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Concluding Remarks by the Chairman
Global Financial Stability Report
Executive Board Meeting 02/89—August 28, 2002

Executive Directors broadly agreed with the thrust of the staff's analysis of financial markets developments, risks, and policy issues in the latest Global Financial Stability Report (GFSR). They welcomed the report's progress in forward-looking analysis and frank discussion of risks, which they encouraged, and generally agreed with the staff's recommendations for heightened vigilance and policies aimed at bolstering financial stability. They considered the GFSR to be a useful complement to the World Economic Outlook Report, and asked the staff to continue to ensure complementarity and coherence between the two documents. Directors made a variety of other suggestions on structure, frequency, and documentation. We will reflect on these suggestions and come back to them once we have completed a full year of GFSRs. Directors also looked forward to the results of the staff work underway, together with the World Bank, on the financing of foreign direct investment.

Key Developments and Sources of Financial Markets Risks

Directors noted that, notwithstanding the recent rebound in equity prices, conditions in global financial markets have deteriorated significantly during the period under review, reflecting eroding investor confidence and heightened risk aversion. A combination of corporate earnings disappointments, increased investor pessimism and uncertainty about the earnings outlook, and further corporate accounting scandals has triggered re-pricings and volatility in a range of markets. Higher-risk borrowers, including those in emerging markets, face tighter terms of market access as investors have reduced their appetite for risk. In addition, portfolio rebalancing by international investors appears to have contributed to downward pressure on the U.S. dollar and on U.S. asset prices.

Looking ahead, Directors assessed several potential sources of risk to international financial stability in both mature and emerging markets. In mature markets, a risk remains that investor trust and confidence could erode to a point where investors withdraw en-masse from risk taking, triggering further corrections in corporate securities markets and a greater cutback of lending, especially to high-risk borrowers. Relatedly, accumulated losses could impair the capital positions of financial institutions, exacerbating a withdrawal of risk taking and lending, including to emerging market countries. Some Directors also warned that a fall in housing prices in the United States could impair the economic recovery and feed back onto financial markets. Some others, however, felt that real estate prices fundamentally reflected strong demand and low interest rates. In addition, Directors considered the potential for further changes in the pattern of international capital flows as foreign purchases of U.S.

financial assets slow and the dollar weakens. There remains a risk that if international investors reappraise the risk-adjusted return on investments in the United States relative to other countries, a rapid slowdown of net capital flows into the United States could result, potentially triggering increased volatility in the major currencies and disorderly adjustments in financial markets.

Notwithstanding these risks, Directors underlined that so far the global financial system has shown considerable overall resilience in the face of dramatic asset price movements and significant financial losses for investors. This favorable outcome has reflected the dispersion of corporate and financial risks to nonbank financial institutions and households, as well as the relatively favorable capital and liquidity positions of major financial institutions prior to the deterioration in market conditions and credit quality. As a result, Directors noted, market adjustments have remained orderly, and an overall flight from risk that might derail the global recovery or threaten financial stability has been avoided. Most Directors agreed with the staff's assessment that, for the reasons laid out in the report, financial resilience and stability are likely to be maintained in the future. Directors considered that the probability of a sudden, sharp reversal of capital flows to the United States is low, given the relative underlying strength of the U.S. economy and the seeming perception among investors that the risk-adjusted expected returns on U.S. assets are superior to those on major alternatives. Also, it was noted that past adjustment by major countries did not seem to have been disruptive or involved serious threats to systemic financial stability. Some Directors, however, considered that an assessment of the balance of risks regarding the future resilience of the financial system must, for the present, remain cautious, particularly since any conclusions regarding the adequacy of the policy response so far must still be considered preliminary.

Turning to emerging markets, Directors noted that some countries are experiencing financing difficulties because of a reduction of net capital inflows. At the same time, there are signs of investor discrimination as certain investment-grade credits have remained largely immune to the recent turmoil. Most Directors concurred that the recent episode of contagion, emanating from Brazil, serves as a reminder of financial market risks. In addition, there is a risk that the apparent retrenchment of cross-border lending by mature-market banks could spread from South American countries to other emerging markets. Concern was also expressed that the high concentration of lending to emerging markets within a relatively small number of institutions could lead to spillovers that could affect some emerging markets with investment grade ratings. However, Directors stressed that, in assessing possible contagion risks, it should be borne in mind that there are important differences among economies that make some of them more resilient and less subject to financial contagion. Markets have differentiated among economies, as exemplified by the continued market access for some emerging economies in Asia, Europe, and parts of Latin America. Nevertheless, Directors suggested that a more active role by the Fund in informing market participants about these differences could help reduce contagion. At the same time, Directors stressed the importance of continued vigilance and policy continuity in core emerging market countries, particularly those that are currently subject to political uncertainties. Directors also urged the authorities of emerging market economies to maintain a transparent and stable legal framework, which is a sine qua non for sustainable inflows of foreign direct investment.

Directors agreed that action by national authorities and international bodies could help to promote stability in global and key national financial markets in the period ahead. They stressed the importance of continued financial surveillance by the Fund, including through such instruments as the Financial Sector Assessment Program and Reports on the Observance of Standards and Codes, and called on financial regulators to be vigilant for signs of further weakness in key institutions and markets. In advanced countries, policies should continue to support economic activity and an orderly reduction of imbalances over the medium term. In addition, Directors emphasized that strong implementation and enforcement of steps to improve corporate governance, accounting, disclosure and transparency, together with close monitoring by national authorities and the Fund, would be helpful to strengthen markets' self-correcting forces. In emerging market countries, strong policies to bolster macroeconomic and financial stability would help investors to discriminate more clearly between countries as investment destinations. National authorities should also encourage the development of sound and diversified domestic financial systems.

Emerging Local Bond Markets

Directors endorsed the development of local bond markets as an alternative source of financing, and were encouraged by progress made in this area since the Asian crisis. While by no means a panacea, they considered that local bond markets could mitigate the adverse effects of lost access to international capital markets or bank credit, while widening the menu of instruments to deal with inherent currency and maturity mismatches faced by emerging markets borrowers. Directors emphasized the importance of well-developed primary and secondary markets and the roles of foreign investors in these markets.

Despite their rapid growth, emerging local bond markets remain a small part of the increasingly global bond market. Accordingly, Directors stressed the need for appropriate policy initiatives to further develop local markets, including steps to increase market depth and transparency, establish benchmark issues and yield curves, improve market infrastructure, and develop a local investor base. Directors also emphasized that the deepening of the local government bond market should not come at the expense of depth in the corporate bond market, where progress has often been slower in part as a result of crowding out by the government sector. They encouraged the staff to continue to work with national authorities to identify factors that inhibit the development of deeper local bond markets.