BUFF/02/72

May 30, 2002

Concluding Remarks by the Chairman
Global Financial Stability Report
Executive Board Meeting 02/53
May 29, 2002

Executive Directors welcomed the more streamlined and integrated format of the second Global Financial Stability Report (GFSR) and its coverage of conditions in both mature markets and emerging markets. They considered that the report is taking shape as a key tool of the Fund's multilateral surveillance of international financial markets, although, going forward, we will need to reflect further on how to make this report as effective an instrument as possible in the context of Fund surveillance. While acknowledging the difficulties and constraints involved, Directors encouraged the staff not to shy away from its forward-looking approach in its assessments, and many Directors called on the staff to explore more fully the policy implications of financial market developments—possibly by further focusing each report on a few selected special topics. Directors also encouraged continued close collaboration between the International Capital Markets Department (ICM) and the Research Department (RES) to coordinate this report's coverage with that of the World Economic Outlook (WEO) in order to ensure complementarity and coherence between the two reports. The staffs of ICM and RES are already working together to address, in the context of the next round of WEO/GFSR, a number of the issues related to the financial market implications of the outlook for the U.S. dollar and the valuation of other major currencies.

Recent Developments and Risks

Directors noted that, in the context of an improved global economic outlook, no imminent threat to global financial stability appears to exist. Stock prices were broadly unchanged in the United States and Europe in the first quarter of 2002, as concerns over the recovery and quality of reported earnings weighed heavily on the stock prices of highly-leveraged firms and of firms that had been active in mergers and acquisitions. At the same time, emerging market bond and equity markets rallied in the first quarter, reflecting new inflows from dedicated investors and increased interest from crossover investors. Directors noted the increased bond market flows to emerging markets during the first quarter of 2002, which, in spite of decreased overall capital flows, have allowed many sovereigns to satisfy substantial portions of their 2002 financing needs. Although most emerging markets have been largely unaffected by the continuing turmoil in Argentina, Directors noted that conditions in emerging markets have weakened more recently and spreads on the EMBI+ have widened.

Despite the generally improved conditions in international financial markets, Directors observed that important risks and uncertainties remain in key countries and market segments. In particular, uncertainties about the outlook for corporate earnings in mature markets, along with heightened concerns about corporate accounting and disclosure practices in the wake of Enron's collapse, have contributed to the risk of equity price corrections and have adverse implications for commercial bank profitability. In addition, while European stock markets have experienced a significant correction, high U.S. price/earnings ratios have raised questions about the sustainability of valuations in the US market. Meanwhile, a recovery in Japanese stock prices has relieved pressure on domestic financial institutions, although significant institutional fragilities and market vulnerabilities remain. A number of Directors also noted that the recent depreciation of the US dollar could be a signal of shifting capital flows that could have implications for global financial markets. Other Directors pointed to the need to assess the prospects for foreign direct investment flows to developing and emerging market countries.

Some Directors warned that if economic conditions in Argentina deteriorate further, wider contagion effects cannot be ruled out. Directors underscored the importance of rapid progress by the Argentine authorities in putting in place a strong program with international support. Most Directors considered that a further deterioration in the condition of Japan's financial and corporate sectors might also give rise to international spillovers. Such spillovers could occur through a disorderly repatriation of assets, a further decline in Japanese flows to emerging markets, a rapid depreciation of the yen, or losses to investors and institutions that are exposed to Japan. However, Directors noted that three factors have moderated these risks. First, overseas investment opportunities remain more attractive than domestic opportunities, limiting the risk that Japanese investors will liquidate overseas assets on a large scale. Second, Asian emerging-market countries are in better shape than in past years to cope with the adjustment that might accompany reduced capital flows from Japan. Third, many international financial institutions have reduced and tightly managed their exposure to Japanese markets and counterparties. Furthermore, it was noted that the Japanese Government is firmly committed to taking whatever measures are necessary to prevent a financial crisis, and that Japanese stock prices have been on an upward trend in 2002—the latter suggesting that the downturn in the Japanese economy may be flattening out and that corporate profits would be recovering. Nevertheless, Directors agreed that there is no room for complacency in dealing with the critical issues of corporate and financial sector reforms in Japan.

Financial Market Activities of Insurance and Reinsurance Companies

Directors welcomed the coverage of issues pertaining to the insurance sector. They noted that insurance and reinsurance companies have become an increasingly important class of institutional investors and financial intermediaries, which convey important benefits to international financial markets by adding to market liquidity and the diversity of market participants. In this context, Directors believed that more information needs to be made available on the market activities of insurance and reinsurance companies, by category of insurance (such as life and non-life insurance), and particularly in newer market segments such as credit derivatives. In addition, they suggested that the regulatory and supervisory frameworks might need to be modified to reflect these companies' expanding asset-market activities and any attendant implications for financial stability.

Directors broadly agreed that the international systemic risks associated with insurers' financial markets activities seem relatively limited compared with those of the major internationally-active investment and commercial banks. Nevertheless, uncertainties remain about whether insurers' capitalization and risk management systems fully reflect the risks associated with their expanding financial markets activities. There are also questions about whether these activities contribute to a migration of financial risks from the banking to the insurance sector. These issues complicate an assessment of the potential systemic risks associated with the expanding financial markets activities of insurance and reinsurance companies, and underscore the importance of improved disclosure and transparency.

Emerging Equity Markets

Directors also found the coverage of emerging equity markets issues quite useful. They noted that the experience with the banking crisis and the loss of access to international capital markets during the Asian crisis of the late 1990s had emphasized the need to develop local securities markets to provide a more stable source of sovereign and corporate funding. Directors considered that the relatively low dollar equivalent returns on emerging market equities over the last decade underlined the need both for more stable macroeconomic conditions and for an adequate domestic and international investor base for this asset class. In this regard, they stressed that making improvements in the legal framework and in corporate transparency and governance would also improve emerging market equity performance. Directors noted that the migration of top-quality emerging market corporates to major mature market financial centers has taken a toll on the liquidity of emerging equity markets, and emphasized that improvements in the trading infrastructure in emerging markets will be crucial for expanding emerging market equities as an asset class. They urged the staff to consider how best to work with member countries to help them develop and improve the functioning of their equity markets, including through more effective use of technical assistance in this area.