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Concluding Remarks by the Chair
Global Financial Stability Report
Executive Board Meeting 02/20
February 27, 2002

Executive Directors have had a fruitful and wide-ranging discussion on the inaugural edition of the *Global Financial Stability Report*, which will become an important tool in strengthening the IMF's multilateral surveillance of international financial markets, and helping the Fund in looking forward and drawing policy implications that support its role in promoting international financial stability and preventing crises. The planned quarterly frequency of the report should enable the Board to keep up with fast-changing events in financial markets. Also, Directors welcomed the combination of the two previous publications, *International Capital Markets Report* and *Emerging Market Financing Report*, into a single document, which should eventually result in a focused and more integrated surveillance of international capital markets. Directors made many useful and constructive suggestions for improving the structure, focus, coverage, and format of the report. For example, many Directors hoped to see a broader, more balanced geographical coverage of developments in mature and emerging financial markets, expanded coverage of financial innovations, and a continuation of the in-depth analysis of emerging market financing that characterized the *Emerging Market Financing Report*. While underscoring the importance of balancing between the timeliness and the comprehensiveness of the report, Directors supported the staff's effort to incorporate a few current issues that may have a significant bearing on financial market stability. The staff will reflect upon and take into consideration these and other suggestions in revising this report and especially in preparing future issues. I believe there was a broad understanding among all that the report should maintain and enhance its forward-looking approach and not shy away from discussing the policy implications of global financial market developments.

Recent Developments and Risks

Directors welcomed the recovery in global markets and reduction in global risk aversion since the fourth quarter of 2001. They noted the remarkable turnaround in market sentiment regarding the strength and speed of a U.S.-led global economic recovery. Overall, Directors concluded that financial markets have responded well to the uncertainties that arose in the context of the slowdown and the events of September 11, and have recovered quickly once it became clear that economic prospects were improving.

Directors noted that, so far in 2002, mature equity markets have shown lackluster performance, reflecting widespread concerns about accounting problems that, among other things, reduced transparency on the true extent of leveraging undertaken by corporations and financial institutions during the boom years.

In emerging markets, Directors agreed that contagion from the default and devaluation in Argentina has been subdued. More careful discrimination by investors across emerging markets, a variety of technical factors, and the adoption of sound economic policies—such as the move to more flexible exchange rates, higher official reserves, lower short-term debt, and stronger current account positions—have contributed to the resilience of emerging markets during the fourth quarter of 2001 and beyond. However, it was recognized that risks remain, as events in Argentina are still unfolding and there is significant uncertainty going forward. Contagion might become evident with some delay in the form of slower capital flows, including foreign direct investment, to some emerging markets. Furthermore, Directors observed that any unexpected changes in the global risk environment or the global economic outlook could have an adverse impact on emerging market borrowers.

Stability Implications of Global Financial Market Conditions

While the international financial system has remained resilient in the face of serious disruptions, global financial conditions worsened during 2001 across a broad range of markets, institutions, and sectors. Deteriorating credit quality and corporate earnings were reflected in higher corporate bond spreads and lower stock prices. These price adjustments adversely affected the balance sheets of corporations and households, which had increasingly relied on markets during the 1990s, adding to the pressure from cumulated financial imbalances. The slowdown has also affected financial institutions, although the systemically important institutions in the United States and Europe seem to be well capitalized. Directors acknowledged the heightened strains in Japan's financial system, and underscored the importance of decisive moves by the Japanese authorities to deal with the longstanding weaknesses in the banking, insurance, and corporate sectors.

Turning to the outlook for global financial market conditions, Directors agreed that the main risks relate to the potential for a subdued or delayed global recovery. With asset prices seemingly reflecting expectations of a near-term economic rebound, a subdued or delayed recovery could give rise to market corrections. These corrections could put stress on household and corporate balance sheets, thereby weakening consumption and investment spending. Directors noted that Japan and emerging-markets borrowers could experience particularly adverse effects in this scenario. The adjustment could also include a temporary and selective withdrawal from risk-taking by financial institutions. At the same time, however, Directors considered that the resilience of the international financial system during financial disruptions in the 1990s, which reflected important elements of dynamism and self-correction, is cause for optimism that the adjustments will be manageable.

Credit-Risk Transfer Market

Directors noted that credit-risk transfer markets have grown very rapidly in recent years, reflecting the useful role that these markets play in spreading risk among economic agents and contributing to portfolio diversification, and in providing alternative sources of liquidity. Some Directors saw the markets as working reasonably effectively, despite the global economic slowdown, and were confident that current weaknesses in the legal and operational infrastructure will be resolved as the markets evolve. Directors considered that concerns about the activities of new and less-regulated participants in credit markets could be addressed by improved disclosure and transparency. Many Directors also called for strengthened oversight of nonbank and nonfinancial entities that are active in financial markets. They expressed concern that regulatory arbitrage may be shifting risks to institutions least capable of managing them, and that accounting and auditing standards and practices may be deficient in several major countries. These Directors suggested that updating the supervisory and regulatory frameworks to keep pace with the evolving credit-risk transfer markets should be a top priority in the period ahead.

The Need to Further Develop Early Warning System Models

Directors agreed that an important element for effective market surveillance and crisis prevention is the development of forward-looking models that could provide advance warning of a country's vulnerability to crisis and of the build-up of systemic risk in financial markets. Although such early warning could be a useful instrument for helping the Fund to provide timely advice to prevent crises, Directors cautioned that, given their current limited predictive power, early warning system (EWS) models should be used carefully and in conjunction with qualitative and other methods of vulnerability assessment. With this caveat in mind, Directors supported the staff's efforts to refine the EWS models now being used in the Fund's work. These efforts could also usefully complement work at the national level on early warning systems. Noting that currency crises are not the only threat to financial stability, most Directors welcomed the staff's efforts to develop the basic building blocks of a more general early warning system able to predict other types of crises, including debt and banking crises.

The Role of Alternative Financing Instruments

Directors urged caution on the use of alternative debt instruments, other than plain vanilla bonds and regular loan issues, to maintain access to global capital markets in times of financial difficulties. While acknowledging that some of these instruments may be useful under certain conditions, Directors generally stressed that they should not substitute for strong economic policies and sound debt management practices, which are the main foundation for sound and sustainable access by emerging markets to international capital markets. They noted that where high bond yield spreads reflect investor concerns about a country's solvency, the use of some of these alternative instruments could make the problems worse.