same time, prudential regulation in the banking sector may well be influencing the cutback in international loans. The need for considering and estimating, ex-ante, the risks involved in each operation for the purpose of defining the level of provisions in the balance sheets of banks, results in a situation in which the regulations may take on pro-cyclical characteristics, in seeking to protect the equity situation of each institution. This is due to the fact that constitution of provisions has a direct negative impact on capital since it reduces the institution’s Basel capital ratio and, in more extreme circumstances, may force the institution to capitalize or reduce its higher risk assets. However, one should certainly stress the positive effects of regulations on banking systems, particularly in light of the fact that they have been able to withstand the current process of economic downturn and remain fundamentally healthy.
Parallel to the lesser volume of credit operations, this deterioration is also evident in increased spreads, both for investment grade companies in certain sectors, including the financial sector, as confirmed by BIS, and companies below investment grade that are trying to cope with more difficult conditions of access to financing. The emerging countries, particularly those in Latin America, have been seriously impacted by these liquidity restrictions.

Recent stock market evolution in the major industrialized countries has been resoundingly negative. In the 1990s, stock markets moved sharply upward, particularly in the sector classified within the so-called “new economy”. The performance of the variable income market was important to that growth to the extent that it made it possible to achieve across-the-board expansion in financing, with particularly positive impacts on new projects as initial public offers expanded. At the same time, this performance also stimulated growth in consumer spending, as a result of the wealth effect.

Starting in mid-2000, however, the speculative bubble burst and, since that time, markets have been characterized by a long and accentuated decline in the indices and capitalization levels of the companies listed. Among the causes indicated for this performance, mention should be made of the slow recovery registered in the industrialized economies in the wake of the 2001 recession; accounting frauds in major corporations that have clearly undermined investor confidence; successive announcements of lower-than-expected profits and cutbacks in dividends to be paid; and increased volatility of indices in a framework of growing aversion to risk. Taken together, all of these factors contributed to an increase in demand for fixed income papers and help to explain the recent drop in earnings on ten year United States government papers.

In 2002, despite the fact that United States stock markets registered highs in February, May and August, the Dow Jones, Standard and Poor’s (S&P) 500 and National Association of Securities Dealers Automated Quotations (Nasdaq) indices registered losses between 26% and 43% in the year up to the end of September, as the Dow Jones closed the month below 8,000 points and the Nasdaq index at 1,172 points. In relation to the historical highs of these indices in
early 2000, the reduction in the value of open capital corporations measured by the major indices came to 35.2% for the Dow Jones, 46.6% according to S&P 500 and 76.8% for Nasdaq.

The negative performance of stock market indices has a direct impact on the capital base of the companies listed. In the case of nonfinancial companies, the reduction in their market value can represent the need for strengthening the guaranties offered in credit operation or, in more extreme cases, restrictions on their access to credit. For banks, this loss may well demand additional capitalization or reductions in the risk level of their funding operations to meet the demands of prudential regulations. The joint capitalization of the New York Stock Exchange (NYSE) and Nasdaq, which had come to US$18.2 trillion in September 2000, dropped to US$11.3 trillion in September of this year, reflecting a drop of US$3.1 trillion in the current year alone.

The stock indices that measure the performance of European and Japanese markets performed in a manner similar to the United States. The Financial Times Securities Exchange Index (FTSE 100), which is used as the London exchange index, registered a reduction of 30.1% in the current year, while the Deutscher Aktienindex (DAX), which is the index used at the Frankfurt market, declined by 47.9%. The Nikkei index, used in Tokyo, also turned in a negative growth performance, with a loss of 13.7% in the year up to September. When the figures for the end of September 2002 for these three stock indices are compared to their highpoints in early 1999, the result points to falloffs of 46.3%, 65.7% and 55%, respectively.
In the exchange market, the dollar declined, particularly as of March. In mid-July, the dollar reached maximum depreciation in the year, with 1.0117 dollars/euro and 115.81 yens/dollar, for reductions of 13.7% and 12% in the same order compared to the start of the year. Though the United States currency did register some degree of recovery in the following period, at the end of September accumulated depreciation still totaled 10.9% in relation to the euro and 7.5% in relation to the yen.

Depreciation of the dollar is a consequence of deteriorating expectations regarding economic recovery and the performance of financial markets, which had been seriously undermined by the scandals provoked by successive announcements of accounting fraud. In this framework, marked as it is by uncertainties regarding the pace and structure of the adjustment of foreign accounts in the United States, the deficit in the current accounts balance, expressed as a percentage of GDP, came to 5.01% in the second quarter of this year and has been expanding since the third quarter of 2001.

However, more recent evolution suggests that external adjustments must be more gradual and ordered, without generating excessive impacts on world financial stability. These expectations incorporate maintenance of United States financial assets as the risk benchmark for the world, permanence of the dollar as the international currency for financial and trade operations and, at the same time, the very limited economic growth dynamics of the economies of the major countries that could compete with the United States in attracting investments.
1.1.3 Financial institutions

The impact of the adverse international financial climate on banks has been limited. Taken as a whole, financial institutions in the United States and Europe remain solid, with adequate levels of capitalization and positive profitability, though they have been impacted by domestic and foreign losses. The most probable outlook for financial institutions is continued systemic solidity, though several specific countries have had to cope with banking crises.

In the case of the United States the market value of banks has dropped sharply as a result of involvement in accounting frauds or exposure to companies that have had to restructure their debts, at the same time in which the industry itself has been hard hit by the recession. However, despite all this, the sector has registered increasingly larger quarterly profits since the third quarter of 2001, according to the Federal Deposit Insurance Corporation (FDIC). In the second quarter of the current year, net profits of commercial banks came to US$23.4 billion, the highest level of the historic quarterly series. Despite this result, the number and volume of bank’s assets facing problems has increased. The number of commercial banks classified as problematic hit the mark of 115 in June, the highest level since the end of 1996. Parallel to this, the assets of these institutions have been stable since December 2001, reaching a level of US$36 billion, the highest mark since 1994. In relation to the dimensions of the United States commercial banking network guarantied by the FDIC, the number of problem banks is equivalent to 1.4% and their assets to 0.5%.

Insofar as bank investments in the United States are concerned, the annual report known as Shared National Credit Program, which was released on October 8 by the Board of Governors of the
Federal Reserve System (Fed), FDIC and Office of the Comptroller of the Currency (OCC) and compiles and analyzes information on syndicated loan operations above US$20 million, indicated an ongoing process of deterioration in the quality of loans. In June, the data base encompassed loans totaling US$1.9 trillion or 18% of GDP, reflecting a reduction of 8.7% compared to 2001 and involving more than 9 thousand operations for 5.5 thousand clients. Of this total, US$236 billion, or 12.6%, were adversely rated, including credits with effective and potential difficulties, registering growth of US$43.3 billion in relation to the result for the previous year which, in turn, had already grown by US$93.1 billion in comparison to 2000.

The overall growth of these loans and of the adversely rated operations seems to follow the evolution of the nation’s macroeconomic situation rather closely. Three distinct moments can be distinguished. The first extending up to 1998, marked by sharp credit growth, coupled with a decline in adversely rated operations. In the period up to 2001, loan growth decelerated and adversely rated credits increased rapidly, possibly as a result of a certain attenuation of the criteria applied in the previous period. Finally, in 2002, total loans dropped, further increasing the proportion of problem credits.

In Europe, banks with stock holdings or high levels of exposure in companies/sectors involved in telecommunications, media and technology and those institutions following an international growth policy targeted to Latin America were the hardest hit. For example, Banco de España required – and the nation’s banks complied with the demand - full provisioning of the investments made by Spanish banks in Argentina.
In Japan, the problem of matured and unpaid loans was further aggravated by deficiencies in corporate governance. This has become the major economic concern of that country. The expansionary fiscal policy followed in the 1990s also aided in postponing a definitive solution to the problem by providing support to such industrial sectors as construction, real estate and nonbanking financial services, precisely the major sources of poor quality loans in Japan.

As of April 1, 2001, Japanese banks, which had previously recorded their assets at their historic value, had to shift into the system that forces them to review their balance sheets and adopt a marked-to-market methodology. Obviously, this resulted in even greater losses given the low value of these stocks.

Currently, the Japanese banking system accumulates a total of ¥52.4 trillion (US$428 billion) in matured and unpaid loans. Evidently, this has had a strong impact on credit flows. In order to introduce greater dynamics into its credit system, the Bank of Japan opted to adopted the strategy used in Hong Kong in 1988 and utilize part of its external reserves of US$456 billion to acquire approximately US$200 billion in stocks directly from banks. This decision represents one more attempt to reduce the losses generated by declining stock prices since, to the extent that the market index drops, banks become more reluctant to write-off matured and unpaid loans.

Under the impact of the prolonged economic and political crisis that has held the economy in a state of stagnation, the Argentine banking system has had to cope with an increasingly grave situation. Starting in 2001, the worsening economic scenario generated a crisis of confidence in the system that resulted, in turn, in an outflow of deposits over the course of the year and, in December, obligated the government to adopt a series of severe restrictions on bank withdrawals. The end of the system of currency convertibility in early 2002 and adoption of asymmetric rules for conversion of bank assets and liabilities into local currency, justified by the high degree of the population’s indebtedness in foreign currency, further aggravated the situation and provoked accentuated equity distortions in financial institutions.
1.2 National financial market

Aside from the factors already analyzed in the evaluation of the international financial market, the behavior of the domestic market over the course of 2002 was also impacted by the uncertainties of the electoral process. Increased perceptions of public sector credit risk, the downturn in the volume of foreign capital inflows, uncertainties surrounding the financing of the balance of payments and increased risk aversion on the part of investors produced considerable local market instability, coupled with alterations in domestic asset prices.

Notwithstanding this turbulence, the financial market followed a relatively tranquil trajectory marked by increasingly higher levels of confidence up to the month of March 2002, following a period of extreme volatility in the second and third quarters of 2001 which reached a peak in the wake of the events of September 11.

The economic policy measures adopted by the government in the second half of 2001 were of fundamental importance to the stability that marked the early part of the year. Among these, mention should be made of the signing of the IMF agreement, the increase in the target for the fiscal surplus, Banco Central’s policy of daily exchange market interventions, placements of exchange securities, high compulsory reserve levels and increased capital requirements for exchange exposure. Another factor of importance was the reversal in the expectations that had generated the excessive pessimism of mid-2001 or, in other words, better perception on the part of market agents of balance of payments financing conditions and the clear differences between the Brazilian and Argentine situations.

In this sense, the period between November 2001 and March 2002 was marked by upward movement in the rate of exchange, declines in the level of the Brazil risk and recovery in Ibovespa. The more positive macroeconomic situation and the projected decline in inflation made it possible to achieve consecutive 25 base point reductions in the basic interest rate target, as defined by Copom in its February and March meetings.
At the end of February, Banco Central announced exchange swap operations as a complement to sales of exchange securities. This measure was taken in light of the possibility of difficulties in rolling the debt in the second half of the year, in the context of a financial market characterized by severe uncertainties. These auctions began toward the end of March and, initially, were combined with National Treasury LFT offers.

With this new instrument, Banco Central sought to repeat the sale of exchange securities with the added advantage of offering two instruments instead of just one (exchange swap + LFT versus NTN-D), thus making it possible for the market to negotiate them separately and more effectively. The new system made it possible to individually price the risk of exchange growth, of the exchange coupon and LFT, thus stimulating a drop in the premiums demanded in the auctions.

The exchange swap auction was also viewed as a way of avoiding the turbulence that had been observed in the exchange coupon curve, while preventing secondary and undesirable impacts on monetary policy implementation. Starting in May, Banco Central initiated direct placements of exchange swaps with no ties to LFT purchases. This was seen as a way of facilitating the rolling of the market exchange hedge in an environment of growing difficulties for sales of public debt securities.

The National Treasury’s strategy for the internal securities debt in the period was concentrated in issues of preset papers (LTN) and was able to take advantage of the low differential between the Selic rate and the long-term interest rate. The interest curve registered the same negative inclination in some periods. The reason for this
was the expectation that the Selic rate target would be reduced in a more aggressive manner due to perceptions of an absence of aggregate demand pressures and Banco Central’s position that monetary policy would be analyzed over longer time periods to verify compliance with inflation targets. As a matter of fact, the participation of preset papers in the federal public securities debt moved from 7.8% in December 2001 to 9.8% in April 2002.

With regard to the debt indexed to the Selic rate, LFT placements were suspended in the period from October 2001 to January 2002 and their participation in total debt dropped to about 50% in April. To some extent, the upward movement in the rate of exchange generated a reduction – albeit moderate – in the stock of the exchange debt. It should be noted that this debt had increased by R$64.8 billion over the course of 2001, reflecting exchange depreciation and net issues of R$28.1 billion in exchange securities, mostly to meet growing demand for hedging.

Starting in the month of April, uncertainties regarding the macroeconomic policies of the new federal administration coupled with a worsening external scenario, led to upward movement in the level of the Brazil risk, exchange depreciation and lower stock prices. The Embi Brazil moved from about 700 base points to 2,400 base points in the period from March to September. In the same period, the rate of exchange depreciated by 40% and Ibovespa dropped by 35%.

The increase in perceptions of public sector credit risk and financial market tensions were also evident in the process of devaluation and the high volatility of public securities in general. Discounts in LFT prices followed an upward curve, reaching a peak of 2.75% in August 2002. In this environment of declining public security prices,
the CVM and Banco Central recommendation that investment funds comply with the obligation of marking-to-market, as regulated in 1996, provoked a wide ranging process of recomposition of the portfolios of domestic investors, with migration from investment funds into savings deposits, time deposits and even demand deposits.

The exchange coupon curve rose sharply and reflected the less favorable scenario evident as of May. Starting in July, the curve turned negative mostly as a result of a shortage of dollars on the spot market, of the rolling of the mostly short-term exchange debt and low liquidity in the long segment of the curve, due to the reduced maneuvering space available to financial institutions to assume risk.

In order to stabilize this situation, Banco Central carried out an unprecedented number of public security purchase and exchange operations, aimed at reducing the average term of the LFT held by the market and reverse the process of growing discounts in the prices of these papers. Long-term LFT were exchanged for LFT with maturities in 2002 and 2003 were made, together with a series of purchase options. In order to neutralize the monetary impact of the security purchase program, Banco Central adopted an August increase of 3 p.p. in compulsory reserve rates on demand deposits and time deposits, and 5 p.p. on savings accounts. It should be noted that, in June, Banco Central had already raised compulsory reserve rates on savings deposits by 5 p.p.

Furthermore, Banco Central carried out NBCE and NTN-D exchanges for exchange swaps and LFT without altering the risk exposure of investment fund portfolios. These operations made it possible to release a significant volume of guaranty margins at BM&F through simple offsetting of the asset and liability positions of the stock funds, thus generating greater liquidity and reducing the volatility of quotas.
With regard to primary security auctions, as of the month of May Treasury operations were concentrated on short-term LTN offers in amounts below the volume of maturities. With this, the internal federal securities debt remained practically stable through the second half of the year, despite the impact of exchange depreciation on the stock of securities indexed to exchange. On the other hand, the position of excess banking liquidity, expressed by the difference between the volume of banking reserves and compulsory reserves on time deposits, sterilized daily by the Banco Central open market dealers desk, moved from R$5 billion at the end of April to R$27 billion, at the end of September.

Though it has grown as a result of exchange depreciation, the debt indexed to exchange diminished when this effect is isolated. Thus, the stock measured in dollars shrank from US$77 billion at the start of the year to US$68.8 billion in September. Net redemptions of exchange securities added up to R$28.5 billion in accumulated terms for the year, or practically equal to net 2001 placements of the same paper. It is interesting to note that the performance of demand for exchange papers in 2002 vis-a-vis the previous year was precisely the opposite. Demand for exchange hedge in the nonfinancial sector, represented by still open exchange swap contracts at Cetip, turned in a reduction of US$13.7 billion in 2002 up to the end of September, compared to an increase of US$15 billion in 2001.

The measures taken by the Banco Central and the Treasury made it possible to stabilize discounts on public securities and reverse the migration into investment funds. It is important to stress that, at that point, monetary policy was facilitated by the preventive measures taken in the 2000/2001 period, when an effort was made to lengthen the term of the public securities debt, avoid debt maturities between the final quarter of 2002 and the first quarter of 2003 and form a liquidity cushion for the Treasury.
1.3 Conclusion

The current scenario and outlook for evolution of the international financial market registered sharp deterioration over the course of 2002. To a great extent, the unfavorable environment is a result of cutbacks in net inflows of private capital to the emerging economies, particularly those located in Latin America, as well as restrictions on access to financing on the part of below investment grade debtors. Among the factors responsible for these new financial market conditions, one could list the slow pace of world economic recovery, particularly in the United States in the wake of the 2001 recession; large scale corporate frauds involving multinational companies; forecasts of lower business profits; reductions in business confidence and, especially, in consumer confidence; and accentuated growth in risk aversion on the part of investors. Taken as a whole, these factors led to some degree of reduction in the liquidity conditions of the international market.

International capital market forecasts project continuation of low global liquidity and more difficult financing for adversely rated debtors. There are other extra-economy risks that deserve mention, such as the growing tensions that have marked ongoing conflicts in the Middle East which, in turn, have exerted upward pressure on oil prices.

Despite the adverse factors noted in 2001 and 2002, one should highlight the absence of systemic banking crises in practically all countries. In general, the solidity of national banking sectors, as reflected in adequate levels of capitalization and profitability is due, among other factors, to greater financial market diversification, with a larger number of agents involved in assuming risks; improved prudential regulations, with adoption of international standards by an increasingly greater number of countries; and the current situation of relative monetary policy stability in the major industrialized countries. In the cases of Japan and Argentina, their banking crises were fundamentally due to developments in their national economies and to adoption of specific economic and sectoral policies.
With respect to the domestic financial market, performance has showed adequate levels of solidity and profitability, despite the influence of the highly adverse external situation, as evident in reduced international liquidity and significant changes in the risk perception of foreign investors. The use of monetary policy instruments by Banco Central, including such new instruments as exchange swaps, and more traditional ones, like compulsory reserves, was decisive in overcoming the impacts of the volatilities that marked the financial market in 2002. At the same time, both Banco Central and the National Treasury took measures aimed at stabilizing discounts on public security operations and reversing the migration of resources out of investment funds.