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Concluding Remarks by the Chairman
Global Financial Stability Report
Executive Board Meeting 02/116—November 22, 2002

Executive Directors noted that global investor sentiment in the third quarter has been weighed down by concerns over the strength and durability of the global economic recovery, the prospects for corporate profits, and geopolitical conditions. Heightened investor risk aversion has contributed to tiering by credit quality and to continued difficult financing conditions for higher risk corporate and sovereign borrowers. Despite unusually high volatility, global financial markets have nevertheless remained resilient, while an adjustment in asset prices and a reduction in risk taking was appropriate in the wake of past excesses.

Going forward, Directors stressed the need for continued strong vigilance to guard against a further deterioration in investor sentiment and an excessive swing in the pendulum away from risk taking. They agreed that, to help face these risks, macroeconomic and structural policies, in both mature and emerging markets, should aim at boosting investor confidence while maintaining financial stability.

Key Developments and Sources of Risks in Major Financial Centers

Directors observed that the retrenchment of risk taking in the major financial centers has occurred amidst heightened investor risk perceptions and the continued unwinding of bubble-period excesses. Retail investors, notably U.S. households, have suffered further losses, and concerns have risen about banks' and insurance companies' profitability and asset quality, particularly in some European countries. While progress in strengthening financial infrastructures and enhanced capabilities for managing and dispersing financial risks have helped maintain financial stability, and system wide problems are seen as unlikely, Directors noted that, looking ahead, investors and intermediaries remain vulnerable to downside risks. A renewed decline in equity prices could further erode the balance sheets of U.S. households and key European financial institutions, and a prolonged worsening in the operating environment for major financial institutions could undermine their profitability and asset quality. Many Directors also saw a need for close monitoring of developments in the U.S. and U.K. housing markets, whose strength has so far been an important factor in supporting the recovery. Directors also considered the risk that a further deterioration in market conditions in the major financial centers would result in additional cutbacks in risk taking and lending to riskier borrowers, including in emerging markets, with negative implications for global financial stability and economic growth.

Against this backdrop, Directors highlighted several policy measures that, taken together, should help ward off an excessive cutback in risk taking, rebuild investor confidence, and strengthen the markets' self-correcting mechanisms. Macroeconomic policies in the advanced economies should remain responsive to any signs that economic recovery may be faltering. In Japan, strong implementation of financial and corporate sector reforms remains critical to restoring investor confidence. Building on ongoing progress in several countries, Directors urged continued measures to improve transparency and address revealed shortcomings in corporate governance, accounting, auditing, and investment banking practices. Speedy conclusion of the Doha trade negotiations and implementation of other trade liberalization moves would improve confidence in economic prospects, and provide emerging market countries with an opportunity to increase their export earnings and, ultimately, strengthen their debt-servicing capabilities. Supervisors of nonbank financial institutions, particularly insurance companies—and, in a number of cases, pension funds—should be vigilant for signs of significant capital erosion stemming from falling asset prices. Furthermore, the increased reliance of financial institutions upon credit risk transfer instruments to manage their risks warrants enhanced disclosure and regulatory scrutiny.

Emerging Market Financing Conditions

Turning to the emerging markets, Directors observed that emerging market countries have continued to face a difficult environment, characterized by unusually high financial market volatility, increased risk aversion and tiering by credit quality. This environment, coupled with earlier concerns over policy continuity in some key emerging markets, resulted in a continuation of sharply reduced flows and tight external financing to emerging markets as a group, affecting in particular non-investment grade issuers. Although in the primary markets unsecured access has been effectively closed to noninvestment grade issuers in Latin America, broad-based contagion has nevertheless been limited, with investment grade issuers and Asian and Eastern European issuers benefiting relatively open access. Looking ahead, Directors considered that an increase in risk aversion in the major financial centers would exacerbate the financing difficulties faced mainly by sub investment grade borrowers and limit liquidity in the secondary market for emerging market bonds, thereby amplifying price movements. Some Directors observed that recent signs of some increase in risk appetite among global investors, if sustained, would mitigate these concerns. Many Directors also highlighted the importance of continued confidence-building measures by the new administration in Brazil to improve the tone in the global financial centers toward Brazilian sovereign bonds and the region, more generally.

Directors considered that the continued ability of some emerging markets to continue to tap international capital markets in the current environment illustrates the importance of strong commitment to the continued implementation of policies aimed at maintaining macroeconomic and financial stability and strengthening institutional frameworks. This should include the implementation of sound debt management strategies which, market conditions permitting, avoid debt structures that amplify external shocks, and the deepening of local financial markets to facilitate the issuance of longer-term instruments denominated in local currency and help provide a buffer to turbulence in the external financial environment. More generally, Directors stressed that firm commitment to the preservation of property rights, the rule of law, transparency, and stability in the legal and regulatory frameworks are key to fostering investor confidence and building a stable investor base.

Financial Derivatives in Emerging Markets

Directors welcomed the discussion of financial derivatives in emerging market economies, noting that the rapid expansion of these instruments over the past decade was among the key factors facilitating the increase in global cross-border capital flows. They observed that emerging derivatives markets present opportunities as well as certain risks. While derivatives can play a positive role in contributing to a more efficient allocation of risks in financial markets, these instruments can also be used to avoid prudential safeguards and take on excessive leverage. Directors noted that in some of the recent emerging market crisis episodes, the rapid unwinding of derivative positions has accelerated capital outflows and exacerbated the crisis dynamics, although it was stressed that derivatives are not the ultimate cause of the crises. Moreover, deep and liquid local derivatives markets can help market participants to price and manage the risks associated with investing in emerging markets more efficiently.

In light of this, Directors considered that the development of local derivatives markets, including the underlying legal and market infrastructure, can be usefully integrated into a broader and well-sequenced strategy of development of local securities markets. They emphasized the importance of transparency and adequate financial supervision to prevent the build-up of financial system fragilities, and encouraged the staff to continue to work on formulating policy recommendations in this area to promote the appropriate use of derivatives in emerging markets. Directors looked forward to further discussing these issues in the context of the next GFSR.

Future Developments of the GFSR

Directors considered that the completion of the first annual cycle of quarterly reports provides an appropriate opportunity to take stock and consider the periodicity and scope of future reports. They noted with satisfaction that, in a short period of time, the Global Financial Stability Report has become a useful tool of multilateral surveillance of financial market developments and risks, complementing the World Economic Outlook exercise. At the same time, they also made many valuable suggestions to further sharpen and deepen the analytical and policy scope of the report, including through more in-depth analysis of the interactions and transmission mechanisms between financial market and real economy developments, as well as structural issues that shape the operation of financial markets. While some Directors would prefer continuation of quarterly reports, there is a broad agreement that the quality of the report would benefit from moving to a semiannual cycle, timed to coincide with the World Economic Outlook discussions, as this would facilitate the complementarity of the two reports. Directors also suggested regular joint sessions with the Research Department and the International Capital Markets Department in the off-cycle quarters at the time of the WEMD sessions to allow for a frank exchange of views on the situation of the world economy and the international financial system. Many Directors also supported the proposal to prepare, in the quarters falling between the two semiannual reports, a short update, which some Directors suggested should focus on the financing conditions of emerging markets. At the same time, however, today's discussion has again highlighted that the GFSR should maintain its focus on developments and risks in global financial markets, including those stemming from mature markets. To further improve the analytical content and discussion of policy implications in the report, Directors encouraged more cooperation between the International Capital Markets Department and other departments. They also called on staff to examine how to incorporate the analyses produced by other monetary institutions.