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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 02/116

10:00 a.m., November 22, 2002

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Executive Board Attendance

H. Köhler, Chairman
S. Sugisaki, Acting Chair

Executive Directors	**Alternate Executive Directors**
	A.S. Alazzaz
	A.A. Al-Nassar, Temporary
	L. Rutayisire, Temporary
I.E. Bennett	D. Lewis-Bynoe, Temporary
M.J. Callaghan	
F. Zurbrügg	N. Davletov, Temporary
	R. von Kleist
	C. Harzer, Temporary
P.C. Padoan	L. Rizzotti, Temporary
	H.E. Phang, Temporary
	C. Sia, Temporary
Y.V. Reddy	R. Gauba, Temporary
	J. Jonáš, Temporary
	S. Kropas, Temporary
	B. Gulbrandsen, Temporary
	A. Baukol, Temporary
	P.A. Dohlman, Temporary
	S. Boitreaud
A. Mirakhor	M.A. Ahmed, Temporary
	L. Palei, Temporary
	I. Zakharchenkov, Temporary
	M. Beauregard, Temporary
	M.A. Brooke
	D. Taylor, Temporary
	R. Steiner
	A. Maciá, Temporary
	J. Milton, Temporary
	Y. Patel, Temporary
A.S. Shaalan	N.H. Farhan, Temporary
Wei Benhua	Jin Z., Temporary
J. de Beaufort Wijnholds	A.D. Marinescu, Temporary
K. Yagi	T. Sekine, Temporary
G.R. Le Fort	D. Vogel, Temporary

A.S. Linde, Acting Secretary
B. Esdar, Acting Secretary
J. Puig, Assistant
M. Pedroni, Assistant

Also Present

IBRD: P.Conroy, Director, Global Partnerships Department; L. Promisel, Senior Advisor Global Partnerships Department. Asia and Pacific Department: D. Burton, Director; W.S. Tseng, Deputy Director; C. Browne, D. Cowen, K. Kochhar, S. Nolan, A. Richter-Hume, S. Schwartz, A. Wolfson. European I Department: B. Banerjee. External Relations Department: G. Hacche, Deputy Director; C. Andersen, G. Bhatt, J. Hayden, B. Murray. International Capital Markets Department: G. Häusler, Director; H. Tran, Deputy Director; W. Alexander, A. Bertuch-Samuels, C. Blitzer, A. Ilyina, S. Iorgova, C. Kramer, M. Muhleisen, J. Odenius, K. Ohashi, D. Ordoobadi, L. Pedersen, J. Roldos, G. Schinasi, C. Schnure, S. Seshadri, M. Singh. Legal Department: Y. Liu. Monetary and Exchange Affairs Department: G. De Nicolo, A. Gulde, G. Sensenbrenner. Policy Development and Review Department: M. Allen, Deputy Director; Y. Metzgen, M. Schulze-Ghattas, M. Walsh. Research Department: M. Kumar, J. Ostry. Secretary's Department: L. Hubloue, P. Ramlogan. Treasurer's Department: E. Brau, Treasurer; L. Mayor. Western Hemisphere Department: I. Ivaschenko. Office of the Managing Director: V. Read, Personal Assistant; S. Tiwari, A. Tweedie. Advisors to Executive Directors: E. Azoulay, M.P. Bhatta, J.A. Costa, B. Couillault, S.S. Farid, P.R. Fenton, P. Gitton, F. Haupt, A.R. Ismael, H. Litman, Liu F., F. Manno, M.F. Melhem, J. Milton, P.A. Nijsse, S. Rouai, K. Sakr, J.N. Santos. Assistants to Executive Directors: A. Alber, S. Alcaide, D. Baasankhuu, T. Belay, V. Bhaskar, X. Bonnet, Cao L., N.J. Davidson, V. de los Santos, M. Di Maio, N. Epstein, R. Gauba, E. González-Sánchez, C. Gust, T. Hadded, C. Harzer, H.-H. Jang, T. Komatsuzaki, T.-M. Kudiwu, R. Maino, P. Moreno, T. Moser, G. Nadali-Ataabadi, T.P. Nguema-Affane, K.S. Oo, P.R.D. Prasad, A. Rambarran, Y. Saito, B. Siegenthaler, T. Skurzewski, A. Stuart, S. Urinbaev, Wei X., A.Y.T. Wong, N. Yeritsyan.

1. REPORT BY THE MANAGING DIRECTOR

Length: 20 minutes

The Managing Director made a statement on the review of the MAE department.

The Managing Director made the following statement:

I would like to take this opportunity to update the Executive Directors on the review of MAE.

The Review Group, headed by Arminio Fraga, has now delivered its report to management.

Let me first say that I am grateful to all the external and internal members of the Review Group which, as you may recall included Charles Goodhart, Jacob Frankel and Joseph Yam, as well as Yusuke Horiguchi, Mohsin Khan, Teresa Ter-Minassian, and John Dodsworth. I am specially indebted to Governor Fraga for undertaking this work during what must have been a very intensive period for him in Brazil.

The Group has delivered a comprehensive report which touches across all key areas of MAE work and organizational structure. Management has already forwarded this Report to MAE and received MAE's reactions. In order to carry forward the recommendations of the Review Group, while carefully taking into account MAE's reactions, management has appointed an internal task force headed by Jack Boorman to assess the recommendations and advise management on how to implement them. The work of the internal task force is to be concluded by the end of the year.

I am aware that a few Directors had inquired about the timing of the Board discussion of the FSAP and ROSC reviews. Management has decided to endorse staff's proposal to postpone Board consideration of these two papers from mid-December to early in the New Year so that the Board papers could incorporate and benefit fully from the recommendations of the Review Group.

Finally, I would like to mention one point that I also told Mr. Ingves several weeks back. All members of the management team, and I in particular, are deeply indebted to the management and the staff of MAE for taking on and delivering successfully—despite a constantly increasing workload—several initiatives that this Board has approved and management has asked MAE to undertake during the last few years. I very much appreciate MAE's exemplary cooperation with the work of both the Review Group and the task force.

2. GLOBAL FINANCIAL STABILITY REPORT

Documents: Global Financial Stability Report (SM/02/347, 11/8/02; and Cor. 1, 11/12/02)

Staff: Häusler, ICM; Tran, ICM: Ordoobadi, ICM

Length: 2 hours, 50 minutes

Ms. Indrawati and Ms. Phang submitted the following statement:

> Investor risk aversion remained high in the third quarter, reflecting the gale force strength with which investor confidence has been shaken by the unmasking of questionable corporate and accounting practices. This has been exacerbated by the continued sluggishness of the global economy. The GFS Report has indeed covered the most important aspects of the global financial market and staff have not only provided a very good analysis of key developments but have also written the report in a non-alarmist fashion. We agree with the main thrust of the analysis but on a more forward-looking note, we would like to highlight a few areas of concern.
>
> First, staff's assessment is that even though gross investment flows for the first nine months have declined significantly compared to the same period last year, the global financial system has thus far "remained resilient". Second, staff has also concluded that despite the various developments discussed in the report, the "risks to international financial market stability remain limited and manageable". While we appreciate staff's sensitivity to the herd mentality of investors and therefore the importance of being non-alarmist in view of the decision to publish the report, the relatively sanguine assessment appears to be at odds with warnings in various parts of the report, such as the dire consequences for equity markets and therefore the balance sheets of financial institutions, companies and households should revenue growth be not forthcoming. In this vein, we would appreciate staff's response to the following:
>
> Is there a firm basis for the much hoped for recovery? For the past few years, growth in the United States has been driven mainly by auto and property sales financed by easy credit. However, employment has declined further and continued increases in auto sales do not appear to be sustainable. At the same time, a study reported by The *Wall Street Journal* showed that the increase in the median price of houses for 100 large cities in the United States has significantly exceeded the increase in the median income level. This appears to support concerns that the long run-ups in property prices cannot be sustained, given the huge increase in unemployment (e.g., median house prices have exceeded growth in median income by 66 percent for Boston, 61 percent for Portland, 60 percent for San Diego, California, 51 percent for New

York, 40 percent for San Francisco, 30 percent for Washington DC, 21 percent for Houston, Texas and 20 percent for Chicago).

The United States has reported a 3.1 percent growth in GDP in the third quarter but this continues to be driven mainly by domestic demand. It is reported that the increase was largely due to two items, namely, motor vehicles and computers. In the case of computers, demand increased by $4.8 billion to $77.4 billion in the third quarter. After adjustment for inflation (with the use of the Hedonic Index), the increase became $28.3 billion or 32.2 percent of the $72.8 billion increase for the third quarter GDP growth. In the case of motor vehicle, higher sales were achieved largely through the offer of generous “triple zero” consumer incentives, i.e. zero percent financing, zero down payment and zero payment until six months later. It has been estimated that these incentives have cost the auto companies $2,300 per vehicle, and in many cases, this has meant their having to make losses on such sales. Hence, one major component of GDP growth appears to be unsustainable. Indeed, sales for the second largest auto company in the world (also the fourth largest company in the world) had declined by more than 30 percent in October. This company is estimated to have more than $150 billion in debt outstanding, of which some $20–30 billion has to be rolled over in 2003. This company therefore had to issue ten-year bonds which sold at a significant premium above U.S. treasuries of a comparable maturity, and it has been estimated that the company’s earnings have now sunk to half of its interest cost on its debt. Could this example of this auto firm be only the tip of the iceberg just as Enron was? If so, what would be the implications for the U.S. bond market, its financial system and the economy?

Profit figures reported by banks in the United States do appear to support staff’s assessment that “U.S. bank earnings and credit quality have fared reasonably well” (page 27). The reason given by staff for the favorable performance is that “they disintermediated credit risk to markets and investors, syndicated loan risks to overseas banks, and diversified loan credit risk across firms and sectors”. The $45 billion profit reported for the first half of 2002 have already surpassed the profits made for the whole of 1994. However, some sources have estimated that U.S. banks as a whole have a notional derivatives holding of 81 times their equity capital, 13 times their loan portfolio and more than seven times their asset base. While we are not sure of the exactness of those estimates, certainly the orders of magnitude do provide a basis for concern especially in view of the well-known accounting problems associated with derivatives. Staff have correctly pointed out that although financial derivatives allow investors to reallocate risks to a larger pool of investors, including those overseas, they also provide opportunities to avoid prudential safeguards. At the same time, we are concerned that derivatives, which are supposed to reduce risk by spreading it among a larger pool of investors, may actually serve to concentrate them in a handful of major financial institutions because of the wave of mergers worldwide. In the

United States, for example, three financial institutions hold more than 80 percent of total derivatives. Could staff provide an idea of the orders of magnitude of the problem in Japan and major European countries? What is the risk that the manifold increase in derivatives since 1998 ($50 billion to an estimated $2.4 trillion in December 2002) together with the high rate of bond defaults in 2001 and 2002 contain the seeds of a credit market bubble that is on the verge of bursting and what measures are needed for a soft landing?

If growth remains sluggish at best, investors generally would realize that the promise to pay is not quite the same as the ability to pay. To what extent would this combination of sluggish global recovery with the rapid growth of debt worldwide as well as the phenomenal amount of derivatives imply the collapse of the international financial system and the need for a fresh look at the international financial architecture? What measures would staff recommend apart from sound macroeconomic policies and transparency?

In the emerging markets, staff have highlighted a litany of problems that prevent these economies from obtaining badly needed financing. Indeed, it appears that a vicious cycle is in progress, where economies already hit by the global downturn and struggling with structural inadequacies, are effectively cut off from the financial markets, thereby exacerbating their situation.

The broad-based investor risk aversion can be seen in the significantly lower issuance of all types of securities, across all emerging markets. Staff have pointed out that "so long as the external environment remains turbulent, and uncertainty over policy continuity in key emerging markets persists, risks for emerging markets will remain elevated." This does not bode well for such economies given that the outlook in the key industrial countries have been continuously downgraded, while the domestic difficulties in the emerging markets are unlikely to be resolved quickly.

Investor discrimination, tiering by credit quality and hence the concentration of funds flow into certain markets would not mitigate the threat of contagion, if several of the sub-investment grade countries collapse at the same time. It might not be an exaggeration to suggest that we might well be on this destructive path in the light of the problems faced by Latin-American countries, both the ones capturing the headlines, and the ones not yet at the brink, but on shaky ground nonetheless. We would like to ask staff to elaborate further on these risks, and discuss how we should be dealing with them. Given these risks and the fact that the U.S. economy has again "hit a soft spot", just months after recording a tentative upturn from the last recession, we would like to ask staff what is their short-term assessment for emerging markets. What is the probability, in their opinion, of a confluence of negative events triggering a widespread crisis in the emerging markets?

There is no doubt that sound macroeconomic management is of utmost importance for all countries. However, experience has clearly demonstrated that despite their pursuit of sound macroeconomic management, many countries have still been badly affected by events that have largely been outside their control and this is especially true for many of the developing countries. Since it is clear that they will not be able to gain access to the capital markets while at the same time that they are faced with a significant cut-back in FDI flows, what can the IFIs do to help them? What steps would staff recommend for preparing them to gain access to the capital markets?

While it may be true that financial derivatives can facilitate growth of capital flows and reallocate risks, nevertheless, many complexities have yet to be resolved and the experience of the Asian crisis has clearly highlighted the importance of proper sequencing. The intermediation function of the banking system has yet to be fully restored in some of the crisis-affected countries. Appropriate timing is of critical importance for the success of any measure. Not only must the countries have deep and liquid primary markets but they also should have adequate supervisory and regulatory capacity to ensure adherence to prudential standards. What explicit sequencing would staff recommend for developing countries to adopt?

Mr. Bennett submitted the following statement:

Key Points

I welcome the emphasis in the report on the importance of restoring investor confidence and reducing excessive risk aversion through appropriate macroeconomic policies and regulatory initiatives.

The overall content of this report continues to improve. As for the format, I continue to think that the report should be produced as a semi-annual publication that is closely coordinated with the WEO, and have shorter updates which are coordinated with the WEMD.

I appreciate the efforts made by staff to incorporate the suggestions made by Directors in previous meetings. I would like to begin by providing comments on the current GFSR, followed by suggestions to improve the content and format of future issues of the report.

Comments on the Current GFSR

The main message in the current report is that of continued resiliency of the global financial system in spite of a deterioration of investor sentiment. The report correctly highlights the importance of restoring investor confidence and reducing excessive risk aversion through appropriate macroeconomic policies and regulatory initiatives. Two particular themes that I welcome are:

the need for a firm commitment to the preservation of property rights, the rule of law, and stability in the legal and regulatory framework to foster investor confidence, avoid financial contagion, and encourage capital inflows; and, the need for transparency, including the disclosure of debt management policies, financing requirements, and issuance plans. However, a box giving more details about these issues or perhaps some case studies in both mature and emerging markets would be welcome in future reports.

The improvements in Chapter 2 on mature markets are welcome. The stand-alone sections on European Financial Systems and the Japanese Financial System provide a nice counter-balance to the section on U.S. Households and Financial Institutions. The report examines the risks associated with the residential real estate market and concludes that the market is generally sound and that fears of a bubble may be exaggerated. Has a similar analysis been undertaken for the commercial real estate market?

Not much new has been added though in Chapter 3 on emerging markets and it is unfortunate that there is not as much emphasis this time on the analysis of emerging market contagion. Two paragraphs (one in the section on Performance and Spread Developments, one in the Key Risks section) tell us that the current risks of contagion are low, but it would be useful to put back the box from the last report which analyzed three different dimensions of potential contagion. Even if the risks are currently low, I would suggest having a box of this type in all of the main reports of the GFSR (would not necessarily need to have them in the update reports) in order to have a sense of the probability of contagion. Additionally, tables with information on selected financial soundness indicators, as in the section on the major financial centers, would be a useful addition. Is a lack of data the reason why tables of this sort were not included?

The final chapter on the role of derivatives in emerging markets provided an interesting overview and I look forward to a discussion of the policy implications that staff has planned for the next report. In particular, the recent suggestion from the ECB that European banks should satisfy themselves on the robustness of their monitoring system (with respect to derivatives) and the extent to which risk has truly been transferred, applies equally to banks in other mature and emerging markets. It may be worthwhile to consider this question as part of the planned chapter on policy implications of derivatives use in the next report.

Some Suggestions for Improving the Content and Format of the GFSR

In my previous preliminary statements on the GFSR and the Biennial Review of Implementation of Surveillance, I raised the issue of improving the key multilateral surveillance reports—the WEO and the GFSR—through strengthened cooperation among all departments. In particular, at the time of the discussion of the Biennial Review of Implementation of Surveillance in April this year, I noted that the GFSR can play the role of a regularly updated global FSAP. Among other things, it can look at important developments in financial markets that cut across countries, such as regulatory arbitrage, and provide an outlet for the Fund's work on macro prudential indicators. But to do this, it must have access to the required resources. While there is a high level of expertise in ICM, it is not reasonable to expect the department with its limited resources to cover all aspects in the depth expected of such a report. The input of other departments, especially MAE and Research, as well as area departments, is needed to get a full understanding of some developments and their policy implications.

While the report in its current format does a good job of updating developments in global capital markets, I still feel that making the report broader, through the incorporation of material from other departments in the Fund, as described above, would enhance the analytic content of the report and help it to live up to its billing as a Financial Stability Report. In keeping with the theme of integrating multilateral surveillance reports, perhaps linkages with other financial stability reports, such as those from the Bank of England and the BIS would help to strengthen the GFSR. Just as the WEO makes reference to private sector forecasts, perhaps the GFSR could include views from both of these excellent reports when presenting its analysis of the outlook and issues. More generally, could staff provide their strategic vision of this document vis-à-vis the reports from the Bank of England and the BIS? Is the GFSR meant to be a competing or a complementary product to these other reports?

Another way in which the report could be improved is by the addition of a chapter on alternative scenarios or stress-testing (along the lines of those seen in recent Article IVs, but on a global level) which could give a sense of the resilience of global financial markets to withstand low-probability but high-risk events. Two suggestions for scenarios of this type would be the impact of a war with Iraq on global financial stability and the impact of missed payments/defaults in some large heavily indebted countries.

With respect to the timing of the report, I will re-iterate my past suggestion to closely coordinate the GFSR with the WEO. Making the GFSR a semi-annual publication that is published simultaneously with the WEO would provide an overall picture of the Fund's assessment of global developments, with respect to the macroeconomic outlook and financial markets. I would also suggest having smaller update reports to the GFSR that are coordinated with the WEMD and mainly focus on new data since the last full GFSR.

Conclusion

I commend staff for their continuing efforts to improve the content and quality of the GFSR. I expect it will only continue to improve once the suggestions by Directors and new ideas from staff have been incorporated.

Mr. Callaghan and Mr. Di Maio submitted the following statement:

Key Points

While the GFSR continues to improve, it would be more beneficial if it contained more analysis of the implications of developments in financial markets on the real economy and for policy settings.

A biannual publication would reduce the tendency for the report to be descriptive and allow time for more in-depth analysis.

While the global financial system has remained resilient notwithstanding the ongoing deterioration in financial markets, the cumulative deterioration may result in the financial sector being a key source of weakness in the real economy.

The report notes that it is important to guard against excessive investor risk aversion, yet it is difficult to know when it is excessive and it is not clear that there are adequate policy tools to counter such a development.

It would be helpful if there was more analysis of the implications of the responses of financial institutions to the deterioration in financial markets.

The global financial system is worryingly exposed if ongoing stability depends on the state of the U.S. household sector and the maintenance of high house prices and low interest rates.

The report could have paid more attention to the implications of weaker household balance sheets for credit quality for financial institutions. It is also unclear about the relationship between refinancing activity and household debt.

The systemic implications of disinflation/deflation would be a worthwhile topic for future reports.

The more the report covers the implications of financial market developments, the better.

This issue of the GFSR provides a comprehensive overview of recent developments in global financial markets. There are some welcome references to what these developments may mean for policy. But when it comes to the GFSR, we are like children with ice cream, we always want more. We want more analysis of developments in financial markets and a guide as to what they may mean for the real economy and the implications for policy. Our business is policy advice and the main value added from the GFSR will be the extent to which it contributes to our analysis of policy issues.

What are the implications of a cumulative deterioration in the global financial environment?

The GFSR notes that investment sentiment deteriorated in the third quarter of 2002, continuing the trend reported in the previous issues of the report. Financial markets are highly volatile, with heightened investor risk aversion and significant losses in key sectors. Notwithstanding this deterioration, the conclusion is that the global financial system remains resilient and financial stability has been maintained. This is consistent with the assessment in previous GFSR.

Given developments to date in the fourth quarter of 2002, it is likely that the next quarterly GFSR (assuming there is one) will report a further deterioration in financial markets, although again the assessment will be that the financial system remains resilient.

We are, however, experiencing a cumulative build-up in the deterioration in investor sentiment, rise in risk aversion and weakening in the balance sheets of many financial institutions. This cumulative deterioration will weaken the overall ability of the global financial system to withstand unexpected shocks. However, while we can certainly take comfort from the fact that to date there has not been a major dislocation in the global financial system, we need to assess the implications of the ongoing deterioration in financial markets. The GFSR concludes that notwithstanding the series of adverse developments, “the risks to international financial markets stability remain limited and manageable”. However, are we focusing excessively on the risk of a major destabilizing crisis in financial markets and not adequately addressing the implications of a cumulative weakening in their effectiveness of global financial markets. For example, is there a gradual deterioration in the ability of key sectors of the system to effectively fulfill financial intermediation function and handle financial risks?

To express the above point another way, to what extent is the current volatility and weakness in the global financial system a symptom of a slower-than-expected resumption to growth in the global economy, or is the financial system actually a key source of weakness in the real economy? This is clearly the case in Japan, but it may be becoming increasingly widespread.

When is investor discrimination excessive?

Key themes highlighted in the GFSR are heightened investor risk aversion, discrimination and aggressive tiering by credit quality. As the report notes, to some extent greater investor risk aversion is a good thing because there was insufficient discrimination on the basis of risk in the “bubble years”. Moreover, a tiering of emerging market borrowers on the basis of good policy is something that the international community has been seeking. The defense against contagion which the Fund has advocated is the adoption of good policy and appropriate risk assessment by investors so that good policy is recognized. Consequently, as the report notes, we should welcome and highlight the fact that some emerging markets have maintained market access notwithstanding heightened risk aversion because they have maintained a steady commitment to sound policy.

But when does the flight to quality and heightened investor discrimination become excessive? The report states that “it is important to guard against an excessive swing in the pendulum away from risk taking”. Box 3.1 notes that it is difficult to disentangle between investors reacting to higher perceived risk, or a reduced willingness to bear a given level of risk, or a combination of the two. However, even if we knew that the pendulum was swinging too far away from risk taking, it is by no means evident that the policy tools are readily available to quickly reverse the situation. Nevertheless, this is a major risk facing the global financial system and has obvious implications for the strength and nature of the recovery in the world economy. It is a topic which justifies close scrutiny by the Fund.

What are the implications of the responses of financial institutions?

As noted in previous GFSRs, the fact that financial institutions have continued to repackage and distribute risks across a wide range of investors has helped to preserve the resiliency of financial institutions. However, different risk-bearing models have been pursued in the United States compared with Europe and a comparison of the longer-term implications of these different approaches would be timely. In the United States a greater share of financial risks is borne by individuals through holdings of financial assets, while at the same time, the banking system has been quicker to spread risks through the use of credit derivatives, securitization, etc. This should bode well for the resilience of the financial system, but it does mean an increased proportion of risk is being held by those who are less experienced and capable of dealing with changes in the value of their financial assets. This suggests that U.S. households may be more exposed to risks and therefore their consumption may be more volatile than in Europe. In fact, to date the opposite has been the case, influenced to a large degree by another factor, namely, the underdevelopment of retail financial markets in Europe and the inability of

European consumers to smooth their consumption in response to changes in income levels. These are all issues worth exploring in the GFSR.

The GFSR outlines how financial institutions are re-evaluating their strategies and reorganizing their operations, including: becoming less aggressive in seeking business; being increasingly concerned about reputational and legal risks; moving to a smaller "platform", and striving to improve how they manage and price risks. A key question is the implication of these responses by financial institutions on the real economy. The report briefly discusses some possible impact of heightened attention to credit risk management by financial institutions, but a broader assessment of the possible implications of the responses of financial institutions on both the supply and demand for finance would be in order.

Should we be concerned that global financial stability depends on U.S. households?

The report notes that the U.S. household sector is critically important to the stability of the global financial sector. U.S. households are also the key to growth in the world economy. The risks to the U.S. household sector center on the sustainability of housing and equity prices and continuing low interest rates.

Rising house prices have increased household wealth and helped offset the erosion from falling equity prices. The future course of U.S. house prices is therefore important for the global economy. The report notes that while the prospect of an unsustainable bubble cannot be ruled out, there are factors which suggest that the strength in U.S. residential real estate markets reflects economic and demographic factors. This may be so (although further analysis of this issue would be desirable), and while there may not be a bursting of the housing bubble, there may not be the same growth in residential house prices to offset further declines in equity markets. Furthermore, in the absence of continued increases in household wealth, there may not be the same impetus behind the growth in consumption in the United States as has been evident in recent years. The report also overlooks concerns about house price bubbles in areas of Europe and elsewhere.

While the report focuses on the implications of a downturn in U.S. house prices on the appetite of households for risks, it pays little attention to the implications of weaker household balance sheets for credit quality in financial institutions. Rising household debt and increased concentration of lending to the household sector can have important implications for financial institutions from a risk management perspective.

The report is also unclear about the relationship between refinancing activity and household debt. For example, it notes that mortgage refinancing in the United States has supported strong growth in debt (page 23). Yet mortgage refinancing in itself does not increase the stock of debt, unless it is accompanied by equity withdrawal by households. But the report infers that households have not used equity withdrawals to finance stock market investments and so leverage their investment in housing. In support of that contention, the report observes that the ratio of owners' equity to real estate is the same as at end-1996. Of course, this is only a comforting statistic if house prices are not over-valued.

The report highlights that monetary easings by the United States have been important in offsetting the effects of the considerable decline in U.S. equities, particularly in reducing borrowing costs for U.S. households and helping to support the strong growth in house prices. Given the importance of the future course of house prices and the increased indebtedness of U.S. households, a point that has often been raised is that the "potency" of an increase in interest rates has been increased. At the same time, households and firms have locked-in lower interest rates, which begs the question of which institutions would bear the brunt of monetary tightening—does this increase the risks collected in government-supported finance institutions such as Fannie Mae? This would be a useful topic to explore.

Looking ahead, one of the most telling sentences regarding the risks of further U.S. equity correction is that the sustainability of growth in corporate earnings will increasingly depend on revenue growth. In an environment where there seems little prospect of consumer demand accelerating substantially, and over-capacity is dampening the prospect for price increases, where will the income growth come from?

While the report notes the beneficial effects of lower nominal interest rates in the United States, it does not adequately consider them in the context of widening credit spreads and disinflation, both of which raise real interest rates and impinge on credit quality and business conditions. The systemic stability implications of disinflation/deflation would be a worthwhile topic for future reports.

What is required for emerging markets to fund their financing requirements?

In the discussion on the outlook for emerging markets financing, it is unclear the extent to which funding requirements for 2003 have been met, and the outlook for emerging markets to meet their borrowing requirements. This is particularly the case in Latin America, where borrowing requirements remain high, the growth outlook poor, and the impact of funding enhancements from the IFIs seemingly becoming less effective. A continuation of the status quo, which is implied in the outlook for emerging market financing, also appears to be unsustainable for a number of key countries in Latin America under the current circumstances. In other words, a key risk for emerging markets in Latin America is that liquidity and funding costs remain around current levels.

Derivative Markets

The development of derivative markets has allowed risks to be spread more widely and separated, so that companies can take advantage of investments that suit their skills and risk appetite, including more options to take advantage of cross-border investments. Certainly, the derivative market can be both a bonanza and a source of peril to emerging markets. The Latin American crises were cases where the derivative market actually increased volatility. On the other hand, in the Asian crisis, unhedged risks in the absence of derivative markets were a problem. In the Asian case, perhaps an even more serious problem was that off-shore hedging availability was able to be exploited by foreigners from sizeable interest rate differentials in the domestic spot market, while local players remained unhedged. In this situation, the development of on-shore derivative markets is highly desirable.

However, the growth in the use of credit derivatives makes it more difficult to assess the risk inherent in a balance sheet in the absence of adequate information on an organization's derivative positions. In several cases it is clear that policy makers and regulators had a poor understanding of financial positions partly as a result of the use of derivatives. This lesson applies more broadly than just emerging markets, for there is a widespread need for greater transparency from all organizations, governments and institutions on their derivative positions, as well as the need for regulatory structures to ensure that the incentives are not skewed toward excessive risk-taking.

Exchange Rates

The section on the foreign exchange market reads like the daily Global Markets Monitor. Some additional analysis would be in order.

Future GFSR Reports

In terms of the structure of future GFSR reports, we believe greater attention needs to be devoted towards analyzing the implications of developments in financial markets. The September 2002 version of the GFSR was produced at around the same time as the September WEO and there was clear benefit in considering the two reports in close proximity. A tension in the GFSR has been the express intention to stay clear of the real economy, this being the preserve of the WEO. However, as noted at the outset, the implications of financial market developments on the real economy and policy is the main value to be gained from the report. This tension needs to be resolved.

We believe it would be preferable for the GFSR to be a biannual publication. Moving from a quarterly schedule will help reduce the tendency for the GFSR to focus on describing events in financial markets, and allowing more time for a deeper analysis of the implications of these developments.

As regards the timing of the GFSR, as noted, we see value in the report being produced in conjunction with the WEO. However, we do recognize that there are advantages in the GFSR being produced in alternative quarters to the WEO.

In terms of the preparation of the GFSR, we would suggest that there would be advantages in involving the Board at an earlier stage than when the draft report has been prepared. A suggestion is that at the WEMD prior to the preparation of the GFSR, the ICM broadly outline the issues they are thinking of covering in the forthcoming report and invite Directors' comments.

Mr. Yagi and Mr. Toyama submitted the following statement:

As market conditions continue to be regarded as key to the future path of the world economy, this staff report on global financial stability will attract universal interest as the previous issue did. In this regard, we would like to thank staff for drafting a quality report that satisfies the interest of a wide range of readers, including policy makers and market participants. This chair is supportive of the current practice of issuing a quarterly GFSR.

Markets that saw a continuous slump until the third quarter have barely recovered since October. Stock prices in the U.S. and European markets have rebounded from the bottom, while yield spreads on the EMBI+ have modestly tightened. To answer the question of whether or not these trends can be sustained, one need focus on such issues as whether corporate profits can be accelerated by widening their base from cost reduction to an increase in sales, and whether the new Brazilian government can maintain its momentum for reform, among others. In the meantime, it is likely that the markets will continue to be sensitive to news affecting these issues.

Although the current issue of GFSR is not synchronized with WEO, the staff report covers the relationship between market conditions and the real economy, which we appreciate. Recently, the interaction between the real economy and market conditions has increased the extent to which a business cycle swings. While market movements influence the real economy through changes in the wealth effect, confidence, balance sheets of the financial sector, and financing costs of the corporate sector, the prospects for the real economy are reflected in market prices. Recent experiences tell that as the correlation between the real economy and market conditions is strengthened, it becomes increasingly difficult to cause a smooth turnaround, regardless of whether the spiral is directed upward or downward. Accordingly, what is utmost important is to promptly introduce policy countermeasures before the risk that markets become excessive materializes. It is one of the most important roles of the Fund to warn of the existence of such a risk.

At the current juncture, upward momentums including the self-correcting forces inherent in markets and the effects of policy measures such as monetary easing are working, while downward momentums have been strengthened as the prolonged stagnation weakens market institutions, including through changes in the behavior of financial institutions. In addition, as staff points out, there are significant risks in the U.S. household sector and in the European financial sector. It would be premature to say that the risk of creating a downward spiral between the real economy and market conditions is behind us, and the authorities should not loosen their vigilance against such a downward risk.

Mature Markets

In the United States, stock prices have moderately recovered, as large accounting scandals are no longer being reported and part of the corporate sector is beginning to see a recovery in profits. The fear that stock prices will dive further has waned for the moment. However, prospects for recovery of the real economy have been further clouded as consumer confidence has sharply deteriorated and the timing of strong recovery of corporate profits through an increase in sales is at most uncertain. We share staff's view that the household sector is key to the future path of the economy, as it is consumption that has led economic growth and the household sector that principally assumes risks by holding stocks.

The staff report presents a detailed analysis on real estate prices. It concludes that the recent hike in real estate prices can be explained by strong demand, improvements in the quality of houses for sale, and a decrease in mortgage rates. As we pointed out in the previous Board meeting, real estate prices can be considered to reflect prospects for future incomes as stock prices do, and adjustment of real estate prices tends to lag behind those of stocks. Given this, it is quite possible that real estate prices will see moderation in their increase rate, or even a decline. Prices in the higher brackets have somewhat softened already in areas that have experienced a sharp increase in the recent past. We have to be mindful of the risk that an increase in interest rates could accelerate this, particularly if it is not backed by recovery of the real economy, and could have a significant impact on consumer confidence. While staff points out that the locking-in of mortgage rates at the current low level reduces the household sector's interest rate risk, we wish staff had proceeded further to analyze who will eventually bear that interest rate risk. If financial institutions securitize mortgage loans to be sold to institutional investors for private pensioners, we wonder if the interest rate risk is repatriated to the household sector. The interest rate risk, in this scenario, merely moves from the liability side to the asset side on balance sheets of the household sector.

The staff feels that the soundness of the banking sector has not deteriorated through an increase in credit costs, as that sector has transferred risks to other sectors through syndicated loans and securitization, and has also focused back on the retail banking business. However, the risk adverse tendency of investors makes it difficult for the banking sector to split off risks generated in its financing/refinancing activities. If the various sectors attempt to transfer risks to each other, it might end up curtailing financing activities. We would like to hear from staff a more consistent and comprehensive view as to how various categories of risks are distributed among sectors.

In Europe, whether the financial sector can absorb shocks incurred by increasing credit costs and the decline in stock prices is the focus of attention as risks are concentrated in this sector. Staff thinks that these costs have been absorbed by transfer of risks to other sectors, strengthening of the fee business and corporate reorganization, and hence, the soundness of the sector has not become a serious problem. However, as staff admits, the foundation for the fee business has shrunk and cross border reorganization on a large scale has not taken place except for earlier acquisition of investment banks. We wonder if the principal source of profits for European financial institutions is the retail business into which new entry is difficult. The issue that should be questioned, therefore, is whether financial institutions can continue to record handsome profits when the competition in the retail business is strengthened, perhaps along with a change in the business model. Substantial rationalization might become necessary.

In Japan, a renewed initiative to solve NPL problems has just begun. After the Bank of Japan issued a report entitled “Japan’s Nonperforming Loan Problem” on October 11, the Financial Services Agency (FSA) issued a policy statement entitled “Program for Financial Revival” on October 30 with the aim of concluding the NPLs problems by FY 2004. In this program, FSA stated that it would establish a framework for a new financial system, corporate revitalization and new administration over the financial sector, strengthen policies comprehensively, and thereby aggressively accelerate disposition of NPLs. Toward solution of the NPL’s problems at major banks, FSA would strengthen its policy by tightening assessment of assets, enhancing capital adequacy, and strengthening governance so that major banks’ NPL ratio would be reduced to about half by FY 2004. To implement Financial Revival as promptly as possible, FSA and relevant bodies are working very hard to study specific measures so that a work program will be made public by the end of this month.

Emerging Markets

Although yield spreads have modestly tightened since October, financing/refinancing activities of emerging market economies have not pulled out of the slump that began last spring, as the risk averse attitudes of investors have not reversed by much and the political situation in Brazil remains uncertain. It is fortunate to see, however, that markets have discriminating borrowers as evidenced by the successful launching of bond issues by Asian and East European economies, and even within Latin America, by Mexico and El Salvador. As the initial panicky situation wanes, market participants are again calm in evaluating an individual countries' situation, and the correlation among emerging market economies has declined.

However, it would be premature to assume that the situation will continue to improve. First, it is possible that markets will again become sensitive to the debt sustainability of Brazil, depending on the stance of its new government toward a reform agenda. If the credibility in Brazil were impaired, this would cause contagion to many Latin American countries. Second, European and Japanese retail markets have not seen any sign of recovery. Aside from bond issues by neighboring countries, these markets may not be reopened to Latin American countries for a fairly long time. Third, as the current stagnation is prolonged, chances for wholesale investors to change their organizational structure, let alone investment strategy, for Latin American countries, or for the emerging markets in general, increase. We are concerned about staff's finding that a sign for such a change has already been observed.

The Role of Financial Derivatives in Emerging Markets

It is interesting to learn that emerging markets have seen a steady increase in not only simple derivatives to hedge foreign exchange or interest rate risks, but also in credit derivatives for which even mature markets are still in their development stage. As there often exists a difference in the amount of information, and views on risks, of emerging market economies between domestic and international investors and between investors and borrowers, there is a good chance that risks regarding emerging market economies can be transferred among these parties. I would like to support staff's view that derivatives can be tools to facilitate financing to emerging market economies. On the other hand, derivatives could bring about unexpected losses, be used for evading regulations, or for concealing losses unless a stringent internal/external control mechanism is in place. Also, as staff points out, speculative positions created by derivatives triggered and/or exacerbated some crises. Prevention of these dark aspects, while being related to multifaceted dimensions such as supervision of the financial sector, public debt management and HLIs, is paramount, and we wonder if an effective method might be to implement a regular monitoring mechanism of derivative transactions by country or by currency, with the regional survey conducted in this staff report as a starting point.

Mr. Padoan and Mr. Vittas submitted the following statement:

Financial market developments and the macroeconomic outlook influence each other.

Like Mr. Callaghan and Mr. Di Maio, and Mr. Yagi and Mr. Toyama, we feel that the interaction between financial markets and the macroeconomic outlook should be given more emphasis. The GFSR describes a situation of increased fragility with an increasing number of individual sources of risk and, hence, with an increasing risk of "reciprocal contagion" between them. This systemic aspect should be given more consideration in the future. As discussed in the last WEMD session the upturn in global activity will be weaker and will come later than expected. Repeated frustration of expectations dampens confidence and the risk of self-fulfilling expectations increases. In addition, there is a non-negligible threat of an oil-price shock that may not be accommodated by monetary policy. Against this background the emphasis on the resilience of the global financial system should not be overemphasized.

More attention should be devoted to transmission mechanisms.

Further efforts should be made to link the information contained in the Report with the broader macroeconomic framework and to the transmission mechanisms between real and financial developments, as well as between different regions. Two examples can be made to clarify the point.

The Report (page 22) identifies the three main sources of risks in: the household sector in the United States, the financial sector in Europe, and the nexus of the corporate and financial sector in Japan. Clearly, the behavior of each of them has implications for the macroeconomic performance of the respective region. However, there are important real and financial linkages among the regions which should be further explored. The October 2001 edition of the WEO presented an interesting analysis of the transmission mechanism of the cycle working through financial markets and confidence spillovers. Given the state of the cycle at that time, the emphasis was on the transmission of positive stimuli from one region (the United States) to the rest of the world. It would be interesting to carry out a similar exercise (or at least to use the same conceptual framework) now that the outlook is gloomier. To what extent can financial markets "lead" a recovery in the next few months, also by generating positive confidence spillovers? Or are financial markets bound to follow the real cycle?

Due also to the fact that we should be concerned about contagion.

A second example relates to developments in Brazil, which the Report rightly singles out as particularly relevant, given the size of the economy, its importance in emerging-market bond indices, direct and indirect exposure of investors, the fact that the debt structure of the country may amplify external shocks and, last but not least, the point raised at the last WEMD session that markets expect a depreciation of the real over the next few months and that the post election honeymoon with markets might soon be over. As the Report emphasizes, the negative consequences of adverse developments in Brazil would be substantial. There is a strong similarity in borrowing patterns between Brazil and other Latin American countries. In addition, European bank subsidiaries in Brazil could be negatively affected by evolution in that country and transmit negative effects on parent companies. In a nutshell, the risk of contagion cannot be downplayed.

Swings in market confidence will especially hurt Emerging Markets.

Higher volatility indicates swings in market confidence. Emerging markets have been badly hurt by the large swings in market confidence, swings that are unpredictable and far more pronounced than can be justified by changes in the underlying determinants of a country's capacity to service its debt. In several cases in the past these swings have taken the form and size of "sudden stops", which have precipitated crises.

What policy advice can we offer?

Leveraged positions benefit from high and sustained growth, and measures to support the macroeconomic environment, while preserving stability, are obviously important. Sound macroeconomic policies have to be complemented by microeconomic and structural measures. In this regard, recent action by the Fed is helpful and, if the weakness of the global recovery persists, action may well need to be taken in other parts of the industrial world. However, monetary easing alone will not suffice to restore investor confidence on a lasting basis. It needs to be supplemented by strong steps to address the problems in corporate governance, and in accounting and auditing practices that have contributed to risk aversion.

The Fund is making good progress in suggesting measures to improve the functioning of the system under conditions of stress and crises though crisis prevention efforts. In addition measures should be considered to improve the operation of financial markets in normal (i.e., not in crisis, or pre-crisis situation) conditions.

Encourage active risk management.

Improved risk management should be encouraged. The Report interestingly notes that financial intermediaries have been paying attention to credit risk management recently. However, it does so with a predominantly negative attitude (p. 21). An active credit risk management may help to make the business cycle less instable. A more active attitude by banks in selecting their counterparties may significantly improve their balance-sheet stability. This would make the financial system less prone to diffuse shocks to the rest of the economy. Furthermore, the conclusion according to which credit risk terms for riskier borrowers may worsen should also take into account the fact that an active (as opposed to a passive) credit risk management should be able to generate a better risk-pooling, from which all the parties may potentially gain. Active risk management by financial intermediaries together with the ongoing corporate governance reform may lay down the basis for a prudent—though much more resilient—recovery in the period ahead.

Develop local financial markets as complements to global markets.

As far as policy advice for Emerging Markets is concerned we stress two aspects. One, already discussed in the previous GFSR (emerging equity markets) is the development of domestic financial markets to provide effective complements to international borrowing.

We welcome the announcement that the next GFSR will discuss the policy implications of developing local bond equity and derivatives markets. Policy indications should include the development of strong legal systems to ensure the enforcement of contractual obligations and the establishment of adequate supervisory and prudential frameworks to lower the risk of domestic financial crises.

Pursue financial integration along with trade integration.

It will be important to connect the analysis and policy implications for deepening emerging financial markets to liberalization in trade and product markets, so as to further articulate the implications of the relationship between trade and financial integration (or the lack thereof) discussed in the September 2002 edition of the WEO. Trade integration among Emerging Markets has shown its benefits where it has progressed, as demonstrated by the experience of Asia and Eastern Europe, and its costs where it has not, as in Latin America.

Encourage FDI and non-debt-creating capital imports.

Reliance on foreign savings should increasingly take the form of FDI and other non-debt-creating capital imports. By contrast, exposure to debt-creating flows should be reduced. In this regard, governments need to set the example by exercising considerable self-restraint in borrowing in foreign currency, even when conditions for accessing the international capital markets appear favorable. In addition, borrowing by other entities should be monitored closely and action to discourage such borrowing should be taken if the country's foreign currency-denominated debt threatens to reach levels that exceed the country's debt-servicing capacity.

Improve financial instruments to avoid pro-cyclical effects and reinforce debt sustainability.

Another aspect worth developing is the one, discussed in Box 3.2, of the structure of emerging market debt and the implications for debt sustainability. The Fund is increasingly looking at debt sustainability, not only in emerging markets, both for surveillance and for access policy purposes. Macroeconomic debt sustainability can be strengthened by financial instruments that decrease the vulnerability of debt to adverse shocks. The report mentions the advantages of CPI-indexed bonds in keeping the real cost of debt constant and other instruments such as GDP-indexed bonds. More details and analysis in this area are welcome.

Structure of the GFSR.

On the structure of the Report we concur with many of Mr. Bennett's suggestions. As mentioned at the outset a guiding principle for reassessing the structure of the GFSR is that financial market developments and the macroeconomic outlook influence each other, hence more coordination with WEO and WEMD sessions is essential. Coordination would improve analytical clarity, offer better understanding of policy problems, and, importantly, produce more effective multilateral surveillance. The GFSR could move on to a biannual basis, closely coordinated with the WEO, and it could strengthen its regional dimension by exploiting resources from MAE and Research. Coordinated WEMD sessions between ICM and Research would offer an opportunity to fill the information gap between the two reports.

Mr. Daïri submitted the following statement:

Key Points

In many respects, the fault lines in the global financial system may have deepened. While the GFSR strikes a cautiously confident tone, pointing to the resilience of the global financial system, downside risks abound and we should not assume that the worst is behind us;

While we appreciate the desire of ICM staff not to impinge on the work of the WEO, the report could have benefited from a stronger policy focus;

The discussion on structural problems in European financial systems underscores the need for stronger Fund surveillance of financial systems in advanced countries and greater use of FSAPs and ROSCs;

The idea of a rotation of creditor exposure away from Latin America has onerous implications not only for the region but for the smooth functioning of the international financial system. This should have been given greater prominence in the report;

We would like future reports to be broader in scope with stronger inputs from MAE and Research. The GFSR should be published semi-annually in tandem with the WEO.

We thank staff for an interesting report on global financial developments for the third quarter. The report essentially confirms a continuation of trends reported in previous issues of the GFSR but, in many respects, also suggests that the fault lines in the global financial system may have deepened. Against the backdrop of growing uncertainty over the strength and durability of the global economic recovery, financial markets have displayed "heightened investor risk aversion, discrimination and aggressive tiering by credit quality". Major equity and credit markets have been characterized by rising investor risk aversion and high volatility reflecting this uncertainty but also the fall-out from recent revelations of highly questionable business practices. Emerging markets have been particularly hard hit with sharply diminished investor and creditor sentiment, with a long catalogue of risks weighing on the outlook looking ahead. As a consequence, gross inflows declined further and were highly concentrated in investment grade borrowers and there was a general tendency for spreads to widen, especially for Latin America. Although limited leveraging and continued investor discrimination has helped reduce broad-based contagion, as the GFSR notes, there is a danger that the pendulum could swing excessively away from risk taking and undermine the macroeconomic and financial environment even in emerging market and developing countries with strong fundamentals.

Despite these developments, the present GFSR attempts to strike a cautiously confident tone. It notes that the excesses of the bubble years warranted adjustment so that the global financial system could regain its footing. Furthermore, the report argues that the global financial system has, thus far, remained resilient in the face of shocks and the risks, while significant, remain "limited and manageable". Recent policy actions, including with regard to corporate governance, and private sector initiatives have also helped to start the arduous process of rebuilding confidence and it is hoped that these actions would be strengthened and implemented vigorously.

While these developments are noteworthy, we should guard against being complacent and thinking that the worst is behind us. The GFSR acknowledges that although resilience in markets is likely to continue, significant downside risks remain. A further decline in major equity markets cannot be ruled out and could have profound effects on U.S. households and key European financial institutions. A prolongation of a difficult operating environment of major financial institutions could adversely affect their profitability and provoke further retrenchment from risk—reinforcing the current trends of tiering by credit quality in mature and emerging market financing and exacerbating the reduction of flows to emerging markets.

Our recent WEMD session has, unfortunately, given little reason to cheer except for some evidence that global investor sentiment seems to have improved in recent weeks. However, the stock and bond markets seem to be "out of sync" and it is difficult to know what this signals in terms of market expectations of growth and equity market developments. Moreover, the overall picture is worrying, characterized by a slowing pace of global recovery, rising deflationary pressures in Japan, and continued uncertainty about policy continuity and implementation in key emerging markets contributing to heightened uncertainty and downside risks—including risks arising from possible contagion.

Given this difficult environment, the GFSR should have devoted more attention to articulating the policy requirements going forward. While some attempt has been made to do this under "Measures to promote financial stability', the recommendations need more specificity and prioritization. Moreover, the "singularly unsupportive" external financing environment for emerging markets warrants some elaboration on how the international community and member countries should address this situation. We appreciate the desire of ICM staff not to impinge on or duplicate the analysis contained in the WEO; however, the somewhat perfunctory approach to policy requirements deprives the GFSR of its analytical and policy underpinnings. As Mr. Callaghan reminded us in our last discussion, and now again, we are, ultimately, all policy-makers and our business is policy advice.

We welcome the interesting discussion on the structural problems in European financial systems and the need for steps to bolster their strength and resilience. The GFSR is up-front about the rising pressures in the German financial sector although it is careful to point out that the systemic stability of the system is not in question. Nevertheless, a further slump in equity prices or higher credit costs could provoke an excessive retrenchment from risk taking, reduce the room for maneuver, and affect borrowers in many domestic and emerging markets. We wish to re-iterate our call for stronger Fund surveillance of financial markets in advanced countries and greater reliance on FSAPs and ROSCs in this regard.

The idea that a rotation of creditor exposures towards Emerging Europe, the Middle East, and Asia could presage a "structural diversification" away from Latin America and turn into a long-lasting reorientation of capital flows deserved more reflection. The GFSR could have discussed these potentially onerous developments more fully, including the growing risk that further attempts to seek profitability through downsizing could diminish FDI flows and accentuate the concentration of these flows in still fewer countries (page 66). Indeed a prolonged drying up of flows to Latin America would have detrimental effects not only on the countries in the region, but on the smooth functioning of the international financial system as well.

We welcome the section on financial derivatives in emerging markets and the role these instruments have played in crisis dynamics. While the use of financial derivatives has helped investors reallocate risks and foster portfolio diversification, they can also encourage the build-up of financial system vulnerabilities that are unobservable to regulators, underscoring the importance of robust internal risk management practices and stronger supervision and regulation. Although the focus on local derivative markets in emerging markets and the role they played in recent crises episodes is appropriate, we hope that the next GFSR will extend the analysis and policy recommendations to cover mature markets as well. The numbers quoted in the statement of Ms. Indrawati and Ms. Phang in regards to the United States and the rapid growth projected in the GFSR for global outstandings by 2004 suggest that the use of financial derivatives is widespread and could pose a systemic global threat if concerns about “unresolved documentation issues, high levels of volatility and sharp blowouts in spreads for specific names” are not addressed.

On the issue of format and content, we join Mr. Bennett and others in encouraging staff to make future reports broader in scope with stronger inputs from other departments in the Fund—notably MAE and Research—and more reference to quality analysis outside the Fund. This should help make the GFSR a more cohesive document with strong analytical and policy content. We also support making the GFSR a semi-annual publication in tandem with the WEO so as to provide an overall picture of the Fund’s assessment of global macroeconomic and financial developments. Shorter updates could be provided to coincide with WEMD sessions.

Mr. Usman submitted the following statement:

Introduction

We thank the staff for the well written and balanced Global Financial Stability Report (GFSR) for the period under review. We also found the analysis on the derivatives market in developing countries a welcome addition to the report.

The report once again highlights that some regional areas still experience considerable difficulty, and that many risks still prevailed in spite of the relative calmness and stability of the global financial environment. From the report it is clear that risk aversion dominates the actions of market participants in mature markets, with adverse financial repercussions for many emerging economies. The staff appropriately caution against excessive risk aversion and suggest several actions that could be taken to promote further financial stability.

The staff report also highlights that developments in emerging economies are still dominated by regional factors, as well as domestic policies. The financial situation in Latin America is still being mired by the ongoing crisis in Argentina, and the uncertainty surrounding future policy implementation in Brazil; the situation is still reasonably stable in Chile and Mexico. In contrast, financial developments in the emerging markets in Asia and Africa seem more positive during the period under review.

Development in Mature Markets

Equity Market. Although equity markets have improved in the United States and Europe during the period under review, they remained highly volatile, while market developments in Japan continue to be disappointing. Factors accounting for the volatility in the stock markets in mature countries include among others, decline in investor confidence, slower consumer spending, and weaker manufacturing activity. This situation has also been highlighted during the recent WEMD discussions. Furthermore, while economic activity in mature markets is still positive, it is weaker than envisaged a year ago. We are concerned that this slow pace in economic recovery in mature markets is starting to have a negative impact on developing economies, particularly those that depend on exports to mature markets.

Banking Environment. The banking environment is considered to be sound in mature economies, though some deterioration occurred during the period under review. This impacted negatively on the corporate and official sectors in many emerging economies that usually access the banks for financing. We however welcome the fact that banks exercise some degree of discrimination among emerging economies, which allowed emerging economies with sound fundamentals to still gain access to these markets. However, the difficulty of some Latin American economies to access the markets remain a cause for concern.

Policy actions: We are encouraged that monetary authorities, particularly in the United States, have taken the necessary easing measures to ensure sufficient liquidity in the market, and also to encourage investment. We also welcome the steps taken by banks to diversify and repackage risks, including their efforts to improve risk management, and the application of greater discrimination in accessing the soundness of emerging market economies. The latter policy certainly prevented, in our view, an en masse herding away from emerging economies, as often happened in the past.

Remaining risks: Notwithstanding the efforts in both advanced and emerging economies to maintain financial stability, significant risks still remain. These risks include among others; a further weakening of growth performance in advanced economies, sluggish corporate profitability and a possible further weakening in stock markets. Furthermore, a possible deterioration in the household sector in the United States, particularly as regards real estate, which have hitherto been a mitigating force against weak performances in other sectors, could become a significant risk factor for global financial stability. As regards structural reforms in Europe, we fully concur with the staff that structural reforms are needed in the European banking environment. In Japan, asset price deflation and economic weaknesses continue to exacerbate the longstanding difficulties in the banking environment. As a result of these difficulties, there is a potential risk of Japanese banks to further withdraw from domestic and international markets, cannot be excluded. We therefore urge the Japanese authorities to intensify their efforts to implement structural reforms in order to facilitate a turn-around of the Japanese economic performance, and to ensure that Japan makes its contribution toward global growth and financial stability.

Developments in Emerging Markets

Investor sentiment deteriorated sharply during the period under review, particularly with regard to many Latin American countries. Notwithstanding these developments however, we are pleased to note, as was also emphasized during the WEMD discussions, that contagion has been broadly limited. We also welcome the fact that as a result of greater market differentiation, investment graded countries in particular, had better access to financial markets. Bond issuance by emerging markets as a group, though, has declined both in primary and secondary markets. As regards equity, emerging stock markets broadly followed the trend of mature markets, thus making stock markets in emerging economies also a very uncertain source of financing.

Finally, as regards the timing and publication of future GFSRs, we concur with the view expressed by Mr. Bennett in his statement.

Mr. Portugal and Mr. Steiner submitted the following statement:

We would like to commend staff for an extremely interesting and well-thought report that stresses that international financial markets continued to underperform during the third quarter, and that significant downside risks persist over the medium term.

Overview

Staff argues that the persistence of corporate debt overhang in the context of sluggish demand and earnings might be leading investors to withdraw from mature equity markets. Risk aversion pushed U.S. bond yields to 40-year lows, while investor discrimination led investment grade borrowers to experience a decline in borrowing costs. The retrenchment in bank lending also affected emerging markets, which also experienced significant tiering based on credit quality.

According to the report, the risks to financial market stability remain manageable. Monetary easing in the United States together with a steep yield curve have widened interest rate spreads and supported bank profitability. Likewise, low interest rates have lead to a boom in mortgage refinancing, thus sustaining U.S. household demand. In addition, leverage in emerging markets is low and direct contagion appears to be currently limited.

The most immediate risk comes from a further decline in major equity markets. Although equity valuation indicators now appear reasonably in line with historical averages, an increase in risk perceptions cannot be ruled out at this stage. A new round of stock market declines would produce a negative balance sheet effect both in U.S. households and in European financial institutions. Of course, additional risk-taking retrenchment in the mature markets would have a deleterious effect on financing possibilities for emerging markets.

We agree with staff that certain debt structures, particularly in emerging markets, might amplify external shocks and therefore should be avoided. Notwithstanding the undisputable truth behind such advice, we disagree that “excessive reliance on debt indexed to foreign currency movements, very short maturity structures, or a preponderance of floating rate instruments” has been, as a rule, the result of erroneous policy choices and believe that it is usually a result of measures taken in an extremely adverse and constrained environment. And while we concur with the report that “recent developments have highlighted the importance of steadfast adherence to policies that are consistent with macroeconomic and financial stability”, there is ample evidence that several emerging markets following sound macroeconomic and financial policies have been all but shut out of private international capital markets. This underscores the need of ensuring that international financial institutions can continue to support in an opportune and forceful manner countries following sound policies that are subjected to shocks outside of their control.

Key Developments

Staff prudently and wisely warns that price/earning ratios in the U.S. stock market are about 10–15 percent above levels reached in the previous recession. This, of course, supports the claim that a further decline in equity prices, with concomitant adverse impact on household wealth, remains an important source of risk. In that regard, we fully support the recent aggressive move by the U.S. central bank, reducing its key interest rates by 50 basis points. Unfortunately, political turmoil in the Middle East could potentially render this recent expansionary stance insufficient to support the U.S. recovery in general, and equity prices in particular.

According to the report, defaulted corporate debt in mature markets reached $140 billion year-to-date, surpassing the record set in 2001. In addition, volatility in fixed-income, equity, credit and exchange markets in developed countries has remained high. As a result, banks and financial institutions have been under severe stress, with bank stocks losing 10 percent in the United States and 30 percent in Europe. Staff indicates that financial institutions are now revising many of the strategies introduced in the 1990s—including creating synergies between investment and commercial banking, reducing their financial intermediation infrastructure, and improving the way they manage and price credit. As a result of these developments, one should expect that credit conditions to riskier borrowers, including emerging markets, will become even more procyclical than what they are today, both in terms of quantities as well as in terms of prices. To be sure, this would be a most unwelcome development, and we urge staff to comment on policy measures, including institutional changes, that could eventually counter this trend.

The staff correctly gives due importance to household wealth as a key element driving aggregate demand. We believe, however, that the report seems to be extremely pessimistic on this front. On the one hand, it points to the possibility that if the economic recovery is sustained in the United States and Europe, then a rise in interest rates is likely, with adverse effects on housing and equity markets—albeit compensated by higher employment and income growth. On the other hand, were the recovery not to consolidate, then low or negative income growth would affect highly-indebted households. The prospects for sustained household expenditure based on wealth effects would be bleak in either case. Is staff suggesting that in developed countries outside of Japan there is no scope for further monetary easing, in case growth prospects do not improve in the near term? In this regard, and on a more optimistic note, the report supports the claim that in the case of the United States, real estate prices have reflected economic and demographic factors, rather than speculative demand. Can staff comment as to whether fundamentals are also behind the real estate boom recently observed in other developed economies?

The report provides a review of challenges being faced by financial institutions in Europe and Japan. In the case of Europe, the staff correctly underscores the need to make progress addressing structural inefficiencies including a retail banking sector dominated by small institutions with public sector affiliations, underinvestment in technology, steep labor costs, and difficulties in downsizing through labor shedding. Regarding Japan, the report points to continued asset contraction, low profitability, and accumulation of nonperforming loans. The staff might want to comment on the appropriateness or not of the Bank of Japan's proposal to eventually inject public funds if banks' capital was to decline further as a result of more aggressive provisioning

On pages 30 to 32 of the draft there is a factual inaccuracy that should be corrected before publication. It is said that "remaining concerns about [Spanish banks] focus mostly on emerging market exposures, which account for a substantial share of bank capital." And follows, "these concerns relate mainly to Brazil". A look at the banks' balance sheets, however, would show a different story. Banks in Brazil are in a very strong and profitable stance, despite the recent financial turmoil. Spanish banks, accordingly, have posted strong profits in Brazil. BSCH, for instance, had 62 percent of its global profits in the first three quarters of 2002 coming from Latin America, Brazil alone responding for 24 percent. Santander-Banespa in the same period had a profitability ratio of 71 percent over net worth. We believe those figures speak for themselves.

Emerging Markets

The report highlights the fact that investor sentiment towards emerging markets deteriorated sharply during the third quarter. Whether this has been the result of a higher perception of risk in those markets or the result of increased risk aversion on the part of investors or a combination of both is very difficult to determine in practice. We agree with staff that regardless of which effect is dominant, what is not to be disputed is the fact that mature equity market weakness and volatility have been detrimental to emerging market financing, including foreign direct investment. And since the report persuasively suggests that at this stage there is no significant evidence of contagion within emerging markets, then one has to conclude that there are several emerging markets that, while following reasonably prudent macroeconomic and financial policies, have seen their access to foreign financing curtailed because of events in mature markets. In that regard, it is important to take into account that these developments, exogenous to emerging markets, have brought about significant weakening of their currencies which, in and of themselves, have made debt management a much more difficult task.

While it is a fact that emerging markets have faced an unfriendly international financial environment during most of 2002, the report might be hastening into a precarious exercise of prediction when describing markets´ reactions in a very unsteadily evolving environment as a “trend of tiering in emerging markets”. We suggest that this wording, which appears in several places in the document, should be changed or trimmed down.

Recent developments in Brazil are a case in point. The fact that recent presidential and parliamentary elections have played an important role in feeding negative speculation over policy discontinuity is undisputable. Whether this was justified or not, elections are now over and uncertainty has begun to dissipate. Even before ballot day, key economic indicators had already reached record lows and resumed their (until now) positive trends. Unfortunately, GFSR failed to capture this very important turnaround, therefore contemplating worse-case scenarios that look highly unlikely at this point in time. Below there is a brief description of recent economic developments in Brazil.

The exchange rate reached its lowest level at the beginning of October, few weeks before the second-round voting, as herd instincts were at their fiercest moment. From 3.95 reais per dollar, the currency has experienced an 11 percent rebound since, being traded these days at around 3.56 and on the high. By then, the stock exchange was also near its low at 8,370 points. It is in a steady recovery, having gained 20 percent at current 10,000 points. Also, at end-September, spreads on Brazilian foreign bonds were around the 2,500-basis-points-mark. As things began to normalize, we are now at 1,600 spread, a significant improvement for an indicator which is still very high, but on a clearly descending path.

Even more important, the report does not seem to capture a fundamental reduction in the external vulnerability of the country, which was already underway in the recent past and has now accentuated. The Brazilian trade surplus is showing a remarkable improvement as market expectations now range between US$11-12 billion dollars, far in excess of the government’s beginning-of-the-year US$5 billion trade surplus forecast. The 2003 trade surplus forecast ranges up to US$15 billion. This marks an important recovery, as the current account deficit is expected to shrink to US$11 billion this year and US$8 billion in the next. For the first three quarters this year, the same deficit comprises only 2.15 percent of GDP (totally covered by net FDI) compared to 4.60 percent for the same period last year. For 2003, US$16 billion of foreign direct investment are expected. In sum, not only recent coordinated rebound in market variables is being overlooked, but also the lasting improvements on economic fundamental leads us to disagree with the market segmentation suggested on page 66.

We agree with staff that the World Bank's decision related with the rolling and reinstatable guarantee in Argentina came at an inopportune time, when markets are essentially closed for sub-investment grade Latin American issuers, some of whom have been attempting to find new, innovative sources of contingency funds. As staff indicates, these actions prompted the rating agencies to downgrade from investment grade to sub-investment grade Colombia's World Bank guaranteed bond and two CAF guaranteed loans.

We look forward to the next GFSR, in particular to a discussion of local securities markets and the role they can play as alternative sources of funding in emerging markets. This discussion should, however, not detract us from the fact that for many emerging markets, and in fact for several mature ones as well, financial sector credit continues to be the main source of financing for the private sector. In that regard, the next GFSR might be a good opportunity to have an in-depth analysis of the recent evolution of domestic banking sector credit in emerging markets. In several of them, prominently in Latin America, the recent economic slowdown has been accompanied by a sharp decline in private sector credit from the banking system. Whether this observation is dominated by supply or demand considerations is still an open question, with very distinct policy implications. Has crowding-out from the public sector been an issue? Are bank's becoming more risk averse? Has supervision and provisioning been unnecessarily pro-cyclical? A fresh look at these issues would be a most welcome contribution.

We welcome the analysis of Chapter IV on financial derivatives in emerging markets. The study suggests that local derivative markets have played a key role in facilitating growth of capital flows to emerging market economies in the last 15 years, through the unbundling and redistribution of risks. On the other hand, the report wisely underscores the risk of derivatives opening regulatory breaches and allowing for market participants to take on excessive leverage and manipulate accounting rules, practices that could play a deleterious role in the event of a financial crisis. With that reasoning, the chapter highlights the importance of reinforcing internal risk management systems and the overall financial supervision.

We have a comment on Box 4.1, which provides a good overview of the BM&F in São Paulo. While generally agreeing with the description made, we are unsure about the meaning of the very last sentence of the box. What does the text suggest by stating that "BM&F remains highly exposed to sovereign risk when close to 90 percent of the exchange's collateral is comprised by Federal Government Bonds"? We are talking about bonds accepted locally as zero-risk instruments. How does it fit together with the focus that the GFSRs have had "on the role of local markets as a substitute for international markets for raising funds"? In order to remove any ambiguity, we would strongly suggest the staff to consider the deletion of the last sentence of Box 4.1.

Mr. Al-Turki submitted the following statement:

Format of the Report

I thank the staff for a detailed description of international financial market developments in the third quarter. While the report contains a wealth of useful information, I agree with Mr. Callaghan and Mr. Di Maio that it would be beneficial to have more analysis of the impact of financial market developments on the real economy. I also agree with Mr. Bennett and others that two semi-annual comprehensive Global Financial Stability Reports (GFSR) that are more closely coordinated with the World Economic Outlook (WEO) reports will reduce duplication and help provide an overall picture of the Fund's assessment of global developments. To keep in tune with the rapid developments in financial markets, more frequent updates of GFSR could be combined with presentations of the World Economic and Market Developments (WEMD).

Developments in Mature Markets

Financial developments in the third quarter have been less than encouraging. Equity prices fell sharply, growth slowed down, and bank losses rose. The bright spot appears to be the continued buoyancy of the housing market especially in the United States. Indeed, lower interest rates have been important for the continued improvement of the real estate sector and the rise in refinancing. This has helped to sustain consumption by largely insulating households from the impact of the fall in equity prices.

The main risk in the United States at this stage is a slowdown in the real estate market ahead of an increase in corporate profitability, businesses investment, and equity prices. In this connection, the recent report on the decline in housing starts and some indications of weakening in the commercial and the high-end residential real estate market could pose a risk. While the continued absence of inflationary pressures, the recent improvement in manufacturing activity, and the substantial rise in equity prices in October and November provide a welcome cushion, policies should remain geared at supporting the recovery.

Turning to the financial sector, I welcome the findings that the U.S. banking sector has fared reasonably well. This should facilitate the recovery as credit will likely continue to flow to business investment and consumer spending. However, it is important to remain vigilant as the staff rightly notes the risks associated with a sharp rise in interest rates or a large decline in equity and real estate prices. Here, I am interested in the staff's response to Ms. Indrawati and Ms. Phang's question regarding the risks associated with the large exposure of some major banks to derivatives.

The European financial system, unfortunately, does not appear to have fared as well. While the U.K. banking system has enjoyed solid profits, persistent pressures on profitability continue in Germany. The recent Moody's switch of its outlook to negative on a major insurer in Germany as well as the cut in the credit rating of a bank added to the stress. This is a concern not only for the recovery in Europe but also for the availability of credit to developing countries. As the report indicates, Germany has more claims on developing countries than any other European banking system. That said, the progress made in strengthening the financial sector in many continental European countries is encouraging. However, as noted in the report, more needs to be done especially in reducing overcapacity and operating costs.

The continued weakness in the Japanese financial system remains a major concern. While the authorities have taken a number of measures to shore-up the banking system, non-performing loans continue to accumulate. This has prompted a further withdrawal from risk-taking in domestic and international markets. Such a policy could lead to further difficulties in the corporate sector, which will further aggravate the weakness in the banking sector. The substantial reduction in overseas exposure also aggravates the credit difficulties facing many developing and emerging market economies.

Developments in Emerging Market Economies

The report indicates that emerging markets' investor sentiment deteriorated sharply in the third quarter. This reflected both increased flight to quality in the mature markets as well as increased risk perception regarding especially Latin America. At the same time, greater investor discrimination by credit quality has reduced broad-based contagion and may have improved the pricing of risk in some cases. In other instances, however, the sharp increase in risk aversion may have undermined viable investments by many second tier companies due to lack of financing. Here again, it is essential to guard against a vicious cycle of declining credit to emerging markets that weakens growth and reduces ability to repay, which in turn leads to further decline in credit.

The continued vulnerability of the emerging market economies' credit access to developments in mature financial markets highlights the importance of strengthening domestic financial markets. Here it is worth reiterating the critical need to continue expanding local bond markets and to encourage domestic savings. In this connection, I found the chapter on "The Role of financial Derivatives in Emerging Markets" very informative. Indeed, an efficient derivatives market could help distribute the risks and enhance financing options. At the same time, the staff is right to underscore the potential risks of such derivatives. Therefore, a good institutional framework along with strong financial regulations and supervision are a must in order to reap the benefits while minimizing the risks of derivatives trading.

Mr. Le Fort and Mr. Costa submitted the following statement:

Introduction

We thank the staff for this fourth issue of the Global Financial Stability Report (GFSR), in which a candid assessment is made on the international financial system. The report is useful to focus attention on drawbacks and weaknesses arising in the global financial system that may imply significant risks for economic activity. However, we believe that the report could be made more effective for multilateral surveillance by focusing it on interpretation and analysis rather than on description of financial conditions, by increasing the coordination with the WEO, and by enhancing the participation of area departments in the making of the report.

The GFSR could become like the WEO a bi-annual report, with the WEMD acting as the occasion for updating the Board on current events, news and recent trends. A close coordination with the World Economic Outlook is amply justified, as the final aim of the report is to identify financial risks and vulnerabilities that may have significant implications for global macroeconomic developments. Moreover coordination would help to take advantage of potential synergies and to avoid overlapping and repetition. In addition, a closer involvement of area departments in the production of the GFSR, as proposed by Mr. Bennett, would certainly bring the report closer to relevant regional problems and policy issues, thus providing a more efficient contribution to multilateral surveillance. We continue to favor alternated quarterly reports, thus allowing for a better use of shared resources between the WEO and the GFSR, and avoiding the discussion of both reports only few days apart and exactly in the period before the Spring and Fall meeting when the demands on the Board are the highest.

The weakening of the economic outlook over recent quarters calls for redoubled vigilance, despite the perceived resilience of the international financial system. In this regard, we welcome the recommendations for actions to strengthen global financial stability that would reduce vulnerabilities in industrial as well as emerging market economies. Since we share the main thrust of the analysis, we will concentrate our comments on certain elements of risks that should be given additional emphasis.

Mature Markets

The heightened investors' risk aversion is linked in the report to the uncertainty regarding the strength and durability of the recovery which, in turn, negatively impacts the prospects for corporate profits. There are other factors that are somewhat downplayed in the report and that, in our view, should be emphasized. The mounting external imbalances of the U.S. economy implies the risk of a sudden correction entailing a rapid weakening of the U.S. dollar and a downward pressure on U.S. domestic demand. This is, indeed, a source of downward risk for the world economy and financial markets, which will only be dispelled as the existing imbalances are corrected.

Several paradoxical situations are created. First, the larger the short-term success in revamping the U.S. economy, the greater the structural imbalances and the greater the risks of a future painful adjustment. Second, in a scenario of sluggish U.S. growth, the imbalances will be corrected very slowly, if at all, given the weak growth prospects of the U.S. trading partners. And third, only if the U.S. economy is affected by a new recession, such disequilibrium could be quickly addressed, however, at the cost of a further reduction in equity prices and increased aversion to risk. As we have discussed many times before, an orderly adjustment can only take place through a revamping of domestic demand in the rest of the world. In this context, it seems natural to call for stimulative macroeconomic policies everywhere and in particular in Europe and Japan. Experience tells us, however, that stimulative macroeconomic policies have limitations and that they could even be counterproductive, particularly when they entail excessive public debt.

The above discussion brings to the fore the need to count with a clear understanding of the interactions between macroeconomic developments and financial market conditions. We have found the present report somewhat lacking in this regard and share Mr. Bennett's call for a strengthened cooperation among all departments of the Fund. As to Mr. Bennett's suggestions on alternative stress-testing scenarios we would like to add also some of the scenarios depicted in Ms. Indrawati's and Ms. Phang's preliminary statement. Particularly worrisome is the subject of derivatives which are presented in the report as one of the main linchpin of the strength of the banking system in the U.S. and also in Europe, helping to preserve the resiliency of financial systems.

The report makes a perfunctory reference to the risk of the derivatives markets, mainly because of the lack of regulations, but fails to make clear the concern mentioned in Ms. Indrawati's and Ms. Phang's preliminary statement that the derivatives market, far from spreading risk among a large pool of investors, may actually concentrate in a handful of major financial institutions. This is not only a consequence of the wave of bank mergers but it also stems from the fact that the major financial institutions that form the market not only act in the critical role of market-makers but they also take speculative positions through their proprietary desks. Thus, not all derivatives are actually used as a hedge but to increase exposures of some of the main financial players of the world which, due to their sheer size, act almost unhindered by the fear of default because of their implicit access to financial safety nets.

The expectation that market discipline and greater transparency alone may help to bring a more orderly behavior on the part of these institutions seems too optimistic. There also seems to be the need to increase the role of effective supervision supported by an improved regulatory framework. The existence of financial safety nets or large social costs gives governments the right and the responsibility to have a more hands on attitude regarding the developments of the derivatives market.

This issue of the derivatives markets has implications that go beyond the banking system. It is a well known fact that many companies went under because of risk taking in the derivatives market to increase profits. In this regard, some reports on the active participation on derivatives markets by the pillars of the real estate market in the United States, the Mae companies, deserve some investigation. What are effectively the risks carried by those institutions in their derivative position and to what extent these risks may limit their ability to continue expanding mortgage financing in the future? This may have significant effects in one of the sectors that has been key to limit the downturn and then sustain the recovery of the U.S. economy.

Another aspect that should be emphasized is the seriousness of the corporate governance events that have taken place in the United States. The report takes a less concerned view on this issue on the basis that the August 14 deadline for corporations to confirm the accuracy of their accounts passed uneventfully. This fact does not exclude the possibility that accounting problems may still surface in the future through more thorough investigations. Moreover, according with external reports, the package of the corporate-reform measures approved by Congress leaves important issues unresolved, for example, the inflating of pension-fund-return expectations and the failure of companies to account for the cost of their stock-options compensation plans. Both of these issues directly impinge on the short-term earning results and, therefore, they may contribute to undermine confidence in corporate financial statements and the value of stocks. Staff's suggestion that transparency and the early application of the self-correcting mechanism of the markets may suffice deserve, in our view, further examination.

With respect to sources of financial risk in the major financial markets, it is notable that in the United States the attention has not focused in the banking or corporate sectors but in the household sector. This "thinking out of the box" seems quite adequate for the characteristics of the U.S. economy and the active role played by the U.S. consumer as the buyer of last resort of the world economy. As ultimate risk holders, actions taken by U.S. households could significantly affect a wide range of markets. This, in our view, amplifies the importance of the household sector beyond that of consumer and saver, having it play a role in the prevailing risk appetite.

Regarding the European financial systems, the most important consideration has to do with the limited scope of merger activity which has been circumscribed to within national borders, thus reducing the extent of domestic competition and failing to take advantage of the economies of scale of a pan-European operational base. It comes as a surprise to us that, in the context of fully integrated markets for goods and services and the existence of a common currency, the reasons presented by staff for the limited cross-border merger activity are “cultural, legal and political obstacles”. Another aspect that deserves attention is the still large share of public ownership in the banking system which may impinge on the characterization of European banks as run on high cost bases, particularly labor costs and low returns on equity.

The Japanese financial system, in turn, continues to be besieged by weak capitalization, low profitability and the emergence of fresh nonperforming loans linked to the structural problems in the financial and corporate sectors. Of particular concern is the risk that banks and insurance companies may run for the exit of their JGB bonds, presently threatened by a negative outlook on the part of rating agencies, due to mounting deficits and debt which could create significant turbulence in international financial markets.

Emerging Market Economies

On emerging markets, perhaps the most relevant issue is the rather ambiguous message the report is sending regarding contagion. On the one hand, it states that contagion in the bond market has remained subdued reflecting limited leverage and continued discrimination by portfolio investors. It is mentioned that emerging markets were affected by the retrenchment in bank lending associated with the credit events in emerging bond markets, but there is not a proportionate attention given in the paper to other types of contagion. The present conditions in global markets of heightened risk aversion continue to reduce exposure in emerging markets. The declining gross financing flows are most likely linked to negative net financing for emerging markets as a group, and particularly to the Latin American region. In some cases, it could be attributed to the high risks of particular countries, but in others, where strong fundamentals are implicitly recognized in low spreads and financial market differentiation, it is difficult to understand the continuing capital outflows.

Finally, we firmly believe that sticking to macroeconomic and financial stability with open markets, while preserving the rule of law and a strong legal and regulatory framework, is critical to build investor confidence and to ensure emerging market the full benefits of increasingly globalized markets. At the same time, we share the view of those Directors that point out the importance of external factors and of a supportive role of the international community, in order for emerging markets to achieve that goal.

Mr. Beauregard submitted the following statement:

We would like to thank staff for the preparation of the fourth issue of the Global Financial Stability Report and to express this chair's appreciation for taking into account the Board's suggestions.

Having said this, we join other Director's recommendation to limit the production of this report twice a year in conjunction with the World Economic Outlook. In our view, a single report covering issues on both the real economy and the stability of the international financial system would benefit from synergies between the two departments involved, allowing the Fund to send a clearer message to the world. We think that it is also very difficult to separate financial issues from economic developments.

The main messages we got from the report are the following:

The international financial system has been able to withstand satisfactorily the deterioration of the world economy, the impact of terrorist attacks and the accounting and financial scandals in the corporate sector of some developed economies. The challenge in future months is to maintain the stability of this sector in some developed economies and to reinforce it in others;

Markets are discriminating more among emerging market economies. The implementation of good economic policies and more transparency have been crucial to explain this result. On the other hand, for a group of emerging market economies, more discrimination among the asset class has lessen their degrees of freedom to continue their adjustment process as financial conditions have deteriorated substantially;

Derivative markets in emerging market economies are important to attract investment flows. Sound regulatory and supervisory frameworks are important to allow a sustainable development of these instruments and to avoid their potential disestablishing effects. This is true not only for emerging markets but also for developed economies. Mechanisms to transfer credit risk have played a crucial role in the recent past to diversify risk more efficiently, and staff's call for better disclosure and regulatory scrutiny is very important. It would be important to reinforce this issue in our surveillance process.

For the developed markets, staff stresses that investors could withdraw from mature equity markets if concerns on financial and economic developments persist, without mentioning what the consequences would be. It could be appropriate to mention that so far we have observed withdraws from mature equity markets in favor of mature bond markets. Thus, we have not seen a reallocation of resources from maturing economies to elsewhere, but from equities to bonds, including private bonds. This may help to explain the moderate reaction of the U.S. dollar to adverse developments in U.S. corporate governance and financial scandals.

As for the need to coordinate the regulatory and supervisory initiatives to promote financial stability, the measures proposed in the Report are in line with those discussed in other international fora (Joint Forum, Basle Committee on Banking Supervision, Banking Supervision Committee of the ECB). However, we miss an explicit reference to the international coordination of the proposed regulatory and supervisory initiatives aimed at achieving a desirable "coherence" of high-level principles and outcomes. Mention should be made explicitly of the new Basle Accord to be finalized next year, which is intended to foster a strong emphasis on risk management and to encourage ongoing improvements in banks' risk assessment capabilities.

In the United States, it is noteworthy the resilience shown by the financial system. Although some indicators have weakened, it seems that the recent changes in the regulatory and supervisory framework, especially those related with corporate governance, have helped preventing a collapse of equity markets. During difficult times, changing strategies by the financial institutions constitute part of the process of adapting themselves to new circumstances. We welcome these changes although we concur with Mr. Callaghan and Mr. Di Maio that they may have an impact in the real economy.

We thank staff for addressing the issue of the real estate sector in the United States. So far, this sector has performed quite well but the risk of a drop in housing prices could affect not only the financial sector but also the economy at large. Although staff points out some of the factors explaining the increase in housing prices, they did not rule out the possibility of an unsustainable bubble. Given the importance of this sector in the recovery process, close monitoring is called for. In the corporate sector, an increase in profitability margins is crucial to sustain recent improvements in equity markets. A sound corporate governance framework is crucial and although the effectiveness of the measures recently taken is not in dispute, it may be too soon to have definitive conclusions. This is an important issue because practices in the most developed financial centers are used as models for the less developed financial markets.

In Europe, the situation of the financial system looks more diverse. Staff notes that from all the euro area countries, Germany's financial system seems to be in a more fragile situation. Further slowdown in economic activity and the uncertain behavior in inflation, could worsen the current situation in this sector. Given the importance of this economy in the region and in the world economy, we call on staff to remain vigilant on developments in this country's financial system. On the other hand, the improvements noted by staff in the bank's capital levels, asset quality and profitability in France, Italy and Spain are very welcome. One issue that we think the report should have included is an analysis of the exposure of the financial system to the real estate market, as was done in the case of the United States. We would appreciate staff comments.

The report highlights that "further progress can be made in addressing structural problems in the EU financial systems…overcapacities in European banking persist as potential returns to scale remain unexploited"(p. 32). In this regard, a recent study by Banco de España analyses the rationale behind the scarce M&As activity of the financial sector in Europe. The study shows that M&As that involve two financial firms from different countries generate significantly negative value because of the lower return that shareholders of the targeted firm enjoy upon the announcement of the merger. This evidence is consistent with existence of differences in regulations, business culture or other transaction barriers, which make synergies from a cross-border M&A too small. In spite of all the above, we deem that conditions for M&As are improving by degrees in Europe on two relevant fronts:

The consolidation of the providers of infrastructure services that support banking i.e., consolidation of volumes at the automated clearing-houses (ACHs).

The increasing harmonization of European banking regulations.

These changes will slowly increase synergies from cross-border mergers somewhat closer to the levels of domestic M&As.

The financial system in Japan continues to be a source of concern. Recent measures announced by the authorities, without a comprehensive reform of the corporate sector, will have a limited impact. On these measures, does staff know what would be the criteria the Bank of Japan will use to purchase stocks from major banks to reduce their volatility, what will the Bank of Japan do with the purchased shares and what procedures will be implement to sell them? What "moral hazard" implications could this policy have? In my view, the deterioration of the value of bank's shares is simply the reflection that the assets of the institutions are deteriorating. That is, they reflect a lower value of the loan portfolio of the banks. By limiting the decline in the value of these shares, the Japanese authorities are just hiding part of the problem, but they are not solving it. What is important is to move decisively to restructure both the corporate and the financial sector.

With respect to exchange rates, at the end of page 13 and last indent in page 16, a reference to an increase in volatility in foreign exchange markets is made. However, exchange rates have remained well within fluctuation ranges among the main currencies. Moreover, both historical and implicit volatilities do not seem to show particularly high levels. In this regard, the upper part of figure 2.4, on “currency derivatives”, should probably read “euro/dollar” and “yen/dollar” instead of “euro” and “yen” (although there is no explanation on the way the chart has been constructed, it should refer to currency pairs).

The increased risk aversion that has characterized financial markets since last year has had a negative impact on emerging market economies. Yet, it is important to highlight that the market has been less harsh with those countries that have implemented sound economic policies, whose political systems are stable and are more transparent. The Fund’s role in this regard has been and should continue to be in highlighting the differences among economies rather than in highlighting the possibility of contagion. Stable debt structures have been fundamental to protect these economies from current events in the asset class and from higher risk aversion. A comprehensive debt management strategy is important in order to shield these economies from unpredicted events. A message from the report is that countries should continue to implement sound economic policies. Although I agree with this recommendation, I also think that these policies are a necessary but not a sufficient condition to shield economies from contagion. Thus, a policy question for the Fund would be what should the institution do to provide further cushion to these economies from contagion? Staff comments would be welcome.

The available statistics (mainly BIS) do not seem to support the idea of a transmission of Brazil problems to other countries, through a common lender channel, as stated in page 65, paragraph 3. We would ask therefore to delete the last five lines of the paragraph unless supported by relevant evidence.

The staff’s description of the risks an economy could confront by relying on indexed debt structures is very welcome. Experiences, quite often bad, highlight the need to refrain from depending too much on this kind of instruments. The main message here is that even though in the short run the reduction in the cost of funding is attractive, debt managers should take into account possible future developments and its consequences on the debt service profile. Our surveillance process must stress this important aspect, namely that what is important is not just to reduce the cost of funding but to work on a stable debt profile.

Ms. Lundsager and Mr. Baukol submitted the following statement:

Key Points

The GFSR importantly notes that markets have remained orderly in recent months and suggests that the main risks going forward are unlikely to lead to market instability.

The section on markets in major financial centers is well presented. We concur with the view that these markets have remained resilient to shocks due to past progress in strengthening balance sheets, pricing risks, and repackaging and distributing risks more broadly.

Financial flows to emerging markets have fallen significantly, in part due to higher perceptions of risk and risk aversion, to the benefit of the most credit-worthy borrowers.

The role of derivatives in past emerging market crises is overstated in the concluding chapter. This section should be substantially reworked to avoid misleading implications that are not well documented.

Looking forward, we think that a semi-annual GFSR, with quarterly updates on emerging markets, would be more helpful to the Board.

The report correctly notes that market sentiment has deteriorated in recent months, volatility has increased, and prospects for the global recovery look more uncertain. Nonetheless, several mitigating factors, including recent monetary easing by the Fed, suggest that any market instability would likely remain limited and manageable. The report cites a number of risks, and we concur with the judgment that policymakers need to continue to act to support global recovery and stability. In particular, macroeconomic policies in advanced countries should be supportive of growth, and emerging markets need sustained commitment to strong macroeconomic policies.

Major Financial Centers

We are pleased to note an improved balance of coverage between the United States, Europe, and Japan, focusing on the main sources of, or impediments to, stability in the largest financial markets. We generally concur with the main findings in the report, and would highlight the following:

The recovery in the United States remains largely on track, thanks to the resilience of the U.S. consumer, at least so far. Balance sheet indicators, while weaker than before the recession, do not suggest a serious short-term vulnerability in the household or banking sectors.

Balance sheets in Europe are less reassuring, in part because of data problems. The banking sector in Germany in particular has been under pressure, as we recently discussed in the Article IV meeting.

Japan's issues are well known. Expectations of action to address the problems have disappointed markets too often.

It is striking that data presented in the sectoral balance sheets for Japan and Europe are not available except with a significant lag. More timely data would be conducive to better analysis. We encourage staff to work with the authorities to obtain the most recent data for financial soundness indicators. We also encourage staff to look into the issue of the comparability of data between countries, as well as ensuring that data are used consistently across various IMF publications.

Emerging Markets

Financial flows to emerging markets overall have been lower than in recent years. Part of the story relates to lower demand, but part is also due to heightened risk aversion and heightened perceptions of risks, as described in the WEMD session. Of course, markets are differentiating by risks within the context of the trend toward risk aversion. Emerging markets that seek financing need to maintain sound macroeconomic policies, including debt management strategies, while taking steps to improve their investment climates to generate productivity and longer-term growth. In cases where countries are on the right track and have achieved investment-grade ratings, borrowing costs are low. It is striking, for example, that borrowers in Central Europe face lower spreads than their Western European counterparts.

We appreciate the focus on Brazil (although we ask why "corrections" have been issued to delete parts of this from the published version). Clearly, prospects for Brazil will have a significant impact on the region. Other key emerging markets, such as Turkey, should also not be overlooked.

The report refers to other topics that could use more detailed treatment, including:

Credit tiering: The current market environment may be contributing to a more aggressive tiering of credits with respect to sovereigns and other borrowers. The reasons behind this and the implications for borrowers would be useful to explore.

Changes to benchmarking practices: The report notes movement away from benchmarking to the EMBI+ (a practice of 'dedicated' investors) toward other indices and absolute returns. In the latter case, this suggests that some 'dedicated' investors might be behaving more like 'crossover' investors.

Major shifts in these practices could impact the cost and access of emerging market borrowers to international capital markets, including for countries that have thus far been treated by investors as relative ‘safe havens’.

Derivatives

We welcome the chapter on the development of derivatives in emerging markets. In our view, however, the paper provides an unbalanced view of the role of derivatives in some past crises, including the Mexican, Asian and Russian financial crises. We suggest that the last part of that section (pp 87-91) be significantly reworked before publication. Indeed, given that the GFSR is already lengthy and, in light of the substantive revisions required, this section of the chapter could be incorporated in the next report that focuses on policy implications.

In particular, the chapter as written gives the misleading impression that derivatives have caused or greatly exacerbated emerging markets crises, without providing quantitative evidence to bolster these assertions. These emerging market crises have been caused by macroeconomic imbalances, of which derivative market volatility is a symptom, not a cause. For example, the draft suggests that the use of total return swaps helped lead to the Mexican Peso devaluation of 1994, when in fact, weak economic fundamentals and political instability made the exchange-rate peg unsustainable. Also, the analysis of the role of derivatives in the Asian crisis is based on secondary sources that present no quantitative evidence of the role of derivatives in exacerbating the crisis. To some extent, the use (or mis-use) of derivatives in these cases reflected the underdevelopment of domestic financial markets and restrictions on types of financial transactions.

Two points noted in the chapter should be given more prominence. These are that: (1) derivatives were often ‘mis-used’ in that they did not reduce and spread risk but instead increased risk, and (2) derivatives sometimes reduced the transparency of banks’ exposures in these cases. Both of these issues suggest the need for proper regulation and supervision of derivatives and will feed in to the topic of the next GFSR report, which will cover the policy implications for emerging markets.

GFSR Format

Finally, some general concerns about the report itself. We continue to think that the GFSR is too ambitious for a quarterly publication. A semi-annual report would be more useful and a better use of scarce staff resources. If needed, staff could also issue a short summary of emerging market financing trends on a quarterly basis, perhaps in conjunction with the WEMD. The semi-annual report, shorter than current versions, should focus on developments in financial markets, key risks, and the implications for industrial and emerging countries. The GFSR should concentrate on developments in industrial and emerging markets where IMF analysis could add the most value and perhaps less on U.S. market trends, where there is ample public information.

Mr. Ondo Mañe submitted the following statement:

We thank staff for producing this comprehensive update on the Global Financial Market Stability Report that provides a good analysis and assessment of global financial markets.

Since our last Board discussion in August, developments on the financial markets have been marked by a further deterioration in investor sentiment, growing uncertainty and concern over the strength and durability of the global economic recovery, the prospects for corporate profits compounded by geopolitical uncertainties. Despite these developments, the global financial system has remained resilient and the risks to international financial market stability remain limited and manageable as evidenced by recent policy actions, notably by the U.S. authorities, private sector initiatives and market developments. Nevertheless, sources of risks and vulnerabilities still prevail that will require the vigilance of authorities for both developed and emerging markets. In this regard, developments on these markets should be monitored carefully. Indeed, the resiliency of the financial markets will depend on the capacity of policy makers to address the vulnerabilities. Wednesday's WEMD session drew attention to the increasing risks of a further slowdown in the global economy, and the question that comes to mind is whether developments in the financial sector may be contributing to a worsening of the situation, and what additional policy actions should be envisaged? Staff comments will be appreciated.

Developments In Mature-Markets and Sources of Risks and Vulnerabilities

Recent developments in the global financial system have been characterized by growth slowdowns in various industrial countries. Widespread equity price declines and significant financial losses in the key sectors of the global economic have been major symptoms of weaknesses in the global financial system. These have been translated into excessive retrenchment from risk taking in financial markets and especially from lending to less credit-worthy borrowers. The impact of the decline in global stock markets had been severe. Indeed, pressures on banks and financial institutions have been evidenced by the significant decline in bank stocks in the United States and Europe. In the United States, investment banking, insurance and reinsurance companies experienced losses on their asset portfolios. In Europe, the difficult economic and financial environment has worsened structural weaknesses in some financial systems. In Japan, the financial system continues to suffer from structural problems owing to the close links between the corporate and financial sectors.

Nevertheless, the resiliency of the global financial system has been reassuring. Key factors underlying this resilience include the strengthening of financial infrastructures in the major international financial centers; advances by financial institutions in pricing and managing financial risks; and the increased ability to repackage and distribute financial risks more broadly. These have reinforced the capacity of the financial system to resist and absorb shocks. In addition, strategic responses by financial institutions to financial vulnerabilities have limited financial risks. Nevertheless, significant risks remain, and the ability of the financial institutions to play their financial intermediation role may be affected. If this is the case, then they may be contributing to the global economic downturn, and it becomes critical that appropriate policies be developed to address this situation.

In the United States, the large share of securities held by households may prove a source of vulnerability in a situation of deterioration of their financial conditions. Growing household debt is a major concern. While low interest rates and continued strong income growth have supported households' ability to service their debt, we are of the view that record levels of households liabilities need to be addressed. However, it is worth noting that U.S. banks remain sound thanks to the adjustments they made. Nonperforming assets have remained relatively low and capitalization ratios are high by international norms. In Europe, the source of financial risks stem from the deterioration in wholesale and retail credit quality caused by the weak economic environment. Nevertheless, it is reassuring to note that many European banks have maintained regulatory capital ratios thanks to an improvement in underlying profitability. There is however a need to address structural problems in European financial systems so as to strengthen their resilience. In Japan, asset-price deflation and severe economic weakness have continued to impair the financial system and led to the emergence of nonperforming loans. The financial sector suffers considerable exposure to market risk and remains in precarious condition.

We are concerned by the impact of such risks on developing countries' economy, particularly sub-Saharan African countries, given the uncertainty surrounding the economic outlook.

Developments on Emerging Markets

We welcome this chapter that analyses recent developments in the financial markets of the emerging markets. Developments here have been characterized by a sharp deterioration of investor sentiment compounded by uncertainties in the external financial environment of many countries. Indeed, uncertainties over economic policies and political developments in Latin

America have adversely affected investor confidence. In addition, heightened risk aversion, continued mature equity weaknesses and volatility, and bank losses in mature markets and reputation losses were detrimental to emerging market financing. Nevertheless, borrowing requirements remain high, and if not satisfied, they will have an adverse effect on the growth prospects of these countries, and will certainly affect their debt servicing capabilities with serious consequences for the rest of the world.

Role of Financial Derivatives in Emerging Markets

While the share of emerging market derivatives is still small, we share the view that local markets play a key role in raising funds. While they cannot be a perfect substitute for international markets, they bring some advantages, including the redistribution of various risks (foreign exchange, interest rate, default risks), which call for their development. However, we note that they can also be a source of risks. Indeed, they may allow market participants to take on excessive leverage, avoid prudential regulations, and manipulate accounting rules, in particular in an environment where financial supervision and management systems are weak. We note also their role in financial crises. The key issue, therefore, is to find the right balance between the need to promote these markets that provide an alternative source of financing and the need to mitigate their risks. We are of the view that strengthening supervision will be critical to reducing the sources of financial vulnerabilities and prevent financial crises in these markets.

Finally, as regard the timing of the GFSR, we agree with the suggestion made by Mr. Bennett.

Mr. Reddy submitted the following statement:

We thank the staff for this insightful Global Financial Stability Report (GFSR) and the useful analysis of market developments in major financial centers and emerging markets. We welcome the coverage of financial derivatives in emerging markets as a special topic. The report has become much sharper and captures vital developments and important issues. In our view, this quarterly series of publication of GFSR, along with the updates of World Economic and Market Developments, by providing a timely assessment of economic and financial market conditions, is helpful in multilateral surveillance.

In terms of coverage, the report's volume would be enhanced with more attention to the currency markets. We note that Chapter-II (page 16) has raised the point that investors saw heightened uncertainty about future G-3 exchange rates and an increased probability of a dollar depreciation. Has the possibility of sudden and disruptive adjustment in exchange rates of major currencies abated or does it still continue? We invite staff's comments.

It is encouraging that the financial system has exhibited resilience to several adverse developments. However, the statement that `markets, while ….unusually volatile, remained orderly' (page-5, para-2) appears too conciliatory. In view of the discordant behavior of equity markets in the recent past, it may be more appropriate to say that while some discordant behavior of equity market was noticeable in certain segments, the financial system functioned by and large smoothly.

While risk aversion and risk taking follow their own cycle, depending upon the market environment and development, we agree with the assessment that it is important to guard against an excessive swing towards risk aversion since it can jeopardize healthy evolution of the global financial system. The recent events underscore the importance of availability of reliable and timely information to markets. The undue volatilities arise on account of surprises—when some information already available is found to be faulty, as it happened in the case of recent accounting and auditing scandal creating a near panic situation. Steps are therefore needed to rebuild confidence and IFIs have a significant role to play in this regard, apart from the national authorities' watchful eye in individual markets.

In page 10, under measures to promote financial stability, there is a mention that `regulatory forbearance should be avoided'. While we broadly agree with this statement, in our view, while regulatory indifference could be dangerous and detrimental to orderly market development, regulatory forbearance should be acceptable when it is a matter of conscious choice depending on the context. Regulatory concern for financial stability may require at times an exercise of such a choice particularly when systemically important institutions and markets face the potential threat of a failure, mainly because of external factors and shocks. Bailouts nevertheless should be exceptions both in domestic and international environment. We suggest therefore that this statement should be appropriately qualified.

Financial intermediation even at the global level is governed by assumption and distribution of risks based on information, both old and new. As reports like GFSR strengthen the information base, in an analytical form, it can have significant influence on risk assessments and perceptions by market participants, regulators and analysts. From this angle, the report needs to be publicized widely and, if considered necessary, in shorter versions. While doing so, it is important in our view to highlight and further elaborate on positive developments in the functioning of markets such as advances by financial institutions in pricing and managing financial risks and the increased ability of the markets to repackage and distribute financial risks and the positive steps taken by authorities for improving market stability such as the passing of Sarbans-Oxley Act and establishment of Public Accounting Oversight Board in the United States, preferably as separate box items. Such information dissemination could act as a risk mitigating factor and promote the cause of financial stability.

Discussion on financial system risks in major financial centers like the United States, euro area and Japan is very aptly supported by useful data analysis of sectoral balance sheets and relevant ratios. We appreciate the staff efforts for this contribution. The very low interest rates have spurred heavy housing demand in the United States and general consumer demand in Europe, but it has also resulted in substantial accumulation of debt by households. The financial system risk in the United States appears to be milder than in Europe. Perhaps, the financial system feels more secure about retail financing like housing and consumer credit, compared to other commercial credit. Apparently, there is no serious problem about this, except that a housing bubble following a stock market bubble in the United States could lead the financial system into a somewhat slippery path. But, what is of more serious concern is that apart from deceleration in cross border financial and capital flows, even in domestic markets, the credit flows into productive and commercial sectors appear to be shrinking. This does not auger well for revival of real sector activity. Secondly, the return to credit portfolio in general in preference to investment banking activity represent a reversal of a healthy financial development. Therefore, confidence building among the investor community is a clear necessity if the market integrity is to be preserved and financial development is to be nurtured. Ways may have to be found how to strengthen or create conditions to strengthen the balance sheets of both financial institutions and corporates so that they are able to take reasonable risks. Confidence building requires strengthening of governance at both private corporate sector and government and public sector level to restore stability and also to make the financial system to sub serve the cause of growth and recovery.

The discussion on emerging market derivatives is a fair assessment and provides lessons for sequencing and phasing of market reforms in emerging and transition economies. While derivative products have attracted capital flows into these economies, they also exacerbated crises dynamics in these economies. There should therefore a guarded development of these products, preceded by strengthening of internal control and risk management systems among the market participants. We welcome in this regard the idea that the next GFSR will examine policy implications of developing local bond, equity and derivatives markets. It would be useful to present some successful case studies, as part of this analysis.

Mr. Wijnholds submitted the following statement:

Key Issues

Further downward risks for European stock markets seems to be limited. In the United States, however, stock prices have not fallen as deeply as in Europe and downward risks seem to be more pronounced.

A fall of house prices caused by rising interest rates remains a risk for economic recovery, mainly in the United States but also in some European countries.

For Europe, the report seems to overestimate the risks to the financial system of the balance sheet problems of some German banks. However, the report could have paid more attention to the effects on consumption and growth of the loss of value of pension funds as a result of the fall in stock markets.

The Global Financial Stability Report could be further improved by focusing more on emerging market issues and by having a more forward looking approach, so as to give us practical guidance in our work on crisis prevention. Furthermore, the report could be somewhat shorter and more 'to the point'. However, the Special Topic should not be lost in this process of streamlining.

A semi-annual report instead of a quarterly issue seems to be adequate. This could also free up some resources to do more background analysis on specific developments and provide suggestions for our policy reactions.

Introduction

I very much welcome the opportunity during this discussion of the fourth Global Financial Stability report to discuss not only the content of the report, but also its format. I will start with my remarks on the current issue and then make some general suggestions for further improvement.

General Developments

The staff rightly emphasizes the importance of stock market sentiment, which has contributed significantly to the current uncertainty in financial markets. In this context, a key question is whether further downward corrections may be expected. According to various indicators, European share prices may have reached sustainable levels now. Since early 2000 there have been downward corrections of 50 percent or more in most European countries' broad indexes, while price/earnings ratios are in line with their historical averages (around 15). Hence, in the medium term downward risks seem to be limited. For the United States the story may be different, as share prices have not decreased as much as in Europe. This is somewhat puzzling, as some of the main driving forces behind the stock market corrections originate from the United States, in particular the September 11 terrorist attacks and the accounting scandals. High productivity growth may account for this feature. However, as highlighted above, the continuation of this productivity trend is questionable.

United States

Furthermore, given the high level of household debt and the exposure to asset markets, I agree that the financial position of U.S. households is of key importance. In this context, the risks of a cooling housing market may be somewhat understated in Chapter II of the report. After all, as various recent studies show, the impact of changes in house prices on the economy is substantially larger than the impact of the stock market. The strength of housing demand, which is supposed to buttress house prices, may soon evaporate if interest rates rise. After all, despite the growth in fixed rate mortgages, in such a scenario first-time buyers' borrowing capacity will decline, which creates a downward pressure on prices. As a consequence, existing house owners will face a reduction in home equity. Net wealth positions may even become negative, especially for recent home buyers. As these are often young households, which on average have a high propensity to consume, negative wealth effects may be substantial. Moreover, negative wealth effects of rising interest rates may kick in much faster than positive wealth effects, as people tend to service their mortgage as long as possible at the cost of consumption spending.

In addition, a change in the interest rate may impact the banking sector through the interest rate risk implied in fixed mortgage rates. With the long end of the yield curve being fixed at historical lows, profit margins may be squeezed in this scenario. Altogether, whilst an interest rate hike will not cause immediate financial problems for most home owners, it is likely to have a significant impact on the economy through negative wealth effects and banking profits.

Europe

With regard to Europe, I have the impression that the report overemphasizes the risks of the deteriorating balances in the (mainly) German banks. As the analysis is quite positive about British, French, Dutch, Italian and Spanish banks, and given that the indicators for the German banks are not yet dramatic either, I think that the report gives too much the impression that there are major problems on the horizon.

What could, however, have been an aspect deserving somewhat more attention, is the European (and worldwide) pension sector. Some pension funds have seen the value of their asset portfolio shrink as a result of the fall in stock prices, and they might have to raise premiums or reduce benefits to comply with supervisory standards. In the Netherlands for instance, requirements by the supervisory authorities may lead to steep increases in pension contributions or reductions in benefits, both having a direct impact on consumption demand. It would be interesting to make an international comparison in that area to judge if this is a problem with wider implications.

Emerging Markets

Staff's analysis supports the view that international investors continue to discriminate between emerging markets, thereby limiting the possibility of broad-based contagion. However, an apparently high degree of differentiation by investors can be reversed in a matter of weeks, so that vigilance remains appropriate.

Another issue which could be usefully discussed on a next occasion, is the developments in credit markets and financial systems in Asia. Especially the fast growth of consumer credit in Korea might be a reason for concern in this respect.

Emerging Market Credit Derivatives

Turnover in emerging market derivative activity increased sharply in the past few years. Important reasons behind this development are deeper domestic capital markets and fewer (effective) regulatory restrictions that hamper the use of derivatives. The entrance of domestic pension funds and other institutional investors has stimulated both these factors (since these funds are frequently biased towards domestic securities and are a paramount force in promoting financial innovations). Moreover, the demand for derivatives may also have been stimulated because of the higher proportion of both domestic and international securities with a longer maturity. Regarding international securities, the longer maturity profile is not necessarily a source of strength; while it reduces rollover risks, it increases exchange rate risks and thus demand for currency hedging.

Furthermore, staff indicates that currently most sellers of protection in the Emerging Credit Default Swap (CDS) market are local market participants for corporate credit risk. In times of stress, however, these are not ideal counterparts. When default risk of corporates in emerging markets increases, this is often caused by a deterioration of the political or macro economic environment. In that case, the fact that the CDS is sold by a local market participant is not comforting, because a more hostile macro-environment also increases counter party risk.

Format

In general, I believe that the Global Financial Stability Report has been a good addition to our list of publications, although it still suffers somewhat from having to succeed two rather different predecessors: the International Capital Markets Report and the Quarterly Emerging Markets report. As I have indicated before, I think that we should focus somewhat more on issues in which the Fund has a 'competitive advantage'. And in my opinion, that is the analysis of developments in emerging markets. For developed markets, ample economic and financial analysis is freely available, also on the internet. For emerging markets, however, available data are often limited and good analysis is scarce. The Fund generally has a long history and experience in countries for which market participants only start showing some interest. Furthermore, our lending facilities make us focus very much on potential program countries with large market access.

With regard to the frequency, I could go along with having only two reports each year, preferably issued in between the dates of the World Economic Outlook. In my opinion, these reports could be somewhat shorter and more compact than the current issue, although I think that the 'Selected Topics' should not disappear. These Selected Topics give us the sort of background analysis on market developments that made us create the International Capital Markets Department in the first place.

Finally, I think that the report could place somewhat less emphasis on the description of past developments, and be more forward looking. It is our job is after all to look into the future to distinguish potential dangers to the financial stability and to develop adequate policy measures to prevent them from materializing.

Mr. Andersen submitted the following statement:

General Remarks

I thank the staff for another interesting report on Global Financial Stability issues. The report is, again, comprehensive with a systematic approach to assessing the key developments and risks facing global financial stability, and I share the assessment of others that the GFSR continues to improve. As I also commented on in August, I appreciate the way the report clearly lists the major risk factors to the financial system, and makes policy recommendations based on the analysis. I note, however, that the policy recommendations are fairly general, and I do not have any problems in supporting the main thrust of them. At the same time, I agree with those who have recommended more emphasis on the implications of financial market developments for the real economy, including to the various transmission mechanisms referred to by Mr. Padoan and Mr. Vittas. And it is only natural then to focus on policy recommendations as well, as also mentioned by Mr. Callaghan and Mr. Di Maio. Indeed, I concur with their observation on children's appetite for ice cream and would add that all of us like the toppings as well.

As the Secretary mentioned in his memorandum of November 12, this discussion would provide an opportunity for the Board to consider options for the periodicity, structure, and forms of future GFSRs and their synergy with other work on surveillance. Some of us have indeed used previous GFSR discussions to address these issues, and my position is very close to that of Mr. Bennett. While discussing financial market developments quarterly in the Board seems to be an appropriate frequency, it may be a more efficient use of ICM's resources to produce only two full-length reports per year, and have additional, briefer capital market presentations in connection with WEMD discussions in between. It might also be possible to make these reports even more focused partly in light of the abundance of financial information that is readily available from a number of authoritative sources, including to make better use of existing stability reports of central banks and supervisory institutions. Shorter updates coordinated with the WEMD could perhaps, in particular, focus on developments in emerging markets where the information is otherwise more limited available. I also agree that the reports are likely to benefit significantly from close collaboration with other Departments.

Overall, I feel that this report presents a more balanced view than the previous report, with more emphasis on factors affecting all countries. In particular, I found it useful that the report in its assessment of the sources of risk discusses the remaining financial resilience of key financial institutions and investors in the major financial centers. The report focuses on the sluggish developments in financial markets and the heightened investor risk aversion. It rightly points out that the global financial system has remained resilient in spite of these developments. Markets have generally remained orderly and the financial system has functioned smoothly. The report emphasizes that a number of recent policy actions, private sector initiatives, and market developments underpin this assessment, such as the monetary easing by the U.S. authorities, the boom in mortgage refinancing in the United States, and steps to regain the confidence of investors.

Specific Issues

I welcome the focus on the European banking sector, but tend to believe that the conclusions are too heavily dependent on developments in the German banking sector. Furthermore, I would not think that the analysis fully justifies placing the risks facing the European financial sector in the same category as the long-term and severe problems facing the Japanese financial sector, and the significant risk represented by the U.S. household sector's exposure. While I certainly agree that the European banking sector is facing a number of risks, I also think the analysis put too much emphasis on the structural rigidities. A recently published report from the ECB on structural developments in the EU banking sector concludes that structural trends have enhanced the robustness of the EU banking sector, and thus increased its resilience. Indeed, the levels of capitalization and asset quality are generally sound, provisions have been increased significantly, and the non-performing loans seem closely related with the impact of a normal economic downturn. In a future report, I think it could be useful to address the European banking sector's exposures to Latin-American countries in crises, or to the TMT sector where an analysis of whether the debt of TMT companies is sustainable or not could be useful.

As homeowners' equity, especially in the United States, seems to be the "savor" for continued growth, the sustainability of this channel of consumption deserves to be assessed in one of the coming reports. To follow-up on another of Mr. Bennett's many useful suggestions, such an analysis could be presented in the form of a stress test or a sensitivity analysis.

The report does not seem to make a clear distinction between problems in non-life insurance and in life insurance/pension funds. As the nature and the possible impact are quite different, there is a need to analyze each sector separately. Footnote 11 on page 34 briefly mentions that changes in accounting standards seem to be the way several countries help insurance companies (here, again, a clear distinction between non-life and life insurance is needed). A future report may elaborate more on this. A related issue that could hide future risks to the global financial stability is the increased use of risk mitigation instruments, as the institutions most suited to carry credit risk such as banks transfer credit risk to institutions such as insurance companies, which are neither suited, nor experienced with handling credit risk. A further look at the U.S. insurance and pension plans may also be of interest, including in view of the strong presence in the United States of corporate defined benefit pension plans.

On a minor point, I note that staff uses the term "excessive risk aversion" in chapter 1. The analysis of developments in risk aversion presented elsewhere in the report indicates to me that investors' risk behavior is a rational response to sluggish economic developments, the substantial losses many investors have experienced throughout the last 20 months, and the significant shortcomings revealed in corporate governance, auditing, accounting and investment banking practices. Could staff briefly comment on which indicators that indicate that the recent risk retrenchment represent some kind of overshooting?

The deteriorating sentiment toward emerging markets that was described in the previous report continued in the third quarter. Uncertain prospects for economic growth and concerns over excessive leverage and capacity were exacerbated by investor doubts over policy continuity in Brazil and other emerging markets, and to some extent the risk of war in Iraq. In looking forward, I fully agree with staff that developments in Brazil will be critical for how investors approach emerging markets in the near to medium-term future. And therefore, like Mr. Bennett, I find it unfortunate that so little emphasis is put on the analysis of emerging market contagion in this report. I would say that developments in several Latin American countries this summer had justified a closer analysis of contagion effects. An alternative way for staff to follow up on this could be by including some analysis of contagion issues and other vulnerabilities in Latin America in the next Informal Country Matters Session, which I understand will include information from Western Hemisphere Department. To have close cooperation between the various Departments could be of relevance also on such occasions where we should expect to be briefed about major vulnerabilities.

I would like to add that I found several of the Boxes in the report very informative. For example Box 3.1, that gives an informative description of three widely used risk indicators. But the accompanying charts seem to give a somewhat differing picture of the most recent developments in risk appetite. Could staff comment on this?

I welcome the chapter on the role of financial derivatives in emerging markets. This chapter in the ongoing series of local securities markets provides highly interesting information on the scale of the derivatives trading activity in the major emerging markets, and is a good example of an area where the Fund may have comparative advantages in its analysis. The potential buffer-role these domestic markets, both in derivatives and other securities, can play in periods of turbulent external environment is very important. I also agree that strong derivatives markets can play a positive role by reallocating risks and facilitate growth of capital flows. The potential risks related to the use of such instruments, should, however, also be emphasized, particularly if the development of derivatives markets does not coincide with a sufficient strengthening of prudential regulations.

One particular problem for supervisors in this regard is the limited availability in many countries of systematic information about the financial institutions' derivatives activities, and even less information is available on other institutions derivatives trading. In particular, I note that many of the derivatives linked to the Central European countries are traded from offshore centers, partly due to restrictions on derivatives trading in several countries. This further increases financial supervisors' difficulty in obtaining sufficient information about the activities in these instruments. In sum, I very much look forward to the "toppings", i.e., the announced analysis of the policy implications of developing local bond, equity and derivatives markets.

Mr. Zurbrügg and Mr. Moser submitted the following statement:

The current issue of the GFSR again entails a wealth of ideas and information. We again found it rather difficult to put all of these insights into perspective. The report has various overlaps, and it does not sufficiently focus on the main points. No doubt, the production of such an extensive publication on a quarterly basis is very demanding, and during the reading of the report we could not help but be reminded of the dictum by the French philosopher and mathematician Blaise Pascal, when he wrote: "I have made this letter longer than usual, only because I have not had the time to make it shorter." We thus agree with Mr. Bennett and other Directors that future reports should be produced on a semi-annual basis, preferably coordinated with the publication of the WEO, with interim updates.

In order to accomplish its purpose, namely to identify potential systemic weaknesses that could lead to crises, the report should be improved in two directions. First, we reiterate our call for a clearer focus on the main risks. Here, it is also important that staff does not shy away from calling a spade a spade out of respect for possible market reactions. Of course, we are aware of the difficulty that market sensitivity poses, but if this concern is our overriding principle for this report then its value is significantly reduced. A case in point are the corrections regarding Brazil on pages 65 and 66, which remove nothing more than a realistic assessment of the situation. Second, the risks must be embedded in scenarios in order to better grasp their possible implications. A standard set of vulnerability indicators for the most important countries would also be very helpful in order to allow cross-country comparisons and track developments.

Main Risks to Global Financial Stability

Identifying the main current sources of risk to global financial stability is one of the central goals of the GFSR. In the overview chapter, staff presents a broad range of such risks that go from the most immediate risk, a further decline in major equity markets, over the possibility that a further retrenchment from risk taking in the major financial markets could reinforce the current trend of tiering in emerging market financing, to "particularly important" developments in Brazil. Unfortunately, the treatment of these diverse risks in the main body differs significantly. While there is little follow up on the declines in equity markets, Chapter 2 stresses that "the main sources of risk to global financial stability seem[s] to be associated with a further significant and excessive retrenchment from risk taking." Moving on to Chapter 3, the points raised under the heading Key Risks are again many, making the identification of what staff considers to be the main risks difficult. While we recognize the challenge of distilling the main risks out of the myriad of developments in the financial markets, a high frequency publication aimed at identifying key current risks must try to focus on the essential. In our view, the GFSR would benefit from a more concise and prioritized list of risks.

In the current situation, we feel that the mentioning of at least three other major and relevant risks is missing: a possible war in Iraq, the likelihood of deflation in the major economies, and a further deterioration in Brazil. Regarding deflation, Mr. Rogoff has elaborated on this risk in his WEMD presentation on Wednesday and we fully share his assessment. Given the extensive deflation discussion in the press and in the financial community, however, it would have been appropriate to touch on this issue.

Major Markets

The sectoral balance sheets for the United States and for Europe provide valuable information. When comparing the data for the corporate sectors, however, we were somehow surprised to learn that European debt/equity ratios are almost twice as large as in the United States, while at the same time (nonfinancial) corporate credit spreads seem to be systematically higher for U.S. corporates, both in the AA rated segment as well as in the BBB rated segment (Figure 2.2). We would appreciate if staff could elaborate on this issue.

As regards the European financial system, the report notes that a lack of progress in addressing structural inefficiencies has led to a situation in which low profitability, particularly in domestic retail operations, is limiting the scope for some key institutions to earn their way out of problems associated with the deteriorating wholesale business environment. This seems to be somewhat less the case in the Swiss banking sector, at least for the two major Swiss banks, which report very healthy profits in their domestic retail business. This might be a fruit of the fundamental banking-system restructuring that has taken place in Switzerland in the early 90s, following the domestic real estate crisis.

Emerging Markets

As mentioned in the original version, within emerging markets, developments in Brazil are critical. Spreads remain extremely high and the refinancing needs for the reminder of the year are substantial. Developments in the rest of Latin America do also need to be monitored closely, however, given weak growth outlooks, high debt levels, and spillovers from Argentina and Brazil. In central and eastern European Emerging Markets, progress in EU accession talks affect financial market developments positively. In Russia, however, the banking sector should be closely monitored, given negative real interest rates and strong private sector credit growth. In Asian emerging economies, we wonder whether we should be concerned about deflation in China and increasing risks within the Chinese banking system.

Box 3.2 on local debt structure and vulnerability to volatile debt dynamics touches on a very important issue. In earlier reports, staff has emphasized the importance of deep local markets as a buffer against global financial shocks, but indexation that increases the issuer's vulnerability to external shocks is often the only practical means of raising funds. The case of Turkey and Brazil, which both have deep and liquid domestic financial markets, is a case in point. Staff points out that there are bond structures whose servicing cost are positively correlated with payment capacity, but how viable are such schemes for solving the dilemma? Staff comments would be appreciated.

Box 3.3. highlights the very high annualized return that can be achieved on defaulted debt, while Box 3.4 updates on the use of CACs. Both of these boxes contain very valuable and important information for our discussion of crisis resolution mechanisms. We think this is a good example of where a GFSR can provide important information on general trends not found elsewhere. We reiterate our call for a broader coverage of CACs, and we would have welcomed a table showing country by country the use of CACs in new issues.

The selected topic issue on financial derivatives in emerging markets provides us with specific and interesting information. Particularly interesting and relevant is the part about the role of derivatives in Emerging Market crises, which hints at how traditional balance of payments accounting and thus vulnerability indicators can provide a misguided representation of capital flows and associated risks. The chapter ends a bit abrupt, however, promising to discuss policy implications in the next report. It somehow gives the impression as if the deadline was too tight in order to finish the chapter, which would reinforce our call for a less frequent publication of the report.

Extending his remarks, Mr. Steiner made the following additional statement:

On the structure of the report, we agree with Mr. Callaghan and others that the report is at times excessively descriptive, and that more in-depth analysis would be welcome. We also support Mr. Bennett's point that, like in the case of the WEO, the GFSR could benefit from including the views provided in other reports, like those of the Bank of England and the Bank for International Settlements (BIS). We agree with Messrs. Zurbrügg and Moser that a high frequency publication aimed at identifying current risks should focus on the essentials, and that the report would benefit from a more concise and prioritized list of risks.

On periodicity, we do not see why the GFSR should be biannual, with quarterly updates for emerging markets. It would be ideal to discuss the GFSR around the same time as the WEO in the quarters when this is produced—as the two reports would benefit from synergies between the departments involved—but financial developments should also be reviewed in the alternate quarters. While looking at the real economy on a semiannual basis seems appropriate, volatility and continuous change in financial markets warrant quarterly updates of developments in these markets. Therefore, we support Messrs. Yagi and Toyama in that the current practice of issuing quarterly GFSRs should be maintained.

We cannot support Ms. Lundsager's and Mr. Baukol's position that the GFSR should focus on emerging markets. A GFSR that does not deal with developments in mature markets is pretty much like Hamlet without the Prince. From the preliminary statements issued by Directors, it is evident that there is a wide range of concerns regarding developments in the United States, Europe, and Japan. Depending on conditions, the GFSR can on some occasions focus on emerging markets, but there will be occasions when the overriding concerns will relate to mature markets. Therefore, the GFSR should, in principle, cover all markets, with particular focus and emphasis changing as events warrant.

Extending her remarks, Ms. Phang made the following additional statement:

On the structure of the report, I agree with Mr. Steiner that the presentation should not be confined to emerging markets alone, but that it should cover all markets, with the focus changing depending on the circumstances. There should be a biannual full report for publication, and a joint presentation in the other quarters focusing on policy issues.

I would also like to stress the need to take the analysis beyond the macro level to address the point raised in our preliminary statement regarding the risks to the financial system in the United States—which has been picked up by a number of Directors—and the point raised by Mr. Callaghan that the situation continues to deteriorate despite the staff's assessment that the financial system is resilient and that we are heading for recovery. The WEMD and the GFSR focus on analysis at the macro level, and it would be important to complement this analysis with developments at the micro level to see if these are consistent with the picture presented at the macro level. Figures at the macro level often hide trends which are only evident if investigated at the micro level.

The point that I raised on the possible effects of a confluence of different events illustrates the need to cover industrial countries. For example, debt in industrial countries is high and it continues to rise. In the case of the United States, it has been reported in the press that total public and private debt is at $32 trillion—compared to a GNP of $10 trillion—and annual debt service stands at $7 trillion, 70 percent of GNP. Financial institutions like Fannie Mae have used asset-backed securities like interest rate swaps and options to sustain the demand for housing, and possibly the development of a bubble, although the staff considers in the report that a bubble has not developed in the United States. On a related note, could the staff comment on a September 30 report stating that Fannie Mae has a negative duration gap of 10 months in its assets and liabilities? Also, while low interest rates benefit the consumer, are financial institutions now bearing the risk of an increase in interest rates?

In the United Kindgom, consumer spending has been propped by the secondary mortgage market. The increases in housing prices appear to be higher than in the United States, and the Bank of England is certainly concerned about the property bubble. The Institute of Fiscal Studies also reports that the burden of consumer debt in the United Kingdom is unevenly spread across the population and that a slight increase in interest rates or unemployment could lead to insolvencies. According to this study, household debt has gone up to £80 billion, or 111 percent of disposable income. The confluence of these negative developments raises concerns about whether we are witnessing a financial bubble which is on the verge of bursting. If that is the case, the consequences would be very dire.

In the United States, besides the risk posed by derivatives, I wonder whether the currently high level of personal and business bankruptcies could lead to widespread collapse of the financial system. For example, the situation of the car manufacturer Ford has important implications for the banking sector. Unemployment in the United States increased by 117,000 in October 2002, from 8.092 million in September. The situation is similarly difficult in several European countries, including Germany, and in Japan.

Regarding the point that we made in our preliminary statement about the high concentration of risks in a few financial institutions as a result of the wave of mergers in this sector, I agree with the additional comments made by Messrs. Le Fort and Costa about the fact that big banks are not only the market movers but also market makers. For these reasons, risks have concentrated in a few large financial institutions, rather than being spread out through the use of financial derivatives as currently assumed. Various anecdotal evidence suggests that the magnitude of these risks is a cause for serious concern. I understand that J.P. Morgan had $26 trillion in derivatives as of June 2002, accounting for 50 percent of the derivatives market in the United States, Bank of America had more than $10 trillion, or 20 percent of the total, and Citigroup had $9 trillion, 18 percent of the total. In Japan, the top three or four banks also account for a large proportion of total banking assets after a wave of mergers in recent years. It is important to stress these risks, because developments in large industrial countries will have spillover effects on emerging market and developing countries regardless of whether their economic fundamentals are strong.

> For these reasons, I do not agree with Ms. Lundsager's and Mr. Baukol's suggestion that we should leave the United States out of the analysis in the future, and concentrate mainly on emerging market countries, and perhaps some key developing countries. There is a need to pool together the various pieces of information to obtain the full picture, identify trends, and derive adequate policy implications. That is why it is important to always analyze both developing and developed countries, even if the focus can change depending on the circumstances.
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> To conclude, I am glad that there is at last some recognition of the need for proper regulation and supervision of derivatives, as indicated in Ms. Lundsager's and Mr. Baukol's preliminary statement. As they indicate, derivatives have often been misused, resulting in increased risk and reduced transparency of banks' exposures. These issues suggest the need for proper regulation and supervision of derivatives and we are looking forward to the upcoming GFSR, which will cover the policy implications for emerging markets. Again, the only qualification is that we should not cover only emerging markets, but all markets.

Mr. Wijnholds clarified that while the GFSR should also cover mature markets, the focus should be on emerging markets, as the report was a prime source of information on emerging markets. While mature markets were already extensively covered in many other reports, data and quality analysis on emerging markets were scarce. In addition, the Fund's close involvement with these countries gave it a comparative advantage in this area. Therefore, Ms. Lundsager's and Mr. Baukol's suggestion to have comprehensive semiannual reports accompanied by updates in alternate quarters focusing on emerging markets seemed to be appropriate. Finally, perhaps the staff could react to the point made by Messrs. Portugal and Steiner that, since there was no significant evidence of contagion within emerging markets—a point that could be disputed—then one would have to conclude that the limited access to foreign financing experienced by several emerging markets that were following reasonably prudent macroeconomic and financial policies had to be related to developments in mature markets.

Ms. Lundsager agreed with Mr. Wijnholds that while the Fund would cover both mature industrial markets and emerging markets in its multilateral surveillance exercises, the focus should be on emerging markets, where the Fund had a comparative advantage and could create greater value added. A lot of information was already available on the United States and a number of the other industrial countries, and the Fund could focus on drawing policy implications from the available information without the need to replicate work undertaken by the private sector and other institutions. In particular, the Fund should build on its comparative advantage in collecting and disseminating information on emerging market countries. The report should also go beyond macroeconomic developments and base its policy recommendations on thorough microeconomic analysis of developments in the market place, even if this was not always an easy task. The issue of whether developments in derivative markets were a cause or a symptom of crises in emerging markets illustrated the need for, as well as the difficulties inherent in, such analysis. The aim would be to help emerging market countries develop their domestic markets and regulatory capabilities, including different segments like equities, bonds, insurance, and derivatives. Increased intermediation of funds and financial innovation would allow them to generate and mobilize greater domestic savings, minimize the fluctuations generated by markets, and better utilize international flows to achieve higher economic growth. Therefore, surveillance should be oriented to produce policy recommendations to achieve these aims. While the coverage of the biannual reports would be more general, the shorter reports produced in alternate quarters should focus on emerging markets. The conclusions reached could then be fed into the work of area departments and of other functional departments, like the Monetary and Exchange Affairs (MAE), the Policy Development and Review (PDR), and the Research Departments.

Mr. Padoan agreed with Mr. Wijnholds's and Ms. Lundsager's point that while industrial countries should not be excluded from the GFSR, the report should concentrate on emerging markets, as that was the area where the Fund had a comparative advantage. As indicated by Ms. Phang, transmission mechanisms across different sectors and regions should be covered in multilateral surveillance. Integrating the GFSR more closely with the WEO would help make those transmission mechanisms more explicit and improve the effectiveness of multilateral surveillance.

Mr. Steiner agreed with Mr. Wijnholds and Ms. Lundsager that the area where the Fund could provide more value-added was in emerging markets, and he reiterated the point made in his preliminary statement that the next report should cover developments in those countries' financial systems, as well as in international capital markets. However, the fact that emerging markets following sound policies were being affected by developments in developed markets in times of crisis should not be ignored. While not all emerging markets were following sound policies and were merely being affected by developments outside their region, that was certainly the case in some emerging instances.

The Counsellor and Director of the International Capital Markets Department (Mr. Häusler), in response to questions from Directors, made the following statement:

> I would like to thank Directors for their comments and valid suggestions that the International Capital Market (ICM) Department will take into account going forward. The full cycle of four quarterly GFSRs completed thus far provides a good opportunity to debate its format and content. I would also like to comment on the feedback received from various groups of readers, including Executive Directors, national authorities, Fund management and staff, and private sector market participants, academia, and other agents outside the Fund.
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> The GFSR was created as an amalgamation of what used to be the annual international capital markets report and the quarterly emerging markets finance report. Judging from the feedback received, including from the previous Managing Director, the GFSR has evolved to be accepted as a tool of multilateral surveillance of international capital markets. It complements the WEO, which is one of the flagship publications of the Fund, but also other

publications on bilateral surveillance activities like Article IV Consultation reports and the Financial Sector Assessment Program (FSAP).

In terms of lessons learnt, producing the GFSR is a resource- and time-intensive process which has a long lead time requirement of approximately eight weeks between the first draft and the press briefing, which in this case will take place in New York two weeks after the current discussion. Eight weeks is a long time in financial markets, and we are always nervous that the content of the report might be overtaken by events during this lead period. The fact that the GFSR is published—notwithstanding the legal disclaimers included in the report—puts a certain limit on how candid the report can be. There is probably more room for an open discussion in joint WEMD sessions, and these sessions also provide a good opportunity to pool the resources of the ICM and the Research Departments together.

Based on these lessons, I would like to outline different options for the future production of the GFSR. The key issues are periodicity, structure and focus, as well as synergy with other Fund products and departments. In terms of periodicity, most preliminary statements have indicated a preference for semiannual reports to avoid overburdening the small ICM department, which also performs a considerable amount of country work. Other Directors, however, favor maintaining the current quarterly frequency to help the Board perform its surveillance function under fast-changing conditions in international capital markets. The possibility of conducting joint WEMD sessions as a way to obtain such quarterly updates—or even more frequent updates in times of crisis—provides an alternative to the request to have quarterly reports.

The main alternative would be to shift to semiannual frequency with two full-length GFSRs discussed at the Board around the time of the IMFC meetings—as is the case with the WEO—and to hold joint WEMD sessions in alternate quarters. What is less clear is whether in alternate quarters we should not only have joint WEMD sessions, but also a short report for publication on emerging market financing, along the lines of the old quarterly report on emerging markets. The other alternative would be to maintain the current quarterly frequency of the GFSR.

In terms of the focus of the report, I gladly accept the point made by Directors that structural issues should be given more prominence, especially if the report moves to semiannual frequency, as indicated in Mr. Bennett's preliminary statement. We are already working on longer-term structural issues like the ways in which financial markets cope with high volatility, or the effects on confidence of the lack of transparency in some sectors of the market.

Directors have repeatedly made the point that it is somewhat artificial to separate the surveillance of financial markets and the real economy, given the high level of interaction between these two sectors of the economy. The ICM Department has closely followed its mandate to monitor financial markets, but looking at transmission mechanisms between the real economy and financial markets clearly requires more integration of surveillance of these two sectors. For example, the GFSR would not just look at the likelihood of certain financial institutions to go bankrupt, but also at possible collective reactions to those events in financial markets and, ultimately, in the real economy.

I agree that policy implications of developments in financial markets should be flagged, as many Directors have stressed. We are making progress in this respect, but we cannot draw policy conclusions unless we are really firm and comfortable with them. I would be happy to receive suggestions from the Directors that have raised this point as to how this could be done. We will also seek inputs from other departments, like the Research, MAE, and Statistics Departments. We have already discussed this with them, although the ongoing review of the MAE Department has slowed down this process. There is already a firm intention to publish the financial soundness indicators together with statistics.

I also agree on the need for analysis and judgment beyond a merely descriptive approach. However, it should be noted that drawing policy conclusions requires an element of judgment, based on the professional experience of those involvement in making the policy recommendations. Looking back over the last four GFSRs, the judgments made seemed to have been mostly correct, but we need to increase the expertise and skills of the department even further. This refers not only to the macro side of financial markets, but also to the reactions at the micro level that Ms. Phang was alluding to. This requires a good understanding of the business models of financial institutions, the business logic behind them, and the implications for their preferences for risk appetite, as well as the role played by nonfinancial institutions. Some of that expertise has already been assembled in the institution, but we need to increase it even further.

These considerations are related to the work that is still ahead in reshaping the ICM department. We need to have access to decision-makers in financial markets that are shaping the strategies and business models of individual financial institutions. The Fund has a comparative advantage in emerging markets, but it also has a unique advantage in the surveillance of financial markets, not only through the GFSR, but also through Article IV consultations, FSAPs, and ROSCs. If we are able to pool all the knowledge that is available in the institution, our surveillance of financial markets could not be easily matched by other institutions around the world. Given that we have this unique pool of knowledge, we should use it for the benefit of the membership.

Regarding the suggestion to increase the linkages with financial stability reports issued by other institutions, like the Bank for International Settlements (BIS), the Financial Stability Forum (FSF), and the Bank of England among others, I have personally contacted all these institutions, and most have expressed interest in working with the Fund, except for the Committee on Global Financial Stability of Central Banks that meets several times a year in Basel.

To conclude my comments on the format of the GFSR going forward, I would like to say that the staff from the ICM Department is working with great enthusiasm and commitment to further improve the report, and we are very grateful for the comments provided by Directors.

Turning to the content of the latest report, I would like to provide Directors with an update on the most recent developments in financial markets since the report was drafted. Recent developments have been characterized by an overlap of conjunctural and structural changes in financial markets. For the sake of analysis, I will try to artificially separate the two aspects, and I will start by looking at conjunctural developments in financial markets.

Financial markets have calmed down over the four weeks prior to the current discussion. Investor sentiment has improved somewhat since early October 2002. Mature equity markets have recovered, with the S&P 500 ending up by about 17 percent. Credit spreads have narrowed and volatility has somewhat declined, prompted among other things by the 6.9 percent rise in S&P 500 corporate earnings in the third quarter. The improvement in market sentiment in mature markets, the search for yield—the term used in market jargon when greed starts to overtake fear again after a downturn—and confidence-building statements by the newly-elected governments in Turkey and Brazil have helped underpin an emerging bond market rally. As Messrs. Portugal and Steiner have indicated in their preliminary statement, this has not been adequately captured because of the necessary lag in issuing the report.

The EMBI spread has narrowed by somewhat more than 200 basis points since the end of the third quarter, and volatilities and cross-correlations have declined. Subinvestment grade credits outperformed, giving further evidence of some increase in risk appetite. These positive developments in secondary markets have set the stage for several sovereign borrowers to issue bonds in primary markets, the most recent ones including a $500 million issuance by Turkey, a $100 million issuance by Chile, and $450 million by El Salvador. However, it is also true that the planned issue of $500 million by the Philippines had to be postponed for domestic reasons. Just hours before the current discussion, Ukraine has come to the market, and Turkey most likely will come to the market again in the next few days.

The question therefore is: Are we out of the woods? Is this the turning point in risk appetite and risk aversion? I am not convinced yet for conjunctural and structural reasons. On the conjunctural side, as the Economic Counselor said in the recent WEMD session, recent economic data has been disappointing and growth estimates for the United States, Europe, and Japan in the last quarter of 2002 and in 2003 may be revised downward. In addition, growth in emerging Asia, which has acted as an engine thus far, has slackened. There are also so-called geo-political uncertainties, which may weigh more heavily in Europe than in the United States. Most importantly, the somewhat divergent performance in financial markets and in the economic outlook, as the Economic Counselor explained, is reminiscent of the situation in late 2001 and early 2002.

Similar to the risk highlighted in our first GFSR in February 2002, the risk is again a potential disappointment of corporate earnings expectations. The recent upswing in the stock markets is underpinned by hopes and expectations on corporate earnings, but we have to accept that the recovery in corporate earnings in the third quarter has been largely driven by cost cutting, especially in American companies, but also abroad. By definition, there is a limit to how much cost-cutting can be undertaken. From now on, the key will be top-line or gross revenue, which by definition depends on the state of the real economy, as on the aggregate there is a zero-sum game among individual companies. Furthermore, as indicated in a previous WEMD session, there has been an built-in bias in analysts' estimates of earnings in the S&P 500, and actual earnings have consistently lagged projected earnings. While this is not unusual, the gap between realized earnings and projected earnings seems to be wider at present than it used to be over the last two quarters. This could be an indicator that expectations have gotten ahead of themselves. Unless these fairly optimistic corporate earnings expectations are validated, there is a risk that there may be a disappointment in equity markets six weeks to ten weeks down the road.

Another point, which has also been mentioned in a couple of preliminary statements, is that the outlook for corporate profit is clouded by uncertainty over how the deficits in many defined-benefit pension plans will be covered in the future. We have not been able to deal with this important and complicated issue in the current GFSR in any seriousness, but there is strong anecdotal evidence that in those countries which rely more on private pension plans than on government-sponsored pension structures, the balance sheets of pension funds which have invested heavily in equities over the last couple of years have deteriorated significantly. The main concern is that the big corporations that finance these funds—the blue chips of the world—will have to inject serious money to plug the gap in those pension funds. This could further deteriorate the capacity and willingness of these companies to invest.

Turning to the structural factors behind recent developments, Directors have enquired about the positive assessment given by the staff on the resilience of the global financial system despite negative developments like the high volatility and other risks mentioned in the report. This assessment is based on the improved risk management capabilities of financial institutions, and, most importantly, on the fact that the risks which 10 or 20 years ago were concentrated in the banking system have now been repackaged and moved to the insurance system and to the retail sector of the economy. Nevertheless, there is a price to be paid for the resilience of banks, which have been able to shed the risk of financial losses to other market participants, as there is a question as to how much more risk are the insurance companies and retail and institutional investors willing and able to take. There is also a question as to whether they are willing to return to the markets if these recover. For instance, the equity culture among retail investors in Europe is fairly new—with the exception maybe of the United Kingdom—and it is unclear whether they will be willing to take any of that credit risk going forward.

It is difficult to assess whether the increase in risk aversion, as financial institutions continue to scale back their risk-taking activities as a response to the stress experienced, represents a return to a normal situation after a bubble or whether the pendulum has now swung too far in the other direction. The Fund and the other institutions that conduct surveillance of financial markets do not have a definitive answer to this question. One way to make this assessment would be to establish whether a credit crunch is taking hold in the economy. I do not think that this is the case around the world, although there are some symptoms of a credit crunch in a few isolated areas. While I would not feel comfortable with saying by how much risk aversion has exceeded its reasonable level, or by how much it should swing back, my advice would be to take all the policies needed to keep risk aversion in check, and possibly reverse some of its increase without going back to the previous situation of over optimism and exuberance.

European financial institutions are still in the process of repairing their balance sheets. They have a perception that markets have not rewarded their risk-taking, and corporate executives in the financial sector and outside are still being cautious and with less appetite in making investments, especially risky investments. This is the impression that we received in Europe and other areas based on anecdotal evidence from a wide range of business executives, global risk managers, and portfolio analysts. These observations refer to wholesale banking, not retail banking. With regard to the insurance sector, we raised concerns in the report about the sector in the United Kingdom and Germany, but we should probably also include the Swiss insurance industry.

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Directors have also made comments about the German banking system. In particular, Messrs. Wijnholds and Andersen wondered if it was appropriate to single out this system as a source of weakness. Our main concern is not the situation of a single bank, but the reaction of their strategies going forward. There is a unique combination of circumstances in the German banking system. Continental banks in general, but specifically German banks, are struggling with a very rigid high cost base. While it is always difficult to reduce costs, it is even harder under the rigidities of the German labor law. Provisions for credits are higher than in most other countries, which has to do with the fact that German banks have very large balance sheets and they are dealing with a large number of borrowers. German banks are also more undercapitalized than average, and they are dealing with a fragmented home market that does not allow for wide margins to compensate for a decline in profitability. There are other countries with banking systems in trouble, for example in Latin America, but it is easier to overcome the situation if the home market in which they operate is profitable. Banks with large balance sheets, large credit portfolios and thin margins follow what we call in the jargon of the street a Japanese business model.

In the case of Japan, we are somewhat disappointed by recent developments. The financial reconstruction program was a step in the right direction, but it lacks concrete details and timetables for implementation. Corporate restructuring continues to be the key requirement, and it sometimes takes a new management team to do that. Therefore, we were not comfortable to see that guarantees were given to incumbent managements.

The real issue is whether the conjunctural and structural issues that are affecting the financial system might reinforce themselves. The structural reorientation of some financial institutions under a somewhat strained conjunctural situation is reinforcing the risks. The interaction between the need to repair corporate balance sheets and the prospect of slower growth than anticipated will maintain the pressure. Risk aversion may have dropped recently and risk appetite might have risen, but there is still some scope for risk aversion to re-emerge.

To conclude, a short word about policy implications. On the conjunctural side, I have nothing to add to what the Economic Counsellor said a few days before the current discussion on macroeconomic stimuli. On the structural side, we have a unique window to introduce confidence-building measures in the financial system. Some of these measures are already underway, but they need to be implemented with all the vigor and force to restore confidence in the financial markets, because we do not know what other problems may come up, and we really need to use that window of opportunity.

The Deputy Director of the International Capital Markets Department (Mr. Tran), in response to questions from Directors, made the following statement:

> I would like to start by responding to comments from Directors on the issue of exposure to the derivative markets by internationally active financial institutions like the large banks in the United States. We should approach with caution the figures cited by Directors to indicate the level of exposure for different banks, as these are gross notional amounts that do not distinguish between the long and short positions of the institutions. Taking the net residual of long and short positions, their exposure appears manageable, and that is also the view that the U.S. authorities have expressed. We agree that a better understanding of these transactions and the final recipients of different derivative contracts would be welcome. Indeed, we have called for more transparency and disclosure in different issues of the GFSR.
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> Several Directors have touched upon the analysis of the housing market in the United States, and there was a specific question about the risks in the commercial real estate market, which has softened significantly in recent months. Vacancy rates have risen and property prices have softened as demand for office spaces has declined. However, the fallout has been modest, and delinquency rates on commercial mortgages held by banks stand only at 1.76 percent of total loans, which is far below the 10 percent plus rates reached in the early 1990s. Particularly helpful in this favorable performance of the commercial mortgage market during the downturn is the fact that a lot of these mortgage loans have been securitized. Securitization requires using uniform underwriting standards, which strengthens and improves the standards of loan application and approval. In the U.S. commercial mortgage markets, about 20 percent of mortgage loans are currently being securitized, compared to only 7 percent five years ago.
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> Mr. Portugal asked whether the fundamentals support real estate booms in different countries, and particularly in the United Kingdom. The Financial Stability Review (FSR) issued in June 2002 by the Bank of England notes that robust mortgage borrowing in the United Kingdom has been associated with strong real disposable income growth, intense competition among lenders, and low interest rates like in the United States. By and large, these provide fundamental good support for growth in the housing market. At the same time, the FSR points out that U.K. house prices have risen substantially relative to earnings and earnings growth, particularly in the recent period, and that is a potential issue.
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> Several Directors have raised the issue of exposure to interest rate risk, particularly again with reference to developments in the United States housing market. We made the point that homeowners have taken advantage of low interest rates to refinance their mortgages, managing to a large extent to lock in low interest rates with fixed-rate long-term mortgages. This means that they

are protected from interest rate risks going forward, but somebody else has to bear those risks. The lenders have securitized and sold on a lot of their mortgages to institutional investors who will be exposed to interest rate risks when these eventually rise. This brings us back to the importance of monitoring and understanding the value of the assets of different players in the financial systems, and the exposure of this valuation to adverse market developments, as indicated in previous GFSRs.

Regarding Ms. Phang's question on the duration gap in Fannie Mae, the latest developments are that the institution has managed to reduce it to a more acceptable level of minus six months.

On the question related to the criteria used by the Bank of Japan to purchase stocks from major banks, we are not at this point aware that any specific criteria have been announced for the purchase of individual stocks. Going forward we would like to see if there is more clarification on this point. As the Director of ICM has mentioned in his opening remarks, we will follow closely the theme of how the pressure on banks and the changes in their business models and strategies will affect financial markets and the real economy.

Finally, Mr. Reddy asked about the risk of sudden and disruptive changes in major currency markets in the future. Currently, there is a divergence between the limited level of volatility in currency markets and the high volatility in global equity and bond markets. It remains to be seen whether this divergence will disappear in the future, but based on the options for currencies, there are no expectations of large changes in currencies in the foreseeable future.

The staff representative from the International Capital Markets Department (Mr. Ordoobadi), in response to questions from Directors, made the following statement:

I would like to address three issues that have been raised. First, I would like to talk about developments in emerging markets since the end of September 2002. Second, I will address some of the questions raised about the analysis of debt structures and vulnerability to external shocks that appears in Box 3.2 of the report. Finally, I would like to say a few words about the impact of heightened risk aversion on emerging markets.

On recent developments, there has indeed been a shift in investor sentiment since the end of September. Risk appetite has increased markedly and sub investment grade credits have performed particularly strongly since end-September, outperforming their higher grade counterparts. A rebound in Latin American bonds is particularly evident since end-September. The Latin American sub index of the EMBI+ has risen by over 14 percent in that time compared with an overall increase in the index of 11 percent.

As Messrs. Portugal and Steiner point out in their preliminary statement, market sentiment toward Brazil has improved markedly since the third quarter, and this has been a major factor for the rebound in the EMBI+. Spreads on the Brazilian sub index of the EMBI+ have narrowed considerably from almost 24 hundred basis pounds at end-September to a little over 15 hundred basis points at the time of the current discussion. As a result, the Brazilian component of the index has increased by 31 percent. The real has also appreciated strongly. Part of this improvement reflects an improved external environment for emerging markets and a generalized reduction in risk aversion. In addition, as Messrs. Portugal and Steiner point out, part of the improvement in sentiment toward Brazil also can be attributed to signs of policy continuity and the much larger than expected surplus in the external current account. Flow data and surveys of investor positioning also suggest an increase in risk appetite. Flows into high-yield U.S.-based mutual funds have increased in recent weeks, and cash balances in emerging market-dedicated portfolios have fallen. Subinvestment grade issuers have been the main beneficiaries of these declining cash balances, and allocations to those issuers have increased in October.

While we can paint a much improved picture of secondary market conditions, primary market conditions remain difficult, particularly for sub investment grade issuers, although there have been some exceptions—the Director of ICM has noted for example the bond issuance of $500 million dollar by Turkey in November. It is noteworthy to point out that by the end of 2001, emerging market sovereigns had prefinanced up to 30 percent of their 2002 targets, while by now there has been virtually no prefinancing of needs for 2003.

There were a number of questions on Box 3.2, which provided an assessment of the debt structure of local market bonds, and how that can amplify the vulnerability to external shocks. The report makes the point that certain domestic debt structures—like instruments linked to foreign exchange, floating rate instruments and debt structures dominated by very short maturities—can amplify external shocks. At the same time, we acknowledge in the report that these potentially problematic debt structures arise in large part as a result of the difficult financing environment faced by issuers on some occasions, as indicated by Messrs. Portugal and Steiner.

Mr. Zurbrügg and other Directors suggested in their preliminary statements that the alternative debt structures explored in the report are less likely to amplify external shocks. Those include inflation-indexed bonds, long-term debt issued in local currencies, and bonds linked to commodity prices or GDP. But those instruments which reduce vulnerability often fail to attract investors. While acknowledging these difficulties, there is still scope to work toward deepening local markets to permit the issuance of long-term debt denominated in local currency, inflation-linked bonds, and other instruments whose costs tend to increase with the capacity of the issuer to pay. Ultimately, however, investor appetite for debt hinges on confidence in macroeconomic and financial stability, and debt structures are inevitably of secondary importance. Nevertheless, debt structures have a role to play in creating a cushion against exogenous shocks, and it is fair to say that issuers in the past have not been sufficiently willing to accept higher ex ante yields on instruments that have the potential to contribute to more stability down the road.

Finally, there were a number of questions about heightened risk aversion and the impact on emerging market countries. One of the major themes in the report is that heightened risk aversion has led to a reduction in flows to emerging markets. As pointed out in Chapter 3, the cumulative gross issuance of loans, bonds, and equities in 2002 has fallen significantly below the level of previous years, and there has been more concentration on higher-grade issuers than in the past. In this sense, heightened risk aversion in global financial markets has spilled over to emerging markets. To highlight this development, we have made risk aversion and it effects on existing vulnerabilities a major theme of Chapter 3, and that is the rationale for Box 3.1, which takes a critical look at different measures of risk aversion used both in the Fund and by market participants. The main conclusion reached is that, while it is difficult to disentangle changes in market risks from changes in risk appetite, there appears to have been a major increase in risk aversion in the third quarter. Risk appetite, however, increased toward the end of the third quarter, and that increase has thus far continued in the fourth quarter with results in tightening spreads and improved performance of higher-yield credits as described in the opening remarks.

Mr. Yagi asked the staff to elaborate on the point made in his preliminary statement that interest rate risks might still remain in the household sector despite the low long-term interest rates locked in through mortgage refinancing. The fact that financial institutions had sold those loans to the market through securitization meant that risks were carried mostly by private pensioners. Therefore, the interest rate risk remained with the household sector—as it had merely shifted from the liability side to the asset side of its balance sheet—and it would be incorrect to assume that the trend of refinancing mortgages at low rates would help households maintain consumption at its current pace and support the recovery.

Mr. Steiner did not agree with Messrs. Zurbrügg's and Moser's opinion that the original language in the report provided a more realistic assessment of the situation in Brazil. Recent developments in Brazil had been favorable, both before the presidential election, when the leading candidate supported the agreement with the Fund, and after the election when the statements of the elected candidate and those of his closest associates had been well taken by the markets. During this period, the real had strengthened, spreads had come down significantly, and a strong reserve position was currently forecasted. While the existence of downside risks could not be denied, and the staff's role should not be to cheerlead the market, a realistic assessment should take into account the strengthening of markets in Brazil in the period between the production of the report and its Board discussion.

On a related note, Mr. Steiner stressed the importance of sending a consistent message from different parts of the institution. The statements made in the context of the mission that was currently reviewing the Fund-supported program indicated that Brazil had made significant progress in recent weeks, and this was consitent with the remarks made by staff from ICM. However, during the recent WEMD session, the Economic Counsellor had referred to expectations of a weakening of the currency, suggesting, in the Counsellor's own words, that market participants expected the new President to deliver on the populist proposals made during his campaign. Those comments were unfortunate, as the new President supported the agreement with the Fund, and there were several reasons to expect the situation to continue improving in the near term.

Mr. Zurbrügg agreed that there had been recent positive developments in Brazil. There was clearly a time consistency problem in the production of the report as a result of the lag between drafting the report and publishing it, but the staff could not be expected to continuously update the report. Moreover, it was important for the staff to provide their realistic assessments of the situation, which would always require a degree of judgment. As the staff representative from ICM had indicated, the situation had not significantly improved in primary markets and Brazil was currently facing significant refinancing risks. Finally, perhaps the staff could comment on the intriguing inconsistencies between nonfinancial corporate credit spreads and debt equity ratios in Europe and the United States.

The Deputy Director of the International Capital Markets Department (Mr. Tran), in response to Mr. Yagi's question, explained that U.S. insurance companies and pension funds currently held around 40 percent of securitized mortgage loans, foreign investors held another 20 percent, and households directly held 14 percent of the total, with the rest distributed among banks, mutual funds, and other investors. Therefore, interest rate risks currently were on the asset side of these investors.

Regarding Mr. Zurbrügg's question on corporate spreads in Europe and the United States, one reason for U.S. higher spreads despite lower debt-equity ratios could be differences in the composition of the indices used in each area, the Deputy Director continued. The index used for the United States might contain more telecom and high-tech companies, which had been particularly affected by the downturn. The staff would have to review the composition of these indices in more detail to provide a more definitive answer to Mr. Zurbrügg's question.

Mr. Yagi stressed that the staff should be more cautious in asserting that households would likely maintain consumption and support the recovery, given that interest rate risks continued to be concentrated in this sector.

Ms. Lundsager observed that systemic risks had fallen with the securitization of mortgage loans, which had helped spread risks more widely across a larger number of agents. While this might imply continued risks on the consumer side despite the trend of locking in low interest rates through mortgage refinancing, the risk that a crisis in a particular industry or sector—in this case the housing sector—could have broader implications for the banking sector had significantly fallen. Although the overall effects of the trend toward securitization could only be assessed in the longer-term, the diversification of risks that it implied appeared thus far to have helped moderate the swings in the real economy.

Mr. Yagi agreed with the benefits of the trend toward diversification of risks in the U.S. financial system, but he stressed the need to avoid giving the impression that such diversification had completely eliminated risks, as such a misperception could lead to reckless behavior on the part of consumers. It had to be acknowledged that risks had to be borne by some party to the financial transactions despite diversification.

Ms. Lundsager agreed that diversification did not completely eliminate risks to the economy, but it should be acknowledged that, by reducing the concentration of such risks in individual agents like banks, it reduced systemic risks to the economy as problems in the banking sector could have ripple effects throughout the entire economy. While it was still possible for a large event to have negative effects on aggregate consumption despite the small share of risk borne by individual agents, the dangers of a wider implosion in the economy were certainly lower as a result of the diversification of risks.

The Chairman observed that the discussion on the effects of the trend toward securitization of mortgage loans illustrated the need for the ICM Department to undertake more analytical research on the interactions between developments in the financial sector and in the real economy. This was also a pre-condition for the development of policy recommendations, as it would be premature to make those recommendations before more progress could be made in resolving related analytical issues. The ICM Department was already making progress toward this aim, and the current issue of the GFSR represented another step forward in this process.

Mr. Wei made the following statement:

> At the outset, we thank the staff for the fourth Global Financial Stability Report (GFSR) which has well-focused on the key issues of financial markets and the trends have been evaluated thoroughly. The staff should be commended for their great effort in conducting such challenging work. Since many of our views have been expressed in the preliminary statements and we are in broad agreement with the thrust of the report, I would like to focus my comments on several specific issues where further discussion might be necessary.
>
> The report has made a good analysis of the interrelationship between capital market development, the household sector, and the financial sector. We share the staff's view that a key risk is that stock and housing prices could grow more slowly or decline if downside risks to the economic outlook are realized. The report touched upon another critical issue—the decline in equities markets eroded the assets in defined benefit pension plans. It seems

that a more comprehensive analysis can be made on the full impact of a worsening financial condition on pension plans. If people perceive that their future cash inflow promised by pension plans is diminishing, they will choose to increase saving and reduce consumption. Households may also change their net worth composition by shifting from less liquid to liquid assets. If these happen, both equity price and housing price will be negatively affected.

The report indicated that U.S. household net worth stands at about 5.15 times household income, which is still well above the average of 4.75 attained during 1990–95. However, it is not clear whether the evaluation of households' net worth has included the asset in pension plans and whether a mark-to-market approach has been adopted to reflect the deterioration of financial conditions of the pension plans. Staffs' comments are welcome.

During the Board discussion of the last issue of GFSR, some Directors asked for a more detailed and specific analysis on the potential problem in European banks. This latest report seems to have been appropriately focused on this issue. We welcome the responsiveness of the report.

The report has correctly chosen the banking system in continental Europe as one of the focal points of analysis. The lack of intra-European competition and strong pan-European operational base has caused overcapacities in the European banking system. It has been part of the factors behind the structural rigidity in the European economy. This banking system's total amount of consolidated cross-border claims on all countries is larger than cross-border claims held by Japan. Its closer link with equity markets is a major concern since the stock price bubble in some major European countries was even larger than that of the United States. The report may have neglected discussing the situation in some specific institutions. But we can still discern the potential problem from the revealed information. The financial situation of certain large banks seems particularly weak. Their Net Return on Equity was close to be negligible and their Reserves/Impaired Loans ratios are significantly lower than the group average. These in turn mean that their Net ROE may turn into negative should they increase the level of reserves.

Although there seems to be no evidence of immediate systemic risk, further credit retrenchment by these banks may drag down the recovery in the Euro area which has already lagged behind most of the other developed countries. In light of this, it will be very helpful if the staff could make further analysis on this situation. Particularly, we would like to know whether the existing problems have anything to do with the universal banking approach prevailing in this region. Is there any lesson that the supervisory authorities can learn from this development?

We have noticed that the government has responded to financial-system weaknesses with a series of measures. The announcement of Bank of

Japan in September to purchase stocks from major banks to reduce their vulnerability to declining stock prices was very impressive. Most recently, at end-October, the newly released Financial Reconstruction Program proposed the creation of an Industrial Reconstruction Corporation (IRC) that would purchase loans to corporations that are experiencing financial trouble, but have reasonable prospects for rehabilitation. It also proposed to promptly inject capital to undercapitalized financial institutions.

We share the staff's view that there are still important technical details that need further clarification. Specifically, the division of labor between the IRC and the existing Resolution and Collection Corporation (RCC) seems not to have been clearly defined. The pricing method used by the IRC to purchase loans is not clear, either. Besides, the size of the IRC and the estimated capital injection to undercapitalized banks are not announced. More information is needed to give a realistic evaluation on the effectiveness of the above programs. In this regard, it is encouraging to learn from Mr. Yagi's statement that his authorities are working very hard to study specific measures so that a work program can be made public by the end of this month.

It seems that financial derivatives can almost do anything, from unbundling and redistributing various risks to circumventing prudential regulation, bypassing capital control, and taking on excessive leverage. In the case of circumventing prudential regulation and bypassing capital control, it may not be easy to detect the exact national amount of derivative transactions and the parties involved. Therefore, it is possible that some derivatives are being used underground even though their usage is officially prohibited. The keys to this issue may not only lie in the supervision system, but also in the governance structure and risk management system of the financial institutions themselves. Mr. Callaghan has made very useful comments on this issue which I fully share.

On the chapter of emerging markets. Like many others, we agree with staff's view that emerging market financing, including FDI has been affected by the weakness of mature equity markets. On the economic situation of Brazil, I fully share the comments made by Mr. Portugal and Mr. Steiner that many positive developments have not been captured in the report.

Having worked out four issues of GFSR, it is time for us to rethink the format of this report. I would like to echo some other Directors' point that the frequency of this report could be changed from quarterly to semiannually. This will give staff more time to do enhanced analysis and comparative studies based on the existing facts and statistics. The publication of this report can be done with WEO simultaneously or intermittently. Meanwhile, some key statistics on the international financial market can be updated on the occasions of WEMD discussion. On the coverage of the report, I agree with Mr. Steiner and Ms. Phang that it is necessary and useful that both mature and emerging markets should be covered in the report given the increasing links between the two markets.

Mr. Brooke made the following statement:

As Mr. Häusler noted in his introductory remarks, financial market conditions have improved a bit since the draft GFSR was prepared. On the one hand, forecasts for the global recovery have been revised down slightly in the past three months and equity and bond markets have remained extremely volatile. But, on the other hand, the major currency markets have been relatively calm, market uncertainties related to elections in Brazil and Turkey have diminished somewhat, there have been few signs of contagion in the emerging markets, and, in the past month or so, equity prices in the advanced economies have begun to rise.

These mixed developments suggest to me that advanced country financial and macroeconomic conditions have not changed dramatically since the time of the September GFSR and that our central case forecast should remain a gradual global economic recovery. It is appropriate, therefore, that the findings and policy recommendations set out in Chapter I of this GFSR are broadly similar to those of the previous edition. Consequently, we continue to agree with staff's main conclusion that the risks to international financial stability are manageable. We also support the policy recommendations set out in Chapter 1 of this report.

The resilience of the international financial system owes much to the benefits of strengthened macroeconomic policy frameworks; heightened investor discrimination; greater diversification of risks across the financial system; and the fact that recent equity market declines have restored more plausible long run valuations.

In addition, we see the development of greater tiering of credit quality as welcome since it demonstrates increasing risk discrimination by investors(between countries, between sectors, and between corporations. Such considerations, we feel, have played an important role in limiting contagion effects between the emerging markets.

Nevertheless, we recognize that the risks to the outlook continue to lie predominantly on the downside. In particular, we are mindful that the cumulative effects of past equity market declines have revealed vulnerabilities in some of the large and complex financial institutions, as well as in insurance and pension firms and some large corporations.

We have a number of comments to make about the prioritization and continuity of the main messages in Chapters II and III of this report.

Given that the GFSR is published, outside commentators are likely to scrutinize it for changes in focus and tone from one issue to the next. As I noted in my opening remarks, we do not think that the world has changed significantly in the past three months. Consequently, the main risks identified in Chapter I of this report are rightly the same as those identified in Chapter I of the September GFSR.

However, there is one notable difference (the latest GFSR makes no mention of global current account imbalances and the associated risks of sudden and disruptive exchange rate movements among the major currencies). While we continue to believe that such a rapid adjustment is a low probability event, I think it is odd not to mention anything about developments in this area if staff saw this as a major risk to the outlook in September.

The principal risk identified in both this and the previous GFSR relates to the likely implications of further equity price declines for household, corporate and financial sector balance sheets in advanced economies. Here, while we feel that the messages in Chapter I of the latest edition are appropriate and in line with what staff said in September, we noted a few changes in tone and prioritization in Chapter II.

In particular, we see the risks in Japan as remaining sizeable and feel that these are underplayed in this report. Given the recent announcement by the authorities of an action plan to address banking sector weaknesses, we were surprised that staff did not use the GFSR as a vehicle to provide a comprehensive assessment of the authorities' new plan. Here, I welcome Mr. Häusler's remarks at the start of the meeting indicating his concerns that the new plans may not fully address the problems and his disappointment at the lack of a timetable for the authorities' actions.

In the United States, we broadly share staff's analysis of the risks posed by the high level of private sector debt and low household saving rates. We also welcome the further investigation of these issues in this report using household balance sheet data as we had suggested in the previous GFSR discussion. We think this additional information confirms our previously held view that a gradual adjustment in consumption and saving is more likely than a sudden change. We also share staff's view that the U.S. housing market is not significantly overvalued (in aggregate). In this regard, the latest Bank of England Inflation Report highlights the concerns in the United Kingdom over house price inflation and provides some evidence about the differences with U.S. developments. Nevertheless, like a few other Directors, we think it would be sensible to further examine the concentration of property market risks in the U.S. financial sector.

Turning to insurance, while we agree with staff's assessment that 'the systemic stability of European insurance sectors is generally not in doubt', we think there are a number of significant problems here that deserve more exposure. In particular, we see a strong case for improving insurance regulation. This is something that we are actively pursuing in the United Kingdom. More needs to be done, however, at the global level.

In contrast to staff's presentation of Japanese risks, we feel that the weaknesses in the German banking sector have been a little over-stated. While we agree with staff that there are genuine concerns here about competition and low profitability as well as weak domestic demand, we doubt that these pose significant short-term risks to global financial stability. Only a small number of German banks have failed or require public capital injections and it should be recognized that Germany's commercial banks have taken some steps to restructure their businesses.

Before commenting on the Emerging Markets, I would like to join Ms Lundsager in highlighting the poor availability of timely data in Table 2.2. This is something that the Fund should continue to highlight as an area that needs to be addressed by European countries. We know that the ECB and Eurostat feel the same way, but they are unlikely to be able to make rapid progress without a greater determination to implement improvements by the EU member countries.

Turning to Chapter III, we tend to agree with those Directors who have called for a greater focus on key issues and themes.

In particular, we continue to feel that weak debt dynamics have been paramount in determining which countries have been the most likely to be adversely affected by changes in investor sentiment and greater credit tiering. We continue to believe, therefore, that the GFSR should present a fuller discussion of which countries are currently considered to have the most vulnerable debt positions, taking account of debt levels and their currency and maturity compositions. In parallel with this, the GFSR should emphasize more strongly the importance for countries to implement policies to reduce vulnerable debt positions and to undertake their own comprehensive DSAs.

In addition to these comments, we agree with Mr. Bennett that the GFSR should regularly monitor and report on the various indicators of contagion. We also support Mr. Padoan's call for staff to emphasize the linkages between financial market and trade liberalizations.

Finally, with regard to periodicity, we could support a move to a semi-annual publication schedule. If this option is chosen, we would join those Directors who have asked for a fuller consideration of financial market developments in the WEMD presentations that take place in the intervening quarters.

Mr. von Kleist made the following statement:

I thank the staff for producing another informative and insightful issue of the GFSR and I thank Mr. Häusler for his additional oral remarks and Mr. Tran and Mr. Ordoobadi for their answers to questions. I am also pleased by the ongoing successful efforts to make the report more focused and forward-looking, in line with previous suggestions. While on the format of the report, let me support the remarks of those Directors who have called for a closer coordination of the GFSR and the WEO. Developments of the real economy and the financial sectors are inextricably linked. The two are different sides of the same coin. We need to look at them in conjunction, in order to effectively carry out our surveillance function and to avoid duplication. As to the periodicity, it appears reasonable to have written GFSRs on a semi-annual basis and in sync with the WEO. In between the written reports, there would, however, need to be oral reports, to be presented jointly with the WEMD sessions. I welcome Staff's proposals of this morning which seem to go very much in this direction.

On the overall findings of the report, we are encouraged by the resilience the global financial system has shown so far, notwithstanding an environment of high volatility and sluggish economic growth. Countercyclical macroeconomic policies in those countries which have the needed leeway as well as necessary adjustments in such areas as corporate governance and risk management have been instrumental to build up and maintain this resilience. Looking ahead, while we share the staff's general sense of cautious optimism, the above mentioned efforts will certainly have to be continued in order to guard against downward risks.

Given the wealth of interesting observations made by other Directos in their preliminary statements, especially Mr. Andersen and Messrs. Padoan and Vittas's, which I share to a large extent, and the previous oral interventions, I would like to concentrate on a few points only:

Starting with the emerging markets, the combination of heightened risk aversion and higher risk perceptions clearly underscores the need for sound macroeconomic policies and prudent debt management practices. Recent developments have shown that prudent policies generally will be rewarded by low borrowing costs. The staff's finding that there have been few signs of contagion is certainly encouraging, although I agree with Mr. Bennett that there is always scope for more analysis here. As to the present juncture, we fully agree with the staff and other Directors that much depends on the ability of Brazil to follow through with confidence-building measures. On the changes in the report, generally, I side with Mr. Zurbrügg's comment that the Fund should call a "spade a spade". Of course, Mr. Steiner has a point concerning most recent developments, but as was said during the WEMD session two days ago, the honeymoon may be short. If other countries in the region and elsewhere deliver their share, then the outlook on the length of the honeymoon may improve.

Turning to the respective sources of risk in the United States, Japan, and Europe, I share the staff's basic assessment, although I would be reluctant to mention the three risk sources in one breath. As to the United States, the evolution of the heavily indebted consumer sector is, perhaps, the pivotal point for future global macro-economic developments. This is not least due to the sheer size of the U.S. market, but due to their additional leverage which follows from the fact that many other markets at least initially follow the lead of the United States, even if fundamentals would suggest otherwise. In addition, heavy mortgage lending has led to increased risks for the U.S. financial sector. Another issue concerns pension plans. Given their vast stock portfolios and the fact that many of them still are on a defined benefit basis, these plans would be sensitive to possible further stock market corrections. I agree with Mr. Wijnholds and others that this issue would be worthwhile exploring more in-depth in the future, not only in the United States, but also in the United Kingdom and the Netherlands.

As regards the German banking system, let me be clear that we share staff's concerns. While the banking sector as a whole is universally regarded by experts to be fundamentally stable, my authorities are nonetheless fully aware that there is a need for further restructuring and improving profitability. I should also note that the newly established unified financial supervisory authority, along with the Bundesbank, is following developments very closely. The other good news is that much is already being done within the sector to address the issues at stake: In all three pillars of the banking sector, considerable efforts are being made to improve the high cost-/income-ratio through staff reductions, mergers, streamlining of branch office networks, and outsourcing. The much scolded publicly owned sector provides, through the absence of an insolvency risk, an insurance against systemic risks. Solvency figures overall are sound and stable. Asset quality is satisfactory, also by international comparisons, and provisions have been raised considerably. By the way, the bulk of non-performing loans in Germany is due to engagements in the United States. There have also been no speculative bubbles capable of jeopardizing the entire system, and property price developments have been modest compared to other countries.

On another point, we do agree that further market shocks could discourage financial institutions from risk-taking in international wholesale markets. However, I share Mr. Andersen's unease about staff's making judgments of "excessive risk aversion". Moreover, in the specific case of Germany, the incidence of excessive risk retrenchment—beyond the degree explained by cyclical factors - is something which is questioned by both the Bundesbank, the ECB, and at least some market analysts. To sum up my point, Mr. Chairman: While we basically share staff's views on the need to strengthen the German banking sector, we feel—like Mr. Andersen, Mr. Wijnholds, and Mr. Brooke—that the report overstates the related risks for the international financial system.

Finally, like other Directors, I very much look forward to the chapter to be included in the next GFSR report on the policy implications of developing local bond, equity and derivatives markets.

Mr. Boitreaud made the following statement:

I would like to join others in thanking staff for this fourth issue of the GFSR. With regard to the quantity and quality of preliminary statements issued, I will only comment on a few points.

Concerning the frequency of the reports, I very much concur with the remarks made by Mr. Bennett, Mr. Callaghan, Mr. Padoan, Mr. Vittas, and Mr. von Kleist, to name but a few, concerning the much-needed coordination with the WEO. Indeed, the present GFSR shows the difficult challenge staff experienced in undertaking an independent examination of financial issues separate from macroeconomic ones. Therefore, the GFSR should probably focus exclusively on its specific domain, such as financial mechanisms and capital markets, along with the structural factors underpinning them. At the same time, the ICM Department should provide input to the WEO report concerning the connection between macroeconomic developments and financial mechanisms. A close collaboration between the authors of both reports is, in any case necessary, and I understand that this view is shared by Mr. Häusler and his staff. In line with Mr. Al-Turki's suggestion, I could even see some advantage in a joint presentation of both reports to the Board. To sum up, we favor a move to having a report issued on a biannual basis and closely coordinated with the WEO.

Regarding the content of the Global Financial Stability Report, I have not much to add to the sharp and comprehensive remarks made by Mr. Zurbrügg and Mr. Moser in their preliminary statement. It would be desirable that the report focus on the main risks and convey very clear messages in its assessment, as well as in its recommendations of economic policy. For instance, the March 2002 report identified the question of credit risk transfers. This point is now revisited within the broader context of the derivatives market in emerging economies, underlining the importance of this particular subject in staff's eyes. Nevertheless, staff does not wrap up its analysis with a clear message or an argumented warning. For example, in March, one risk associated with credit derivatives was the potential legal uncertainty surrounding the definition of the financial triggers, such as default of a sovereign or a corporate entity. We have learned in the present issue that 95 percent of the credit default swaps related to Argentina were settled in mid-February 2002, with limited legal disputes. Does that mean that the CDS instrument is mature, at least with regard to its legal aspects? What lessons could be drawn regarding CDS related to other emerging countries?

In the same perspective of conveying clear messages, it would be useful to concentrate on fewer issues and, to the extent possible, to rank vulnerabilities. Indeed, after reading the present report, one may wonder to what extent the global financial system is really dependent on the U.S. household sector. To have a better idea, we need more evidence of the locking-in of mortgage rates at low levels by U.S. households and, as clearly pointed out by Mr. Yagi and Mr. Toyama, we need to know who the final investors are that bear the interest rate risks. If they are pension funds, as indicated by Mr. Tran, it would be worrisome for the U.S. household balance sheet in light of the fact that defined-benefit pension funds already face an increasingly under funded situation because of depreciation of their assets, as mentioned earlier by Mr. Häusler. In that regard, I fully share Mr. Yagi's call earlier in the discussion for a more cautious approach to future developments in the United States. On the other hand, if the interest rate risk is borne to some degree by government-sponsored enterprises such as Fannie Mae and Freddie Mac, as mentioned by Mr. Callaghan and Mr. Di Maio, a closer examination of the financial situation and risks of these entities would be warranted.

Still on the issue of ranking vulnerabilities, how can the situation of European financial institutions be evaluated? We very much appreciate staff providing further analysis on the topic as compared to previous reports. However, the crucial argument that the financial sector in Europe has borne the consequences of the slump in the stock market, whereas in the United States the households have been primarily affected, should be better argued and supported by more evidence.

In addition, in our view, there is no denying that the German banking sector has weakened over the last years. We have already mentioned our concerns on other occasions, and I take the point made by Mr. Häusler today. However, as stated by Mr. Wijnholds and others, the indicators for the German banks are not yet dramatic either and, in our view, a cut in interest rates in Europe would ease their profitability. Furthermore, as far as the French banking system is concerned, I would like to mention that, thanks to the increase in its global profitability since 1995, allowing for a gradual rise in provisions, it faces the current slowdown in relatively secure conditions.

Finally, concerning emerging market economies, we would have appreciated, like others, a clearer picture of the spillover effects from potential negative developments in Brazil. We also support Mr. Wijnholds's proposal to discuss on the next occasion developments in credit markets and financial systems in Asia. Like Mr. Zurbrügg and Mr. Moser, I have appreciated the paragraphs about the role of derivatives in emerging market crises. I would like to know staff's assessments of the ongoing use of these instruments that could entail today a misguided representation of capital flows and traditional balance of payments accounting in some emerging economies. What lessons should be drawn in that regard concerning our work on debt sustainability analysis? I hope, therefore, that the next issue of the GFSR, focusing on policy implications, will pay attention to these questions.

Identifying the various structural developments of the global financial system and their effects should also be emphasized in future reports. I would mention two examples. First, accounting standards. Recent corporate scandals point to the need for convergence of accounting standards so as to ensure comparability of treatment. A key issue relates to the content of these standards and their potential impact on global financial stability. In this regard, it would be interesting to examine the likely consequences on capital market stability of widening the scope of fair value accounting.

Second, the role of the rating agencies and the potential procyclical effect of their activity would deserve, in our eyes, further attention. I would then be very interested to hear from staff whether they agree that these issues justify close scrutiny. Indeed, in our view, there is a major public interest in trying to identify the elements that are procyclical and those which are anti-cyclical. To do so, it would be useful to underline the articulation of the Fund's work with related reports carried out under the aegis of other international fora or institutions, such as the Financial Stability Forum or the BIS. I therefore very much welcome the comments made by Mr. Häusler on his intention in that regard.

One final remark on Box 3.4, updating the use of collective action clauses. We found this box very useful and interesting and we support Mr. Zurbrügg and Mr. Moser's call for a table showing country by country use of CACs in new issues. To conclude, I believe it is important for the GFSR to follow-up on its main evaluations of risks and scenarios. For instance, many Directors thought that the May report was not specific enough with regard to the insurance and re-insurance sectors. We would have liked to see this question treated in a more precise fashion in consequent reports. In the same vein, like others, we would appreciate a monitoring of the financing of the U.S. current account, as it was addressed as an important matter in the preceding reviews.

Mr. Brooke joined Mr. Boitreaud in welcoming the inclusion in the GFSR of a box on the use of collective action clauses (CACs). He also agreed that it would be useful to receive more detailed information on the use of CACs at the country level in future GFSRs.

Mr. Jonas made the following statement:

At this late stage, let me just make a few selective remarks. First on the format of publication. I welcome the consensus to publish the Global Financial Stability Report (GFSR) semiannually instead of quarterly. As for the timing of the publication, like Mr. Le Fort and Costa, I would prefer to alternate the GFSR with the World Economic Outlook. The WEO is already being discussed together with the World Economic and Market Developments, and adding the GFSR would be probably too much.

Semiannual publication should allow to better accommodate Directors' preference to make the report more forward-looking and analytical. On the forward-looking aspect of the report, I share the view made by Mr. Callaghan and Mr. Di Maio that it would be useful to provide information about the future financing needs of emerging market borrowers and to compare the financing needs with the availability of private market financing. This comparison could provide important information about the degree of adjustment that may be required to reconcile the financing needs with the likely availability of private financing; about the possible effect on exchange rates, interest rates etc.; and on demand for official financing.

I have one remark on an issue that was discussed earlier in the meeting, namely how to update the GFSR for latest information. It was noted that the GFSR should include the information about the latest development in Brazil which shows a much more positive picture that the report. I do not have problem with that. However, I would be concerned if we pursue this policy of updating the GFSR in an ad hoc basis. If we want to do it, we have to do it according to some rules. We have to include not only updates when the situation is better than described in the initial draft of the report, but also updates that show a worsening situation. Another question is when to resort to such updates? One possibility would be to do it in cases where latest developments have materially changed the staff's assessment of risks and prospects.

Mr. Portugal and Mr. Steiner have mentioned an interesting issue: some countries that are pursuing good policies may nevertheless be unable to access international capital market or to access it under a very unfavorable conditions only, and they wondered whether this could reflect the effect of contagion from developments in mature markets. Here, we should realize that good policies may be a necessary but not sufficient condition for maintaining a good access to international capital market. Another important factor determining the access is the extent of external vulnerability, factors like external debt, level of domestic savings, trade openness etc. Policies represent the "flow" aspect of the problem, vulnerabilities the "stock" aspect. It make take time for good policies (the flows) to improve eventual vulnerabilities (the stock). Therefore, we have to look not only on policies but also on these vulnerabilities—Mr. Brooke mentioned the stock of external debt—when assessing countries' access to external borrowing.

Let me now turn to EU accession countries in central and eastern Europe. The staff suggests that a process of tiering could be going on in primary and secondary bond market. I wonder whether the three tiers mentioned by the staff correspond to borrowers' ratings? That is, does tier one represent investment grade, and tiers two and three higher and lower noninvestment grades? On another issue, the staff notes that investors are positioning themselves for the convergence play in the EU accession countries. As the EU/EMU accessions draws near, the issue of convergence plays and capital flows will become even more important and the staff may wish to look in them in more detail. We have discussed this issue last week during the staff's visit to the Czech Republic. In fact, in the Czech Republic, the convergence of interest rates to EU level has already taken place and the spreads are now even negative. This is an interesting development that deserves more attention, and the capital market department with its special expertise of market operation could provide some help.

Finally, Mr. Callaghan and Mr. Di Maio have raised the important point of implications of disinflation/deflation for financial markets. Even if we agree that there is little risk of global deflation at this point, I too think that the implication of low inflation environment on financial markets deserves attention. In his opening remarks, Mr. Häusler mentioned the risk that corporate earnings may grow less than markets presently expect, and that eventual disappointment could trigger another round of equity market weakness. Low inflation, weak pricing power and thus low growth of nominal GDP and earnings could in fact contribute to such disappointment and we need to look on this issue closely.

Mr. Steiner agreed with Mr. Jonas that updates to the GFSR before publication should be made on a systematic basis and in a symmetrical fashion, meaning that both positive and negative developments should be included in the updates. Regarding Mr. Jonas's suggestion that borrowing needs of emerging markets should be clearly spelled out in future GFSRs, if this suggestion were to be taken up, there would be no reason to restrict this information required to emerging markets only. The need for increased coordination between the Research Department, the ICM Department, and area departments that produced this information should be taken into account.

Mr. Palei made the following statement:

After reading many preliminary statements I have an impression that some of the Directors go too far in their expectation with respect to the coverage and the depth of analysis in the GFSR. For example, Mr. Bennett sees an ideal GFSR as a kind of global FSAP, while Mr. Callaghan and Mr. Di Maio call for analysis of the behavior of the world financial system in response to cumulative deterioration with special attention paid to the effects on the real economy. It seems to me that there should be limits to what we can realistically expect from the report. As Mr. Daïri emphasized in his preliminary statement, the comprehensive analyses of the financial sectors including the stress testing is the task assigned to country FSAP exercises. Like many other Directors, I want the report to be improved, but I believe that the improvements should be on the margins: a little more analytical, a little more focused, a bit more data based.

On the interaction with other Departments, I note that many Directors call for a more active involvement of the MAE and area departments into the preparation of the GFSR. This is an important principle, but its application should not lead to an all-inclusive GFSR. In my view, it is much more important for the GFSR insights, sometimes inevitably rather general and superficial, to be taken on board by the other departments to be developed further, with more rigorous analysis, and to be applied to specific countries and/or issues. Thus, in my view, such coordination should be a two-way street with heavy traffic originating from the ICM Department.

I am also concerned about the calls for a switch to bi-annual reports. As Mr. Wijnholds has reminded us, the GFSR has two parents, the International Capital Markets report and the Emerging Markets Financing papers. The first one was subject to complaints about an overlap with the WEO, very much similar to the ones we hear now about the GFSR. However, there is another part in the report devoted to emerging markets. I totally agree with Mr. Wijnholds that this is the area where the Fund has comparative advantage. Countries with emerging markets represent major borrowers of the Fund. I note that the new GFS Report devotes more attention to emerging market financing, which is a welcome development. I also welcome a stream of the interesting working papers generated by the new Department, including a very good paper on market derivatives in emerging markets.

There is no doubt in my mind that quarterly monitoring of the emerging markets is an essential part of multilateral surveillance by the IMF. So I hope that, when entertaining proposals about a switch to a semi-annual reports, Directors do not throw out the baby with the water. On balance, I would either maintain the current practice or, if consensus leans in a different direction, I could support the proposal by Ms. Lundsager and Mr. Baukol about some streamlining of the report, but keeping the quarterly updates on emerging markets. And when I agree to some streamlining, I have in mind, maybe, a 30- to 40-pages report instead of the current 90-pages document.

I repeat that it is our position that the staff are on the right track in shaping the report, and the report needs marginal improvements rather than a complete overhaul. To illustrate what we expect from the report I will make a few comments. In Box 3.1., the staff have discussed the differences between the changes in risk and in risk aversion. This distinction is essential not only for emerging markets, but for the financial markets in general, so it does not necessarily have to be introduced in Chapter III. Indeed, throughout the text of Chapter II the staff continuously search for the ways to reduce or prevent excessive risk aversion. Hence, the Box could be brought forward. From the text of the report it is not entirely clear whether the staff attribute the recent difficulties in the market access more to the change in tastes of investors or they believe that the actual risks turned out to be higher. Despite the difficulties in disentangling the two components of the observed increases in risk premiums, the staff should continue their attempts to distinguish between the two. The staff could make an extra effort and try to apply the indicators described in Box 3.1. to current developments more explicitly and to interpret the results.

Another central theme of the GFS Report is the sharp tiering of emerging market borrowers by credit quality, which is certainly an interesting line of reasoning. There is information in the report showing that most of the primary market activity could be attributed to the investment grade issuers. At the same time, I am not sure whether, in the third quarter, the investment grade was the main factor determining the developments in the secondary markets. When developing this point, the report mainly refers to the widening of spreads between the investment grade and sub-investment grade issuers. It would have been useful to substantiate the staff's claim and to provide more evidence to illustrate their central idea of tiering. For example, one could ask whether there were only two tiers or, maybe, several? In this respect, the tiers could be better defined and a table similar to Table 1.1. for mature markets or a graph accompanied with discussion would be helpful. Alternatively, the staff could at least insert an additional column with ratings into table 3.2. on page 46 of the report.

At the same time, like Mr. Portugal and Mr. Steiner and Mr. Daïri, I am concerned about the statement on page 66 of the report about the possible "restructuring of the primary and secondary emerging bond market into three tiers...", especially about the characterization of the sub-investment Latin American issuers. In light of more recent market developments this statement appears to be too strong. In any case, this key risk could be illustrated by an in-depth analysis.

Another thought I had while reading the report was about the profound effects of the economic crisis in Argentina on emerging market financing through many channels. The staff refer to the effects of the crisis in Argentina on the perceptions of risk among the European banks and on the retail investors in Europe, which used to be a non-negligible part of the investor base for emerging markets. Are there any policy steps that could help to address the associated problems? Furthermore, on page 55, the staff point to the fact that the ratings assigned to the bonds issued with multilateral guarantees were downgraded following the World Bank's decision to grant Argentina an extension. Again, a more in-depth look into this issue is called for.

Similar to Mr. Zurbrügg and others, I welcome the inclusion in the report of the Box on CACs and support the proposal to include a country-by-country information on CACs in the future issue.

Finally, a few words on the deletions. First, I understand the reasons for deletion of the references to a possibility of worsening of economic situation in Brazil. However, the correction also lead to elimination in the concluding section of Chapter III of, probably, the only positive paragraph about differentiation. Maybe, a way could be found to reinstate this positive message. Second, frankly, I was very surprised by the proposal by Ms. Lundsager and Mr. Baukol to delete pages 87-91 from the report. The description of country cases is useful and, at least with respect to Russia appears to be accurate. Moreover, such editing of the text of the report would create an extremely negative precedent. This part of Chapter IV should definitely stay.

Mr. Shaalan made the following statement:

I chose to speak last so that I could benefit from the views and the interventions of colleagues. I have mixed views on the report before us. I shall not go into the details of developments in mature and emerging markets, and the associated risks and vulnerabilities because, as Mr. Brooke rightly noted, we covered this ground in the September 2002 GFSR. That leads me to the suggestion made by many Directors that a biannual report may be a preferred course of action. I shall concentrate my remarks on some broad observations.

First, an overarching premise that we need to keep in mind is that creating a new department, in this case the ICM, in an institution like the Fund is going to be a delicate task. We are in the process of addressing the unavoidable problems that arise in this context, and the department will soon have found its place in the work of the institution. It is fair to say that the GFSR has increasingly attempted to integrate analysis at the microeconomic level of developments in the financial sector with the macroeconomic analysis on the real sector in the WEO. Understandably, more progress needs to be done toward attaining a more meaningful integration.

The report provides a wealth of detail on various aspects of financial markets. However, the report is largely descriptive, as noted by many Directors, and more analysis of policy implications is needed. I appreciate Mr. Häusler's comments in this regard, as well the Chairman's statement that we should not shy away from coming to conclusions on this subject. If these conclusions cannot be published because of their frankness, I would favor discussing them outside the publication process. This is just another example of why unqualified transparency is not always the best course of action. We therefore encourage the staff to provide us with a more focused analysis, which could lead us into a more open discussion outside the report.

I fully support the view that the WEO and the GFSR should be more fully integrated, and perhaps the possibility of merging the two reports could even be explored. An understanding of economic developments in the global economy cannot result from dealing with these two highly interrelated subjects separately.

On the frequency, I firmly support those who call for a report no more than twice a year. If they are not fully integrated into one, the WEO and the GFSR should be discussed at the same time. I do not agree with those who say that we should have a specified agenda for discussing updates. I think they should be dictated by the agenda for the WEMD. In addition to that, should the situation warrant, we can always have an update in the interim.

In summary, the key attributes of the report should be integration of the financial and the real sector, brevity and limited repetition, less frequent issuance of reports, and considerably more analytical focus. Again, I thank the Director of ICM for the tremendous work he has done, and particularly for his open and frank remarks in responding to Directors' concerns at the beginning of the meeting.

The representative of the ECB (Mr. Grisse) made the following statement:

I will focus my remarks on the situation of the European banking system which is analyzed in detail in the report. We fully share Ms. Lundsager's and Mr. Brooke's comments on the statistical availability of the data. We are working on that. The staff has provided us with a list of needs, and we will transfer the appeal of the Board to my European colleagues to make their authorities aware of these needs.

The staff elaborates in Chapter 2 of the GFSR on the various elements underlying the resilience of European banks. The staff's analysis on most euro area banks reveals favorable results. It praises the banks' ability to intermediate and to bear risks. Looking at the insurance sector, Europe is by no means exceptional with regard to current problems in this sector. We are slightly disappointed at how this comprehensive analysis is translated into the summary statements made in the report. For example, the overview in page 8, where the European financial system is mentioned as one of the three main sources of systemic risk, does not in our view properly reflect the rather balanced discussion elsewhere in the report. Likewise, in page 22, the report ranks the sources of risk in order of importance, going from the U.S.

household sector on to the financial sector in Europe, and finally the corporate and financial sectors in Japan. This rankings of risks is somewhat misleading.

We join Messrs. Callaghan's and Padoan's assessment that the report pays little attention to the interaction between financial markets and the macroeconomic outlook. Weakening in the global macroeconomic environment could well lead to a further deterioration in the asset quality of financial institutions. We should certainly bare this in mind.

On the return on investment of the European banking sector, this is actually faring quite well, apart from some big German banks and a few other individual banks. As regards profitability, the ROE figures for mid-2002 are well above 10 percent for large banks, and their solvency levels are good. We do not agree with the implicit suggestion made in the GFSR that the reported ROE levels would be a source of concern. In this respect, it should be noted that earnings well above normal risk adjusted returns can also be a signal of the absence of competitive behavior, and not necessarily the absence of risk. For example, high present levels of ROE could signal relatively limited provisioning against the risks emerged thus far, although we know that in the case of European banks, they have already significantly lifted their provisions.

On nonperforming loans, the ECB is of the view that their level does not in Europe suggest any drastic issue beyond the impact of a regular economic downturn. In particular, German asset quality figures are not dramatic in our view. Nevertheless, the underlying structural and profitability problems must be tackled, and this seems to be already underway. Moreover, the difficulties that some European and German banks in particular are facing are also by no means a regional phenomenon, as recent indications from across the Atlantic suggest.

With regard to claims on developing countries, when illustrating the dangers of contagion stemming from Germany, the report states that German banks have $190 billion in claims on developing economies. In our view, disruptive effects arising from German exposure do not seem more likely than those stemming from probable U.S. exposure. North American bank claims on developing economies stand around $250 billion, and this includes more structurally important banks like J.P. Morgan and Citibank, which have already recognized some problems stemming from their significant international exposure. Let me in this regard come back to the first statement of Ms. Phang, which I found very refreshing and interesting, saying that we should probably go beyond statistics to have a fresh look on qualitative developments, particularly as some of these developments reported in the press are quite shocking. For example, news about the relationship between Sandy Weill and his AT&T analysts illustrates some of the confidence damaging issues at the highest level in Wall Street.

Finally, on the question about a possible credit crunch in Europe, we see clear signs that lower credit demand, rather than lack of supply, is the driving factor for the reduction in credit in this region.

Mr. Shaalan observed that the discussion should not focus on whether European or U.S. banks had more loans outstanding to emerging markets, but on whether the total exposure of banks represented a risk.

After adjourning at 1:05 p.m., the meeting reconvened at 2:30 p.m.

The Counsellor and Director of the International Capital Markets Department (Mr. Häusler), in response to questions from Directors, made the following additional statement:

I will focus on the most important questions and suggest that we take some of the others bilaterally. I take great encouragement from the current discussion for our future work on the GSFR. We welcome the encouragement of Directors for us to work with other departments going forward, and also for them to work with us. Let me start in substance by trying to clarify a few misunderstandings on the report.

Many people have referred to various versions of the report dealing with Brazil, and there has be a reference to a deal between ICM and the Brazilian authorities. Let me clarify that there was no such thing. Every report has its iterations and changes. What happened is that there was a computer glitch which resulted in the ICM Department sending out the final version in hard copy, but a previous draft in the electronic version. We never debated this with any authorities, not even with management or anybody else.

There is another misunderstanding on Chapter 4 on derivatives. This is a special chapter in a special series called local securities markets. By definition, this chapter deals only with the function of derivatives markets in local emerging market securities markets. It does not attempt to deal with derivatives as such. Therefore, those Directors who feel that this is a shortcoming should accept that this was the scope that we wanted to deal with. If at some point in time there is a need and reason to deal with derivatives on a much broader scale, this will be a totally different question.

Another issue was the reference to increased tiering among debtors. The possibility of increased tiering going forward was not meant to be a prediction, but a theoretical risk which would be realized if risk aversion rises. We are not predicting that this will happen, but it remains a possibility.

There was also a misunderstanding in the point made by Ms. Lundsager and Mr. Baukol about the derivatives chapter. I suggest that we iron that out bilaterally. If the language used in the report has contributed to that misunderstanding, we are happy to change that language, but I think that the substance is not controversial.

Another misunderstanding came up this morning on German banks being depicted as a systemic risk. The wording on page 34 of the report and in other parts of the report makes the opposite point, saying explicitly that there are no systemic risks. Let me clarify again that the report does not refer to a danger of collapse for German banks, but to the implications of the strategic decision of senior bank management to scale back their credit exposure and their risk-taking appetite in the current difficult environment. This strategic reorientation is not a hypothetical development, as it is already taking place, and it may have some repercussions on risky asset classes which may not be able to raise the same amount of financing as in the past. This is not an exclusive German phenomenon, but a European-wide banking phenomenon, given that European banks were more exposed to emerging markets than non-European banks. Therefore, this is a relevant issue for the purpose of the report and for Fund surveillance. But, again, the issue is not about whether these banks will have liquidity or even solvency problems going forward.

Regarding the question of addressing individual financial institutions in the GFSR, I should clarify that we cannot mention individual financial institutions or their Chief Executive Officers by name in a report for publication.

As Mr. Brooke has indicated, more could have been said on the Japanese financial restructuring plan. The reason why the report has not commented on this is that the MAE Department has requested that we do not address this issue in a public report at a time when there is an ongoing FSAP, as this is the right vehicle to provide the Fund's views on the plan.

Mr. Brooke also wonders whether the fact that we have not mentioned capital account imbalances, the exchange rate, and potential outflows from the U.S. in the current GFSR as we did in the September 2002 GFSR means that we no longer think that there are risks in these areas. The answer is that we still think that there are risks, but we had nothing to add to what we already said in September, and we decided to focus on a number of other issues in the limited space available in the report. Our approach would be to come back to issues covered in past reports only if there have been substantial changes.

A similar argument applies to the insurance sector. We pointed to the emerging risks in this sector at an early stage, in the June 2002 GFSR, when this had not yet been widely identified as an issue by most observers. We had a special chapter on the insurance sector in this report, and we pointed to the lack of transparency, the opaqueness, and inadequate supervision as problems that needed to be remedied. Again, we did not want to repeat this every time we issued a report.

As to medium-term issues, Mr. Boitreaud has asked about the procyclical contributions of accounting standards and rating agencies, which are sometimes criticized for coming to the battlefield to shoot the wounded. We agree that this is an issue. In fact, we have debated internally the possibility of addressing the issues of volatility and procyclicality in our work program, which is ambitious and can only be expanded if we have the necessary resources. We intend to go beyond accounting standards to also look at bank regulation. To some degree, we all know that Basle II is procyclical. The question comes down to the trade-off between a procyclical supervisory regime that may be adequate for supervisory purposes and the implications for international financial markets of the procyclicality entailed by such a regime. Any conclusions on this can only be reached after thorough analysis. This is in the making, but Directors should not expect firm results to be obtained early. Directors are probably aware that the Securities and Exchange Commission (SEC) is holding hearings on this, and the FSF is also looking at these issues. In particular, the SEC is held by Congress to come up with a view by end-January 2003.

Some Directors have also asked about flagging in the report the financing needs of specific emerging market countries in addition to providing general data on their financing needs as a group. The issue of flagging publicly potentially weak debt dynamics has also been raised. This is related to the discussion about how open surveillance can be. While there is merit in addressing these issues in Board discussions, ICM would not feel comfortable at this stage with providing in a published report data indicating the vulnerabilities faced by individual countries. There would have to be a policy change in the Fund for that to happen. Board discussions allow Directors and staff to discuss openly details that cannot by definition be published in a report.

Regarding Mr. Jonas's question about the convergence play in Central and Eastern Europe, convergence is certainly taking place—for example, Ms. Lundsager's has referred in her statement to the low spreads in that region of the world—but there are reasons to remain cautious, as the convergence play is predicated on one fact that may come true and on an illusion. The fact that may come true is the eventual accession to the European Union. We all hope that that will become a reality. The illusion is the consideration by traders that debt issued by these countries would eventually be backed by the EU. However, markets are not taking into account Article 104(b), which stipulates that each and every country will not be bailed out by other European countries in the EU. In this sense, the currently aggressive convergence play could be generating a small bubble that could lead to disappointments in expectations and a setback in financial markets.

Finally, we are glad that Directors have appreciated the inclusion of a box on the use of CACs, and we will take on board their recommendations to maintain this box in future reports and to make it more country-specific, especially as this can contribute to the ongoing debate on crisis resolution.

Mr. Zurbrügg found the information provided in the previous draft of the GFSR on the effects of a potential credit event in Brazil particularly interesting. While the final version of the report referred to the repercussions for the region as a whole of a further sharp deterioration in Brazil, the previous draft made an interesting differentiation between sub investment grade borrowers, which would be affected by the crisis, and other borrowers—like Mexico, Chile and a number of Asian countries—which would not be severely affected by the crisis.

Mr. Brooke agreed that it was reasonable not to include detailed information on risks in capital account imbalances and the insurance sector if these had already been covered in detail in previous Board discussions. At the same time, it would be useful to at least make reference to these risks if they were still considered to be significant, as ignoring them completely in the report could create the misperception that the Fund no longer considered them to be relevant. Perhaps they could merely be mentioned as major risks, and the reader could then be referred to previous issues of the GFSR for more detailed information on the specific risks.

On debt sustainability analyses (DSA), Mr. Brooke continued, it should be acknowledged that private market participants were carrying out the exact same work as the Fund, and they were therefore aware of the same risks identified by the Fund. The whole point of doing multilateral surveillance and publishing it was to obtain additional leverage on country authorities through press commentaries and market reactions. Therefore, the Fund should strive to use state of the art methodologies for its DSA and to publish the result obtained to try to influence member authorities to reduce their vulnerabilities.

On Japan, while agreeing that the FSAP was the most adequate channel to assess the authorities' plan to address the difficulties in the financial sector, Mr. Brooke considered that a provisional assessment could have been provided in the GFSR. The reader could then be referred to the upcoming FSAP, where a more in-depth assessment of the situation would be provided.

Mr. Palei suggested changes in the wording used in the report to refer to the risk of increased tiering in credit markets for sovereigns, as the current wording appeared to imply that this would be a structural trend, and a fuller discussion of this issue would be needed before such a conclusion could be reached. For example, the word "restructuring" used in the statement that "less brokerage support, less liquidity, and less dedicated investments could lead to a restructuring of the primary and secondary emerging bond markets into three tiers" could be changed to soften the indication that these changes would be permanent.

Mr. Jonas agreed that there could be sensitivities with the publication of financing needs, but he observed that it would still be useful for the Board to receive this information—perhaps during joint WEMD sessions. He also agreed that the aggressive nature of the convergence play in Central and Eastern Europe could be a source of risk going forward.

Mr. Padoan agreed with Mr. Jonas on the desirability of receiving information on financing needs and on the implications of debt sustainability on a multilateral basis. The staff could provide an overall picture for a large number of relevant countries, without necessarily looking at figures for individual countries. While the issue of publication would require further discussion, the Board would certainly find this information useful. These considerations reinforced the need to find a new structure and presentation of materials in GFSRs.

Mr. Beauregard considered that the adequate framework to present DSA on member countries was in Article IV consultations, as debt sustainability should not be analyzed in isolation but in the broader context of all the economic policies taken by member countries.

The Counsellor and Director of the International Capital Markets Department (Mr. Häusler) stressed the need to consider the issue carefully before coming to a conclusion on the work of the ICM Department on debt sustainability.

The Chairman made the following statement:

> As I understand it from today's discussion and the experience of the previous reports, the GFSR is emerging as a useful tool for our multilateral surveillance function. As Directors have indicated, there are also points for further improvement, and the staff has taken note of them and will work to make further progress in those areas.
>
> There is unanimity that the report should be more analytical. Directors are interested in meaningful analysis of policy implications and in concrete policy recommendations, not just statistics and descriptive analysis. In this context, the point has also been raised that we need to look at the value-added of our report compared to other reports, from institutions like the BIS and the Bank of England, as we should avoid a pure duplication of efforts. We should make use of existing reports from other institutions, but the Fund should also be able to base its judgment on its own analysis.
>
> Chairman Greenspan's speeches about derivatives are an example of useful analysis coming from other institutions. Even if there are no particular policy recommendations behind them, he is outspoken in saying that the development of these instruments has helped make markets smooth and flexible. While I agree in principle with this assessment, I would like to have the Fund's own judgment about the merits and the risks also of derivatives, particularly in the context of emerging market finance. There are other examples of issues on which the Fund should have a judgment based on its staff's own expertise.
>
> Regarding the discussion on whether the focus should be on emerging markets only or whether we should also cover mature markets, we need to be aware of the need to look at transfer mechanism in a context of globalization.

Therefore, we ca not exclude looking carefully at mature markets. While we can clearly provide value-added in analyzing emerging markets, we would not be carrying out our function adequately if we did not look at emerging markets in the context of risks coming from the mature markets.

As Mr. Shaalan has indicated, there are inherent difficulties in the process of creating a new department in an institution like the Fund and to ensure that it is attuned to the culture of the institution. The importance of financial and capital markets has increased exponentially since the 1960s when the economics profession did not pay much attention to this aspect of the economy. The creation of the ICM Department should help the Fund close the lag between developments in modern economic and the institution's ability to make adequate judgments on certain policy areas.

I fully associate myself with Directors who have said that we need to have better cooperation between the ICM, and the Research and area departments. There is a need to avoid a segmented culture in the institution, where departments end up working in isolation from each other. We need to increase the exchanges of expertise between departments. I strongly encourage the ICM to work closely with other departments. As long as unnecessary duplications are avoided, we should not be excessively worried about overlaps between the work programs of different departments, as this would allow for some discussion of the relevant issues between departments to share expertise. It is possible that different departments will have different views on specific issues, for example in the context of discussions on the interactions between financial markets and the real economy. No single department has the capacity to address these issues, and we should clearly work toward improving cooperation between departments.

Management will take stock of our experience with the full annual cycle of GFSRs—four quarterly reports have been issued thus far—with the aim of coming to a conclusion on the preferred periodicity and format of the report. The ICM Department is up to speed in terms of following current developments. While it is understandable that the Board some times has a preference for written reports, which help in the task of reporting back to the capitals, certain aspects are better dealt with in the context of Board discussions. We need to further develop a culture of debates in the Board to improve our ability to make judgments. Moving to a semiannual report, with quarterly presentations in between, appears to be the preferred option of Directors. Management will make a decision—based on the views of Directors and on consultations with the staff—whether to change the periodicity and format of the GFSR for the 2003 cycle.

The Chairman made the following concluding remarks:

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.

3. VANUATU—2002 ARTICLE IV CONSULTATION

Documents: Staff Report for the 2002 Article IV Consultation (SM/02/344, 11/7/02; and Cor. 1, 11/20/02); and Selected Issues and Statistical Appendix (SM/02/350, 11/13/02, and Cor. 1, 11/20/02)

Staff: Cowen, APD; Allen, PDR

Length: 1 hour, 15 minutes

The staff representative from the Asia and Pacific Department (Mr. Cowen) submitted the following statement:

> This statement contains information that has become available since the staff report for the 2002 Article IV consultation (SM/02/344) was circulated to the Executive Board on November 7, 2002. The information does not alter the thrust of the staff appraisal.
>
> The government budget for 2003, currently being considered by Parliament and expected to receive final approval by early December, aims for a current budget balance. The overall budget deficit in 2003 is projected to be about 1 percentage point of GDP smaller than indicated in the staff report, mostly on account of lower capital expenditure.

Monetary developments through September 2002 are generally in line with staff projections. Broad money growth rose to 1 percent for the year ending September 2002, reflecting a reversal in the decline in foreign currency deposits observed in August. For the same period, credit to the private sector expanded by 4¾ percent. Net credit to government by the banking system increased by VT 464 million (1½ percent of GDP) from end–August, which the staff understands has since been partially unwound. Inflation (period average) was at 2 percent for the year ending September 2002.

On November 11, Parliament approved the International Banking Act, which aims to strengthen oversight of offshore banks. Under the act, which takes effect from January 1, 2003, offshore banks will be supervised by the Reserve Bank of Vanuatu. They will face significantly tighter prudential regulations (in line with onshore banks), including in the areas of capital requirements, data provision, and audit procedures. Offshore banks can apply for a one–year interim license effective from January 1. To continue to operate beyond 2003, they must subsequently reapply for a regular license by end–August 2003, which will be granted only to those banks maintaining a physical presence in Vanuatu and meeting the minimum capital requirement, as well as all other provisions in the act.

Mr. Callaghan submitted the following statement:

Key Points

Vanuatu faces many challenges, given its small size, high cost structure and cyclone–prone environment. It has faced a significant decline in the prices for its major export crops. Frequent changes in government have also been an impediment to advancing a comprehensive reform agenda.

Notwithstanding these challenges and uncertainties, macroeconomic stability has been maintained—a testament to generally sound macroeconomic policies.

The fiscal position is tight and the authorities have taken steps to control expenditures and boost revenue, particularly through improvements to VAT and customs administration. Capacity limitations hamper the introduction of more comprehensive reforms, including in the area of debt management.

There have been improvements in budget monitoring and steps have been taken to control the growth in the government wage bill.

A cautious approach has been taken with respect to the 2003 budget, which is generally in line with the staff recommendations. The 2003 budget, which the government is to table in Parliament, targets a recurrent deficit of 0.1 percent of GDP and an overall surplus of 0.4 percent of GDP.

The authorities are conscious of the need to maintain healthy reserve levels and have requested technical assistance to examine some of the recommendations with respect to exchange rate and reserve management raised by the staff.

There have been significant developments in strengthening the regulation and supervision of the offshore financial sector and the anti–money laundering regime.

A Challenging Environment

Vanuatu faces many challenges. Some of these are associated with its size and geography. With a population of around 197,000, like other small states it faces the problem of diseconomies of scale that result in a high cost of doing business. Adding to its cost structure is the fact that it consists of a dispersed group of islands, which are a considerable distance from major population centers. There are also the pressures that come from a rapidly growing population. Then there is the weather. Vanuatu experiences an average of 2.6 cyclones each year, with only one year in seven or eight being cyclone–free. There is also the risk of volcanic eruptions and earthquakes. As noted in the Selected Issues paper, the Commonwealth Secretariat has ranked Vanuatu as the most vulnerable country to natural disasters among 111 developing countries.

In recent years Vanuatu has experienced a degree of political uncertainty, which has presented another challenge to pursuing reform. Over the past decade there have been ten changes of government, with three changes since 1999. Added to these uncertainties, the economy has had to contend with the effects of the weaker external environment and a significant decline in the prices of some of its major exports, particularly copra, cocoa and kava. Since 1997, the prices of copra, cocoa and kava have all fallen by more than 50 percent, although there was some improvement in cocoa prices in the first half of 2002.

The tourism sector is particularly important to Vanuatu and was adversely affected by the terrorist attacks on the United States in September 2001. More recently, there has been increased competition from Fiji, which, with greater political stability, has seen a recovery in its tourist sector. The Vanuatu authorities have recently launched a new tourism marketing campaign.

Despite these many challenges, the authorities have maintained macroeconomic stability. Inflation is under control, external debts are manageable, and the fiscal situation has improved. In addition, the authorities have continued to make progress in addressing structural weaknesses in the economy under the Comprehensive Reform Program, and are committed to making further progress in order to strengthen medium–term growth.

As noted, relatively frequent changes of government have not facilitated the implementation of reforms. The current government is a coalition and has a substantial majority in Parliament. This holds out the prospect for greater political stability, although all governing coalition arrangements pose particular challenges.

In terms of the future direction of policy, the government recognizes the importance of maintaining macroeconomic stability as well as the need to advance structural reform in order to enhance the competitiveness of the economy. Specifically, the Prime Minister is emphasizing "Five Millennium Priorities," which are (1) achieving the goals of good governance; (2) supporting and improving private sector led growth; (3) improving the participation of all people in the economic, social and political development of Vanuatu; (4) improving the standard of living for all in Vanuatu; and (5) reducing inequalities and distributing equally all of the benefits, services, and resources of the government.

Fiscal Policy

The authorities are aware of the need to address the fiscal situation and have taken a cautious approach in formulating the 2003 budget. The 2003 budget, which is ready to be tabled in Parliament, targeted a recurrent deficit of 0.1 percent of GDP and an overall surplus of 0.4 percent of GDP.

More broadly, there have been improvements in budget preparation and reporting. Since 1999 the government has published an annual fiscal strategy report. The cash position is very tight and expenditure has been kept under close control through the use of monthly warrants. The introduction of the Financial Management Information System has improved budget monitoring and should allow the use of quarterly expenditure warrants by next year, thus making budget implementation more flexible. The authorities have taken note of the staff's recommendation for greater reliance on treasury bill auctions to meet government financing needs, although the authorities believe this needs to be addressed in the context of strengthening overall debt management.

Some important steps have been made towards strengthening revenue performance. VAT and customs administration have been improved with the introduction of automated systems, which strengthen tax audit and compliance procedures. The Lands Department is in the process of improving the collection of land leases, which would have a positive impact on the 2003 fiscal position. Excises on tobacco and alcohol products are included in the 2003 budget and become effective as of January 2003. The authorities are also considering increasing duties on select imports, and are investigating ways of further improving customs and VAT compliance.

On the expenditure side, the authorities recognize the importance of reducing the wage bill to divert resources to health and education, rural infrastructure and development of the outer islands. In this regard, new arrangements have been introduced whereby additional recruitment by any agency must obtain approval from the Finance Ministry.

Copra is the main source of income in the outer islands, where a significant proportion of the population lives. Given the limited means available to provide support to the outer islands, the authorities have been using copra subsidies. The subsidies are aimed at reducing income disparities between rural and urban communities and to help support producers, given the volatility in international copra prices. Nevertheless, to ensure the subsidies achieve their intended objective and given the tightness of the fiscal position and the need to avoid market distortions, the authorities are looking to ensure that this support is well targeted. The Vanuatu Commodities Marketing Board is readjusting its marketing arrangements to reduce costs. Due to the tight fiscal situation, direct financial assistance by the government to the Vanuatu Commodity Marketing Board has been minimal.

Exchange Rate Regime

While reserves have declined since the late 1990s, the decline has been gradual. This year uncertainty about the elections has affected reserve levels.

The authorities are mindful of the need to maintain healthy reserve levels. In this vein, they have requested technical assistance to examine further the staff's suggestions to improve reserves management. While the authorities are willing to consider deepening the interbank market through widening the Reserve Bank of Vanuatu's trading band, they have reservations about disclosing details of the basket. Based on previous experience, they are concerned that disclosure might encourage destabilizing speculation on exchange rate movements.

Financial Sector Issues

A key focus of the authorities' reform efforts has been on financial sector issues. Notwithstanding limited capacity, they have tackled vigorously the weaknesses in the anti–money laundering regime and the regulation and supervision of the offshore financial sector (OFC). They have made good progress since the last consultation, including:

- approval of the Financial Transactions Report Act in September 2000, which sets out procedures for customer identification, record keeping and suspicious transaction reporting;

- establishment of a Financial Intelligence Unit;

- issuance of a 'know–your–customer' regulation for domestic banks; and,

- on–site examinations of domestic banks' AML procedures.

The Offshore Financial Center Module II Assessment conducted by Monetary and Exchange Affairs (MAE) earlier this year made recommendations to strengthen the regulation and supervision of domestic banks and also the OFC. The authorities support MAE's recommendation and have acted rapidly to address weaknesses identified in both the domestic sector and the OFC.

While the domestic banking sector is generally sound, the Assessment did identify some areas for improvement. To address these issues, customer due diligence guidelines were approved in July. The Financial Institutions Act is being amended to improve oversight of banks' anti-money laundering systems and controls and to introduce a more rigorous 'fit and proper' regime.

The weaknesses in the regulation and supervision of the OFC were more significant, but the authorities have moved to address the weaknesses as quickly as possible, with valuable technical assistance from the Fund. The Parliament recently passed the International Banking Act, which will strengthen the oversight of offshore banks. Under the Act, supervision of the OFC will be brought under the authority of the Reserve Bank of Vanuatu and will take effect on January 1, 2003. Parliament has also recently passed several bills related to combating terrorist financing.

Progress has been made on state–owned enterprise reform since the last Article IV consultation, with the sale or liquidation of 10 enterprises. Further progress is expected to be made following the completion of the review of the divestment strategy at the end of this year.

In closing, we would like to thank the staff for the well-written report. The authorities value this opportunity to consult with the Fund on the broad economic and policy outlook, and also appreciate greatly the technical assistance being provided by the Fund and through PFTAC. This technical assistance has certainly had many benefits, particularly in terms of strengthening the financial sector and improving statistical methods and reporting.

Mr. Wei submitted the following statement:

We would like to thank the staff for a set of helpful papers and Mr. Callaghan for his comprehensive statement.

During the past two years, Vanuatu has successfully maintained macro–economic stability despite changes in government and adverse weather conditions, as well as weak external demand. Inflation was low and so was external vulnerability. These encouraging developments have taken place in the context of the constraints and inherent disadvantages faced by a small island economy. In the past two years there have also been significant structural reforms, especially in financial regulation and supervision. However, despite these positive developments, the potential of the economy is far from being fully exploited, and the risks are substantial, particularly as population growth is outpacing the continued low or even negative economic growth. Since we are in broad agreement with the staff appraisal, I would like to make just a few remarks for emphasis.

As mentioned by Mr. Callaghan, the frequent change of government and lack of political consensus on policy directions has resulted in less–than–expected progress in fiscal performance and a slow-down in some key structural reform areas. On the other hand, as shown in the staff paper, international donors play an active and important role in helping the country in macroeconomic policy-making, institutional capacity building, and development financing. Different donors may have different agendas, priorities, and policy advice. Better coordination of development priorities and greater consistency in donors' policy advice will better serve the development needs of Vanuatu.

On the fiscal front, like the staff, we welcome the recent improvements in public finances and see the need for further actions to achieve lasting fiscal consolidation—the authorities should further strengthen tax administration, expenditure control, and prioritization. The recent improvements in tax administration were encouraging. The authorities are further encouraged to limit both tax exemptions and resorting to advances from the Reserve Bank of Vanuatu to finance gaps. Consistent and resolute actions on expenditure control and prioritization on the part of the authorities are appropriate. In its process of consolidating ministries and cutting civil servants, the authorities should seek to actually achieve a reduction in the share of wage spending. Recognition of insufficient spending on social and infrastructure development should be followed with increased budgetary allocations. Although we can understand the authorities' reluctance to introduce new taxes during the economic downturn, we support the staff's recommendation on pushing forward with an excise on alcohol and tobacco.

The achievements in financial sector reform, as highlighted by Mr. Callaghan, are remarkable—strengthened banking supervision and regulation and compliance in line with international standards. The general soundness of the domestic banking sector not only testifies to the effectiveness of the authorities' efforts, but also indicates that the authorities are capable of complying with international standards once the capacity is established. The staff paper also points out the weakness in OFC oversight. We share the staff's analysis on the benefits of strengthened oversight and welcome the authorities' actions in this regard. On trade reform, it is quite unfortunate that Vanuatu's quest for WTO membership was stalled before completion. Could the staff elaborate on the degree to which WTO accession will contribute to the economic performance of Vanuatu, and what the major obstacles are for garnering domestic support for a wider opening and lower binding rates.

Fostering a benign business environment is crucial for Vanuatu to diversify its economy and promote higher growth. To this end, the streamlining of business licensing and land procurement procedures and the protection of landowners' rights are important steps. The authorities are encouraged to move forward.

The limited institutional capacity still constrains Vanuatu in improving fiscal performance and implementing structural reforms, thus technical assistance continues to figure crucially in developing institutional capacity. In this respect, we recognize and appreciate the contribution made by the Pacific Financial Technical Assistance Center in helping Vanuatu improve banking regulation and supervision, public finance management, and economic statistics. We encourage the authorities to continue to make the best use of technical assistance and enhance institutional capacity.

With these remarks, we wish the authorities all the best in their endeavors.

Mr. Le Fort and Mr. Vogel submitted the following statement:

Key Points

Natural and structural disadvantages severely limit the growth possibilities of Vanuatu, including an extreme dependence on the agricultural sector, which is seriously threatened by cyclones and the fluctuation in international prices.

Efficiency gains and economic diversification are hampered by obstacles that limit competitiveness, including high costs of production and inadequate infrastructure.

Efficient educational spending should be a priority; Vanuatu ranks as the third lowest among 173 countries on the adult literacy rate.

The offshore bank system seems to pose a substantial risk burden for the domestic economy, so that the development of a regulatory and supervisory framework for the offshore system is critical. In the medium term, the authorities should analyze the convenience of maintaining an off–shore banking system.

At the outset, we would like to thank the staff for the well-written reports prepared for this Article IV consultation and Mr. Callaghan for his insightful statement. Vanuatu represents a very complicated case. This is a country with some important disadvantages that severely limit its growth possibilities. Some of these constraints are related to recurrent natural disasters—mostly cyclones—while others relate to demographic issues, including the very limited opportunities to exploit economies of scale, due to a small population, a high degree of political instability, and very limited possibilities for the sustained implementation of economic policies. This instability is shown in a rapid rotation of governments and changing coalitions, that has led to economic mismanagement and structural weaknesses. These deficiencies are reflected in a high cost structure and a poor basic infrastructure.

The economic activity is highly concentrated in the agricultural sector, which is affected by the deficiencies noted above. Agricultural production is exposed to natural disasters and to wide fluctuations in the international prices of Vanuatu's main export commodities—particularly copra. The development of the agricultural sector, and economic diversification, are needed to reverse the declining growth trend. This will require bolstering external competitiveness and expanding productive opportunities in other crops and sectors, for which the authorities would need to take action on the fiscal and structural fronts.

Economic growth and the diversification of economic activity will be needed to reduce the high costs of production and develop adequate infrastructure. Box 1 of the Staff report shows several of Vanuatu's indicators of competitiveness—such as paved roads, the cost of a local telephone call, and others—lagging far below those of other countries in the region. Certainly, more stable political conditions, along with some progress in institutional development and structural policies, could significantly improve the business environment and help to attract additional capital to these areas. The transportation and communication constraints seem to be one of the reasons of the wide disparity in Vanuatu, for example between the capital, Port Vila, and the rest of the country. This has been a matter of concern among Vanuatu's main donor countries. The subsidies to the copra production are precisely aimed at reducing income disparities between rural and urban communities, as copra is the main source of income in the outer island. However, the reduced international prices of this commodity seem to be long-lasting, so that the subsidy is not sustainable given the very limited financial resources of the public sector. In addition, the interest rate spread in Vanuatu's banking system appears to be substantially higher than in other countries of the region, constituting yet another adverse factor hampering product development and diversification.

Beyond the operating costs and policy uncertainty, the situation and prospects of the offshore banks pose an additional burden for the domestic economy. We welcome the finalized legal reforms that will bring the regulatory and supervisory framework for offshore banks in line with those of domestic banks and will extend the supervisory authority of the RBV. Steps should also be taken to comply with the international standards against money laundering and the financing of terrorism. However, the risks and costs associated with the offshore banking system, as compared with the apparently limited benefits, raise questions about the strategy to be followed over the medium term. What are the economic justifications for maintaining an offshore banking system like the current one in Vanuatu, and to what extent could public resources be compromised by such a system? The authorities should make a comprehensive study to analyze benefits and costs and devise an appropriate strategy for the banking system.

We welcome the recent improvements on the fiscal front and Mr. Callaghan's remarks on the authorities' recognition of the importance of reducing the public sector wage bill, in order to divert resources to social spending and the development of infrastructure. Nonetheless, we have some questions on the efficiency of social expenditures allocated to education. The Human Development Report of UNDP (United Nations Development Programme) indicates that, between 1985 and 1987, Vanuatu had high ratios of education expenditure to GNP, as well as to total public expenditure (7.4 percent and 24.6 percent). Even though these ratios have been falling, they remain around average values for countries considered to be in the middle of the human development index group. Despite these ratios, Vanuatu ranks the third lowest among 173 countries in the adult literacy rate, (34 percent versus 86 percent, which is the average in East Asia and Pacific countries, or versus 76 percent in lower-middle income countries), casting doubts on the efficiency of educational expenditure. Is this the result of a measurement problem? If not, are there ways to increase the very low efficiency of spending? Perhaps the staff could elaborate further on this issue.

Finally, on the monetary and exchange rate policy, the adjustable peg arrangement seems to be working for Vanuatu, thus putting the onus of improving external competitiveness on the fiscal and structural policies. Nonetheless, we agree with the staff that, in the event of a further deterioration of the external position, more flexible exchange rate management may be necessary. Moreover, the falling level of international reserves could establish a limitation for the current system. In this vein, the authorities' request for technical assistance to further examine staff suggestions on the monetary and exchange system and to improve reserves management is a welcome step.

Mr. Mirakhor submitted the following statement:

Key Points

The authorities deserve credit for maintaining macroeconomic stability and external viability under difficult circumstances;

Substantial additional actions are required to achieve lasting fiscal consolidation;

We support the authorities' request for Fund technical assistance to improve reserves management;

We welcome the International Banking Act designed to strengthen the oversight of offshore banks;

Promoting growth and productivity requires a stable policy environment and perseverance with structural reforms;

The authorities are encouraged to ensure Vanuatu's timely participation in the Fund's GDDS.

We thank the staff for a useful set of papers, and Mr. Callaghan for his informative statement. Ranked as the most vulnerable developing country to natural disasters, Vanuatu has experienced a considerable economic slow-down since the mid-1990s owing to political instability and structural weaknesses, compounded by adverse exogenous shocks. The authorities, however, deserve credit for preserving macroeconomic stability and external viability under difficult political and economic conditions. In 2001, while the real economy contracted in the context of major cyclones and the global downturn, inflation was kept under control, the fiscal situation improved significantly, the external current account remained in surplus, international reserves were at a reasonable level, and the external debt to GDP ratio declined. Real GDP growth is projected to be slightly negative again in 2002 because of a slump in tourism, and construction and the external current account are expected to deteriorate. However, public finances are expected to improve further. While frequent changes in government over the past three years have slowed structural reforms, the national election in May 2002 has cautiously bolstered reform prospects. We concur with the thrust of the staff appraisal and its main policy recommendations. We also share the view that addressing Vanuatu's poor growth performance and low human development indicators requires a stable policy environment and perseverance with fiscal and structural reforms. While international donors have an important role in assisting Vanuatu, Mr. Wei is correct in recommending better coordination and greater consistency in donors' policy advice.

Notwithstanding recent improvements in the fiscal situation, achieving higher and more sustained growth and meeting the key social and infrastructure needs hinge critically on a strengthened policy framework and fiscal consolidation over the medium term. We welcome the authorities' cautious approach in formulating the 2003 budget, including virtual overall and current balances. However, stronger measures are required to mobilize revenue and prioritize expenditure. On the revenue side, we welcome improvements in VAT and customs administration through the introduction of automated systems to strengthen audit and compliance, as well as the new excises included in the 2003 budget. Broadening the tax base and containing tax exemptions are also essential to strengthening revenue performance over the medium term. On the expenditure side, we note the authorities' acknowledgement of the need for strict limits on supplemental appropriations, as well as rolling back copra subsidies. We also welcome plans to rationalize government employment and control the wage bill, which will provide room for spending on operations and maintenance, as well as on social areas. Given the need to upgrade and expand basic infrastructure, higher capital spending is appropriate within the framework of a well-designed public investment program and with coordinated donor support. Moreover, debt management should be strengthened to enable the use of treasury bill auctions instead of central bank advances to meet financing needs.

Monetary policy has contributed to low inflation and a stable financial environment in recent years. A cautious monetary stance to safeguard inflation performance and support the external position calls for strict limits on deficit financing by the central bank. The effective conduct of monetary policy is also predicated on strengthening the autonomy of the central bank.

Exchange rate policy has been generally appropriate, but declining exports and reserves warrant close monitoring of exchange rate movements. While we understand the authorities' reluctance to disclose the basket composition, we welcome their willingness, as suggested in Mr. Callaghan's statement, to consider widening of the trading band, and support their request for Fund technical assistance to improve reserves management. Given Vanuatu's high reliance on imports and cost structure, lasting competitiveness gains should be sought through the maintenance of a sound fiscal stance and acceleration of structural reforms.

As indicated by the OFC Module II Assessment conducted by the Monetary and Exchange Affairs Department, the domestic banking sector is generally sound. We welcome progress made in strengthening the supervision of domestic banks, including the oversight of banks' anti–money laundering systems, as well as the International Banking Act, which gives the central bank regulatory and supervisory authority over the offshore banks. In this context, the authorities are encouraged to seek adequate resources and support for proper enforcement, including Fund technical assistance. We also welcome completion of the financial and operational restructurings of the Vanuatu National Provident Fund and National Bank of Vanuatu, and underscore the need for a quick resolution of AMU non–performing loans to limit fiscal risks.

Durable higher growth and productivity hinges on renewed efforts to implement key structural reforms, an area where progress has been somewhat uneven since the last consultation. A more aggressive approach to SOE reform, following the authorities' review of their divestment strategy by year–end, would engender efficiency gains and strengthen external competitiveness. Political support needs to be garnered more quickly for a timely implementation of trade commitments, including WTO accession. Moreover, reducing administrative constraints and establishing a more transparent regulatory framework could go a long way in fostering an environment conducive to private sector development and FDI.

Finally, recent improvements in statistical methods and reporting have enhanced policy formulation and monitoring. The authorities are, however, encouraged to continue improving data accuracy and coverage with donor technical assistance, and ensure Vanuatu's timely participation in the Fund's GDDS.

Mr. Callaghan informed the Board that the Vanuatu authorities had agreed to publish the staff report and all related documents.

Mr. Boitreaud made the following statement:

I would like to thank the staff for a very interesting set of papers and Mr. Callaghan for his comprehensive and helpful statement. Since I concur with the thrust of the staff appraisal and its main recommendations, I will limit my intervention to one general comment and five remarks.

Let me start with my general comment. If one should summarize the challenges facing Vanuatu, it would be along the lines of "how can a small archipelago country ranked as the most vulnerable to natural disasters and experiencing steady demographic growth improve its GDP per capita in the medium run?" It is pretty clear that there is no silver bullet answer to such a question but a few ingredients can be identified.

First, nothing can be done without a minimum of political stability. Mr. Callaghan's reference to the current coalition government having a substantial majority is reassuring but the country's history precludes any definitive forecast on this crucial issue.

Second, Vanuatu needs technical support and financing assistance from the donor community. Beyond the concerns over coordination mentioned by Mr. Wei in his preliminary statement, the authorities in Vanuatu should see that multilateral and bilateral donors remain committed to helping the country in the long run. Concerns may rise that continued political instability might lead to some donor fatigue : hopefully it does not appear to be the case now but the authorities should pay close attention to this issue.

Third, investments in human capital should be given a clear priority as a skilled labor force is key to increasing the productivity of the economy and allowing for much needed economic diversification. In that regard, like Messrs. Lefort and Vogel, I have some questions regarding the efficiency of social expenditures allocated to education: on the one hand, the adult literacy rate is no better than in 1990 and remains significantly below both the regional and income group standards; furthermore, the national labor market survey of 2000 indicates that nearly three-fifths of all businesses in the country reported difficulties in recruiting employees with appropriate skills and education. On the other hand, spending in education to GDP has increased by almost 50 percent over the past decade and is significantly higher than both the regional and income group standards. Staff's comments would be appreciated.

Fourth, staff's excellent regional comparison of competitiveness sheds light on one constraint peculiar to Vanuatu, i.e., its very high cost structure compared to other countries in the region. Reasons for this situation do not appear totally clear to me as Mr. Callaghan seems to suggest that most of these costs arise from diseconomies of scale associated with the small size of the economy, while staff tend to put the blame on poor performances of state-owned enterprises. I would appreciate it if Staff could elaborate on that issue.

Let me turn now to my short set of remarks.

First, on structural reforms, it seems that the implementation of the Comprehensive Reform Program has slowed down over the last two years, which is all the more regretful as achievements in 1998 and 1999 were rather encouraging. Let me reiterate this chair's support for the agenda provided under this program.

Second, although noticeable progress has been achieved in the fiscal sector, particularly through improvements in VAT and customs administration, I share staff's insistence on the reduction in the government's wage bill to ensure sufficient resources for key social and infrastructure needs.

Third, turning to monetary and exchange rate policies, I note that in the recent past both have successfully delivered what they were expected to, namely price stability and the lack of balance of payments difficulties. Thus, like others, I am not convinced by staff's argumentation on the need to disclose the composition of the basket of currencies which the vatu is pegged to. However, like Mr. Mirakhor, I welcome the authorities' willingness to consider widening the trading band.

Fourth, on financial and banking issues, we commend the government of Vanuatu for its efforts aimed at improving the supervision and soundness of the financial sector. We also welcome the various initiatives taken since the last consultation to address the deficiencies of the anti-money-laundering system. We call on the authorities to maintain this positive momentum and dedicate their efforts to the day-to-day implementation of the various regulatory measures taken over the last months.

Finally, as Staff put it in a selected issues paper of high quality, Vanuatu's offshore sector is at a critical juncture. Given the increased global focus on combating money laundering and improving the oversight of financial flows, the authorities will not be able to continue dodging the much-needed tightening of their OFC supervisory regime. Staff contends that the limited contribution of the OFC to economic activity entails an overall positive impact stemming from the move to stricter supervision. My naïve reaction is slightly different : if the contribution of the OFC to the onshore economy is so limited, why should the authorities dedicate more public money and human resources to its supervision? To put it more bluntly, is not it the right time to reassess the utility of having an OFC in Vanuatu? I therefore fully support Messrs. Lefort and Vogel's call on the authorities to carry out a comprehensive study to analyze the benefits and costs of the OFC and devise an appropriate strategy.

Having said that, I wish the authorities every success in their challenging endeavors.

Ms. Sia made the following statement:

We thank the staff for its comprehensive report and Selected Issues paper. We also thank Mr. Callaghan for his useful statement.

Vanuatu faces many impediments to economic growth and development, some of which, like the environmental calamities, are beyond its control. At the same time, poor infrastructure, high business costs, rapid population growth and political uncertainty have added to Vanuatu's problems. More recently, the global economic slowdown, exacerbated by the events of September 11, and the decline in commodity prices, have further weakened economic activity, leading to a 2 percent contraction in GDP in 2001. Nevertheless, there continues to be overall macroeconomic stability, with substantial reforms undertaken across various sectors, and we commend the Vanuatu authorities for these achievements.

We broadly agree with the staff's assessment and confine our remarks to the following points.

On the construction and housing sectors, we note that activity has continued to be relatively firm despite the weak performance of the economy. Perhaps the staff could explain what is supporting these investments, and if there is a concern that the significant share of bank loans taken up by these sectors are a potential risk to the stability of the financial sector.

Turning to fiscal policy, we welcome the authorities' cautious approach to formulating the 2003 budget and hope that every effort will be made to achieve the targets. We commend the authorities for their efforts in introducing various measures to restrain the revenue shortfalls, including introducing automated systems to strengthen tax and customs administration. We share the authorities' view that given the weak economy, the introduction of new tax measures at this time is not appropriate, but we think that the excises on tobacco and alcohol products should be implemented as soon as possible. Broadening of the tax base and limiting tax exemptions are undoubtedly necessary to help offset the rising expenditure needs in the health and education sectors. Efforts also should be made on the expenditure side to reduce the public wage bill. While we understand that the authorities are trying to address this issue through the introduction of financial visas, developing a consistent and robust framework for the budget preparation could be a better long–term solution, in order to reduce the administrative burden of issuing and monitoring such visas. In this context, the publication of an annual fiscal strategy report and the introduction of the financial management information system are steps in the right direction.

We agree with the staff's assessment that exchange rate developments need to be closely monitored and a widening of the foreign exchange trading band should be considered in order to deepen the interbank market and to acquire foreign exchange. We also support the authorities' request for technical assistance in implementing the staff's suggestions to improve reserve management. However, we share the authorities' concern about the potential adverse impact of the disclosure of weights in the currency basket. In this regard, we would welcome the staff's elaboration on the details of the assurance, which it gave to the authorities, that there would not be a destabilizing effect if the basket composition is disclosed. We would also suggest that a statement by the Reserve Bank of Vanuatu (RBV), on the rationale of their exchange rate policy adjustments, would go some way toward avoiding the risk of triggering speculation about policy direction.

The domestic banking sector has witnessed significant improvements since 2000. We fully recognize that the RBV has made much effort to strengthen its banking supervision and to improve the soundness of the domestic banking sector, and we join the staff in urging the authorities to press ahead with enacting a new law to give the RBV regulatory and supervisory authority over the offshore banks. As the contributions of the offshore financial center are still small, the authorities would want to seize the opportunity to implement reforms while the cost of such reforms can be minimized. In this regard, we agree with the staff that the RBV will need adequate resources and support for proper implementation and enforcement, including technical assistance.

With these remarks, we wish the authorities much success in their future endeavors.

Mrs. Lewis–Bynoe made the following statement:

Vanuatu, like many of the small island economies that this chair represents, faces numerous challenges that are largely a function of small size, location, and extreme vulnerability to external shocks. Apart from the severe resource constraints that small countries face, there is the added disadvantage of diseconomies of scale, which contributes to the high cost of doing business. In Vanuatu's case, these problems are further compounded by the frequency of the country's exposure to natural disasters—it is ranked by the Commonwealth Secretariat as the most vulnerable country to natural disasters. Understandably, this further slows the development process, as often scarce resources have to be used to repair existing infrastructure rather than for expansion. This being the case, the authorities must be commended for their efforts at maintaining macroeconomic stability in the face of these challenges and uncertainties, which were fully elaborated in the helpful statement by Mr. Callaghan and Mr. Di Maio.

There have been several positive developments since the last Article IV consultation. Of note is the progress on strengthening banking supervision and regulation for domestic banks, the ongoing work in establishing an adequate supervisory and regulatory framework for offshore banks, and addressing the weaknesses in the anti–money laundering regime. Prudent monetary management, noted by the staff, and a small external debt are also among the positive attributes of this economy. The maintenance of political stability under difficult circumstances is admirable and the authorities must also be commended for their efforts at improving data quality and coverage, critical not just for effective surveillance but also for effective policy formulation.

We believe that the authorities of Vanuatu have demonstrated a commitment to the process of reform and we, therefore, want to encourage them to continue their efforts. However, some further actions are needed to ensure continued economic development and in this regard we concur with most of the staff's recommendations, particularly as they relate to removing the fiscal and structural weaknesses which limit competitiveness. A program of structural reforms, aimed at increasing investment opportunities and thereby diversifying the production base, should make the country less susceptible to external shocks. The creation of an enabling environment for investment requires a transparent regulatory and legal framework and so we urge the authorities to intensify their efforts in this area.

In the context of a small resource constrained economy, such as Vanuatu, streamlining fiscal operations, especially state–owned enterprises (SOE), to ensure the most efficient use of limited resources is critical. The released resources can be used more appropriately for the provision of social services, particularly education and health, where the benefits to economic development are significant. Further strengthening of tax compliance would also offer some gains. However, fiscal reforms should be undertaken without compromising (and where possible further promoting) poverty reduction efforts.

Finally, while we acknowledge the need to strengthen overall competitiveness and the external position, we would advise the authorities against the use of a more flexible or floating exchange rate regime. Small countries, like Vanuatu, are likely to have difficulty adjusting to exchange rate fluctuations, which can create uncertainties that often compromise the growth process. As the staff has noted, the adjustable exchange rate peg arrangement is appropriate for this country and we would further offer that it would be best if the authorities were to avoid any significant fluctuations in the rate. Sound macroeconomic and structural reform policies can be used to improve competitiveness, focusing particularly on ensuring labor market flexibility, fiscal, and monetary transparency and lowering the cost of doing business. We fully support the authorities' request for technical assistance to improve reserve management.

With these remarks, we wish the authorities success in their endeavors.

Mr. Moreno made the following statement:

Prior to our comments, we would like to thank the staff for the set of papers they have prepared for the discussion on the 2002 Article IV consultation of Vanuatu. We would also like to commend Mr. Callaghan for his balanced and focused statement.

The authorities should be commended for their sound macroeconomic policy management during Vanuatu's current recession. Despite Vanuatu's "challenging environment", to use Mr. Callaghan's words, derived from natural disaster shocks and the changing political environment, the authorities have managed to contain the fiscal deficit, reduce the share of external debt to the GDP, and keep inflation under control. For the coming years, Vanuatu faces the challenge of returning to a growth trend while improving social equity—goals that are explicitly recognized by the Government on its "Five Millennium Priorities".

We broadly share the staff's assessments; therefore, we will only make a few remarks for emphasis.

Fiscal Policy

We share the staff's implicit support for a moderate fiscal deficit of 1.5 percent in 2003, particularly given the sustainability of the debt and the fact that the economy has yet to move its way out of the recession. We are concerned by the latest news that the projected deficit has been reduced to 1 percent, particularly given that this is largely due to lower capital expenditure. We would welcome the staff's assessment on how this expenditure downscaling might affect the 2 percent growth projection for 2003.

Regarding the burden of the fiscal adjustment process, we believe that there is larger margin for maneuver on the revenue rather than on the expenditure side.

On the expenditure side, the main challenge is to reduce the burden of wages and salaries, which amount for 46 percent of total expenditures of the central government. This is a structural issue that probably calls for a major civil service reform. However, such reforms seem socially and politically difficult in a country where public sector employment accounts for about a third of the formal sector employment. Therefore, any such reform should probably be scheduled for the medium and long term. In the meantime, we welcome the government intention to closely review new recruitment. Other social and capital expenditures need to be augmented, particularly in education, to meet the twin objectives of growth and equity. In education expenditures, we would like to echo Mr. Vogel's comments on the efficiency of education expenditures. We would welcome it if the staff could inform us whether the budget includes contingency funds to cover for natural disasters. We believe that the high vulnerability of the country to natural disasters, with more than two severe cases a year on average, calls for a permanent inclusion of these types of funds on the budget.

The authorities probably have more room to maneuver on the revenue side. We welcome the introduction of excises on tobacco and alcohol starting in 2003, and the ongoing efforts to improve VAT and customs administration. We share the staff's concern on an over–reliance on taxes on international trade, which account for about a third of total non–grant revenues. Any trade liberalization should include compensating fiscal measures to keep government revenue.

Other Issues

We encourage the Vanuatu authorities to address the relative low competitiveness vis–à–vis neighboring and main trading partners. Internal structural reforms such as privatizations, reducing administrative burdens to foster FDI, and fostering public investment are warranted. We also share the staff's and Mr. Wei's views on the need for greater coordination with donors on a public investment program. These measures are all the more important to ensure a smoother transition to a more open economy if the authorities are to continue negotiations with the WTO.

We welcome Vanuatu's new financial legislation improving anti–money laundering policy and financial supervision. Nevertheless, we encourage the authorities to keep on working to meet full compliance with FATF standards. We also encourage the government to reach a commitment with the OECD on transparency and effective exchange of information.

On a procedural note, we would have liked to see data and projections for 2004, particularly given the 24-month Article IV consultation cycle for Vanuatu.

With these comments, we wish the Vanuatu authorities all the success in their policy endeavors.

Ms. Sekine made the following statement:

Like other Directors, I would like to thank Mr. Callaghan for his comprehensive statement and to commend the staff for an informative set of papers.

Vanuatu has been experiencing an economic slowdown since the mid–1990s, and per–capita GDP is still at about the same level as it was in the early 1990s. It is indeed a difficult task for this small island country with a limited production source, weak external competitiveness, vulnerability to climate change, natural disasters, and high cost structure, to achieve sustainable economic growth. Nevertheless, in order to get on the track of the baseline scenario indicated in Box 3, it should be a top priority for the authorities to pursue fiscal and structural reforms, in order to expand the production base and reduce costs to help activate the private sector. In addition to activating tourism, they should increase the growth contributions of agriculture, and hopefully other sectors as well, through diversification, technical development, and improved infrastructure. Noting that frequent changes of government have hampered the advancement of reforms, it will be important to secure a sustained commitment from the authorities to change this situation. I agree with other Directors and the staff that international assistance continues to be crucial to promoting reforms in light of the limited institutional capacity of the authorities. It is regretful that the reforms under the Comprehensive Reform Package (CRP) by the AsDB have stalled since 2000, and I urge the authorities to resume the reform agenda. I would like to comment on fiscal, financial, and structural issues as follows:

First, on the fiscal front, the overall balance has been improving, but I agree with Mr. Moreno that it is regretful that this is a result of lower capital investment. With poor infrastructure and high social needs, capital investment must be enhanced, not reduced. Social services also need to be improved to tackle poverty issues and to better living conditions. I also concur with Mr. Le Fort and Mr. Vogel's comments on education spending and would like to hear the staff's comments. Hence, there is a pressing need to strengthen the revenue base. Broadening of the tax base, improvements in VAT and customs, as well as reduction of exemptions are all essential and it is reassuring to read in Mr. Callaghan's statement that the authorities are making efforts in this direction. Reduction of non-budgeted spending will also be necessary. I expect the Financial Management Information System will further improve budget monitoring. Considering the price decreases and income disparities, copra subsidies are an important income source for the outer islands. However, like Mr. Le Fort and Mr. Vogel, I wonder about the sustainability of this measure when international commodity prices are contained. While making efforts to better target social support, a comprehensive approach to diversify and increase productivity of the outer islands needs to be considered in the long term. The wage bill is posing a great burden on the fiscal balance and I wonder if the authorities' plan to address this issue is sufficient. It is necessary to resume public sector reform, which has slowed down, and at the same time it is crucial to nurture the private sector and improve the social safety net in order to absorb the impact from this.

Second, on the financial sector, the offshore financial center (OFC) is making limited contributions to economic activity and its nontransparency is lowering the reputation of the overall sector. I concur with the staff and other Directors that the impact of strengthening the supervision over the sector will be a positive move. It is reassuring that the International Banking Act has been approved by parliament recently. As bank supervision shifts to the Reserve Bank of Vanuatu (RBV), it is important that the coordination between the Reserve Bank of Vanuatu and Vanuatu Financial Sector Commission (VFSC) be strengthened.

Regarding the banking sector, I have a question on the relationship between savings and investment. I note that 70 percent of the total deposit base is in foreign–currency, and most is redeposited in foreign countries' accounts. On the other hand, the amount of bank loans is very small and is largely denominated in local currency. I am concerned that this indicates that savings are not being injected effectively into domestic investment. If so, there is a need to enhance demand in the non–financial private sector through structural reforms and strengthening of the financial sector so that more savings will be diverted into domestic production activities. The staff's comments are welcome.

Concerning the exchange rate, I share Mr. Mirakhor and Mr. Boitreaud's view to welcome the authorities' willingness to consider widening the trading band, and Fund technical assistance will be useful in addressing this issue. I especially support Mr. Mirakhor's comment that Vanuatu's competitiveness gains should be sought through the maintenance of a sound fiscal stance and acceleration of structural reforms.

Finally, on structural reforms, I urge the authorities to accelerate state owned enterprise reform in order to improve economic efficiency and to reduce budgetary costs. The restructuring of state–owned enterprises, which dominate utility and infrastructure sectors, will help reduce the high cost of economic activities. I also encourage the authorities to improve administrative constraints and provide transparent legislative framework to enhance private sector development and FDI.

With these remarks, I wish the authorities the best in their future endeavors.

Mr. Dohlman made the following statement:

First, we join Mr. Boitreaud, Ms. Sekine and others in commending the staff for their excellent reports. We found Box 4, "Policy Challenges and Responses," particularly useful and would like to see this format used more frequently in staff reports.

Next, we note that Vanuatu is small, poor, and has a limited capacity to implement reforms. We urge the authorities to avoid the overreaching agendas of the past and to prioritize their reform efforts around fiscal and structural reforms that boost private sector–led growth.

The authorities have made recent progress on fiscal and structural reforms, including reduced fiscal imbalances, stronger banking and anti–money laundering regulations, and better statistical reporting. But the authorities have yet to take decisive action to address high cost structure, low investment, and overall poor public sector performance. These factors continue to contribute to low growth, poverty, and large disparities in standards of living, with urban incomes on average 16 times those in rural areas, per one report. Granted, the economy has been subjected to a number of large external shocks that have hurt economic performance. But Vanuatu's poor performance relative to its peers—that have been subject to similar shocks—strongly implies poor policies are also at fault.

On the fiscal side, we agree with the staff and other Directors that the authorities must broaden the tax base and cut expenditures, including the wage bill, while reversing recent declines in capital and social spending—such reversals will be important for reinvigorating growth. Efforts should also be made to better target any remaining copra subsidies to producers rather than the transport segment of this industry. On the structural side, there is a need to streamline the regulatory framework to reduce red tape, lower high borrowing costs, and reduce trade and investment impediments. On a related point, some Fund technical assistance suggesting means to move away from the current heavy reliance on tariff revenues might be value–added. On exchange rate policy, we share the Fund staff's view that greater transparency is desirable, possibly with some loosening of the band. We agree with the staff that increased transparency is not likely to generate destabilizing speculation against the vatu.

We join other Directors in welcoming the authorities' efforts to address the weaknesses identified by the recent IMF Offshore Financial Sector (OFC) Assessment. The next key step will be full implementation of the recently approved International Banking Act legislation. We agree with the staff that this legislation is likely to lead to a significant contraction of the OFC sector—probably not a bad thing for Vanuatu for the reasons laid out in the Selected Issues paper.

On terrorist financing issues, we welcome the recent ratification by Vanuatu's parliament of the International Convention for the Suppression of the Financing of Terrorism and urge the government to implement fully the UN Security Council Resolutions related to terrorist financing (as reported by the staff bilaterally). We are disappointed that the authorities have not taken the necessary steps—including greater transparency and effective exchange of information—that would permit Vanuatu's removal from the OECD's uncooperative tax haven list.

Finally, we welcome Mr. Callaghan's announcement today that the authorities have consented to publication of the staff report and Selected Issues paper.

Mr. Taylor made the following statement:

Let me join others in thanking the staff for a very good report and useful analysis of the medium–term outlook for Vanuatu. I also thank Mr. Callaghan for his interesting statement, which underlines how challenging circumstances are for this small, geographically-dispersed state with a complex social structure and a high vulnerability to natural disasters.

With limited opportunities to diversify the economy, given its narrow resources, a small domestic market, and inevitable institutional capacity issues (with a population of 180,000), Vanuatu has to make the best of the advantages it has. Mr. Boitreaud raised a question here on how, in the medium term, do the authorities grow the economy? Diversification has been mentioned, but look at the example of the agricultural sector and the reliance thus far on copra. There have been attempts to grow other crops, such as cocoa and coffee, but these have not been very successful. So the question of growth is still out there, and it is something which the donor community needs to try to address.

To its credit the government has continued to maintain macroeconomic stability, despite the difficult environment, and made some progress with the Comprehensive Reform Program (CRP). I agree with other colleagues, that still more needs to be done, and perhaps some of the issues with regard to civil service salaries still need to be tackled.

The cautious approach shown in the 2003 budget, which is currently being considered by the Parliament, is praiseworthy. I also noticed the staff's comments regarding the further impending capital expenditure reductions, which are not going to be helpful for future growth.

Since I largely agree with what the staff has suggested, I will comment on just one or two points on the fiscal front. As many other Directors said, the staff recommendations to broaden the tax base and to increase revenues as a percentage of GDP—particularly since there has been a decline in GDP over the past few years—seem sensible and worthy of consideration by the government, and Mr. Callaghan has indicated that there will be some new revenue measures in 2003.

Mr. Le Fort and Mr. Vogel also raised an interesting question about the efficiency of spending, particularly in education. Perhaps part of the answer to future growth strategies lies here, but there are some indivisibilities in the provision of public goods for small states, which mean high costs per person. However, that does not totally answer why education spending is so inefficient, and this topic is something worth a response from the staff, if it can give it.

I am pleased that the oversight of the offshore bank system is to be strengthened, thanks to the passage of the International Banking Act. Activity in the 34 offshore banks has gone largely unrecorded. It is good that the Pacific Financial Technical Assistance Center has been able to provide useful help in this area, and more regard to public management and statistics. I would join others in mentioning with concern the tax–haven issues with the OECD.

Finally, I have one other question. As the WTO accession issue was referred to in the staff paper, I would be interested to know if there have been any further developments on that front since those previous discussions.

Mr. Moreno asked whether the budget included a contingency fund to cover natural disasters, given that the country averages more than two severe cases each year.

The staff representative from the Asia and Pacific Department (Mr. Cowen) made the following statement in response to questions and comments from Executive Directors:

Executive Directors had questions regarding education, growth, and other topics, and I will address them in that order.

We share the concern about the efficiency of education expenditures, both as share of GDP and as a share of total expenditures in the budget, but there are several issues that are unique to Vanuatu. First, the literacy statistics in Vanuatu may be subject to some measurement problem, and we would expect a sharp improvement in the coming years, as the concept of a nearly universal primary education is a fairly recent phenomenon in Vanuatu. However, there is general agreement that overall literacy rates are low compared to both the region and compared to other low-income countries.

Notwithstanding this, education does pose some unique budgetary challenges to Vanuatu. This is a country with more than 100 local languages. It also has two official languages, English and French, and it has one national language, Bislawa. At present, the national curriculum is equally divided between English and French, which is very costly. Recently, the government has also considered expanding into vernacular education, at the preschool and primary level, to improve educational outcomes, and the World Bank has approved support for this project. This may add to the cost of education. Nearly 85 percent of education spending goes to teacher wages, leaving little for teaching material, operating costs, maintenance, and construction, despite a student population that increased by 50 percent in the 1990s. Part of the reason is that the government must provide incentives to get teachers to move to rural areas, where 80 percent of the population resides.

Regarding high cost structures, Directors questioned whether this reflected diseconomies of scale or inefficiencies of state-owned enterprises

(SOEs). Both are factors. Regarding the SOEs, and in particular the telecommunications and electricity companies (the latter of which is now fully privatized), there has been very little new investment in these enterprises over the past decade, and this is reflected in the low level of capital spending in the budget. These enterprises need investments in order to lower their cost structures and to take advantage of new technologies, which will facilitate lower economies of scale. But the cost of these services is always likely to be higher in Vanuatu than in neighboring countries, simply because the population of Vanuatu is relatively dispersed, and at present is on at least 13 separate islands.

There were several questions on sources of growth, and the impact of lower capital expenditure on these sources. We, too, were troubled to see that the budget currently being debated in Parliament has lower capital expenditures than envisaged during the discussions held with the authorities in August. The government has excluded an outer-island development project, which is currently under negotiation with the Asian Development Bank, and there is a possibility that this project could be approved and included in the 2003 budget. However, the authorities have been appropriately cautious about entering into this project, because they realize that, down the road, there will be large recurrent operations and maintenance costs that arise from this.

There was a more general question regarding potential future sources of growth. We do not go into much detail, in either the staff report or the Selected Issues paper, but there are a few areas where Vanuatu stands to gain. The first is the tourism sector. Vanuatu has yet to exploit this sector to its fullest potential. Possibilities include standard tourism, as well as eco-tourism and specialty tourism, which many of the outer islands could offer. Another potential growth area would be agriculture. Vanuatu, unlike some of its neighboring countries, has considerable amounts of untapped fertile land, and greater investment in commercial agriculture could provide a source of growth both in crop and beef production. A third area, related to this, is Vanuatu's relatively unexploited fisheries. At present, Vanuatu only has four minor bilateral fishing agreements. While Vanuatu does not have as much fishing potential as some other countries, this area is still rather under-exploited.

There was also a question related to what is driving the growth in the housing sector, and whether it is posing any risk to banks. Housing is financed through own savings, and based on a review of the available credit data, we believe that the housing sector has remained stable, and accordingly has not outstripped the pace of growth of credit as a whole. Some of this is due to urban drift to the two major population centers, and also to vacation housing, particularly among residents from Australia and New Zealand. The non-performing loan ratios in the banking system are low and have been improving over time, so the growth in the housing sector does not appear to be posing any major risk to the commercial banks at this time.

On the possibility of diverting more savings into domestic investment, there is a chance of this down the road, but it is going to require macroeconomic and structural reform, in an effort to lower the large interest rate spreads. At present, real interest rates are very high in Vanuatu, and this is an impediment to growth. Rates are relatively high and interest rate spreads in the banking sector are relatively wide because of credit and political risks. Some of the credit risk arises from a relatively difficult process for banks to seize collateral, in part because of customs that govern land holdings and land rights in Vanuatu.

There was a question on the administrative burden of the offshore financial sector, particularly with regard to the International Banking Act. This administrative burden is likely to be relatively low. At present, as is indicated in the Selected Issues paper, there are 34 offshore banks in Vanuatu, but only 3 of those banks maintain a physical presence in the country. The authorities believe that most of the other banks are simply shell operations that will quickly disappear once this new law comes into effect on January 1. The licensing requirements necessitate a physical presence in Vanuatu.

We are also glad to report that the Monetary and Exchange Affairs Department will continue to provide an advisor for another year in the Reserve Bank of Vanuatu, and part of the responsibilities of this advisor will be to work closely with the Reserve Bank, in this transition period, as the new supervisory regime for the offshore bank system is put into effect.

We were asked whether there were any contingency funds in the budget for natural disasters. We are not aware of any at this time, as the government continues to have a very tight cash situation.

There was also one question regarding the disclosure of the composition of the basket of currencies against which the exchange rate is pegged, and whether disclosure would encourage destabilizing speculation. We have limited information about the setting of the day-to-day exchange rate. However, there is a formula. The formula takes into account movements of various currencies in the basket vis-à-vis the U.S. dollar, and those movements are put into the formula, and based on the results of that formula, the RBV announces a daily mid-rate. The fact that the formula uses cross rates, which are predetermined from closing prices on international markets, leaves little room for market players within Vanuatu to manipulate these rates. Accordingly, disclosure, in and of itself, would not invite any sort of destabilizing speculation.

On WTO accession, the final meeting of the working party was held in late-October 2001, and the WTO was expected to announce Vanuatu's full accession thereafter, at the Doha meetings. The government rejected a negotiated accession package, at the last minute, owing to concerns about its impact on government revenue—as 35 percent of Vanuatu's revenue comes from trade taxes—as well as the WTO's requirement to enter certain multilateral agreements. The government, as we noted in the staff report, has taken steps to broaden the tax base. However, it may take time to replace lost trade-tax revenue. Much of this loss could be replaced by reviewing the status of various exemptions, improving VAT administration, and taking steps to strengthen customs compliance. In addition, the authorities cited the need to build a consensus within the ruling coalition, as well as among the business community. Consensus regarding the WTO accession package is needed in several areas, in particular in the retail and telecommunications sector, and this may take some time. This is the information that we have been provided by the authorities.

Mr. Callaghan made the following concluding statement:

I would like to thank Directors for their comments and Mr. Cowen for his comprehensive answers. Directors have appropriately focused on the challenges that Vanuatu faces. It is a small island-state, and there are few occasions for a comprehensive look at its economy and policy settings. The Article IV process is one of these few occasions. Accordingly, the Article IV findings, and the comments you make, are important for countries like Vanuatu, and they will certainly be passed along to my authorities.

As many Directors have highlighted, Vanuatu faces the challenges that all small island-states face, including diseconomies of scale. As Mr. Cowen pointed out, the land mass of Vanuatu is small, and spread over several islands, which makes transport difficult, and the provision of services much harder. In addition, the Pacific islands are very remote from other population centers.

There are also capacity constraints, including a small resource base - and the goods it does produce are subject to substantial international price movements—and the challenge posed by adverse weather. It is a cyclone-prone country, and suffers from volcanoes.

Vanuatu also faces some challenges coming from its colonial past. It was a joint dependency of the United Kingdom and France, and has two languages with which to cope. Another relic of its colonial past is the presence of two police forces, which do not get along at the moment, and this has been a major problem. It is not good for investor confidence when you have two separate police forces with tension between them. That is one of the political risks in Vanuatu.

There is also the problem of rapid turnover of governments. There is perhaps "too much" democracy in Vanuatu, given the rapidity of changes in government, and as Mr. Boitreaud pointed out, political stability should be a minimum requirement.

In the context of these challenges, we should give credit to what Vanuatu has achieved. It is noteworthy that it has maintained macroeconomic stability. Some other economies, suffering similar challenges, are in a worse position. Inflation is controlled and low. The public and external debt levels are manageable. There has been progress over the past 12 months on financial sector issues.

Some Directors, particularly Mr. Le Fort and Mr. Vogel, mentioned that the offshore banking system posed substantial risks to the economy, and they questioned the benefits. The Vanuatu parliament has strengthened oversight of the offshore banks, and they will be brought under the authority of the Reserve Bank of Vanuatu, as of January 1, 2003. There is an effort to remove the reputational risk associated with the offshore financial center.

Overall it was a good consultation process, and as Directors have correctly noted, the staff report and Selected Issues paper were good. The staff report was handled well, and that is part of the reason why the authorities have agreed to its publication. It will certainly be positive and helpful to them. The regional comparisons that are in the Article IV report are helpful to the authorities and add to the persuasiveness of the report. Particularly, the comparisons of issues that are easy to digest and very readable, and by making comparisons with your neighbors makes it more evident where the problems lie.

The challenges facing Vanuatu have been well-outlined in Directors' comments and in the staff paper. There is a pressing need to redirect government expenditures away from wages and into boosting infrastructure and improving social services, and at the same time reducing input costs. Vanuatu also has to push ahead with reform of its state-owned enterprises. The authorities are moving on these challenges. They are trying to control expenditure and boost revenue, but it has to be remembered that this is a small country that is experiencing weak economic activity and a weak external environment for its major products, and accordingly GDP fell two percent in 2001, and may fall again this year. There was also negative growth in 1999, so it has been a trend weakness, as Ms. Sekine noted.

When we call for these reforms and urge the authorities to do them, I think of some of the larger economies, including in Europe, which are also slow to address fiscal and structural reforms, and they do not have the same challenges as Vanuatu.

Directors have correctly identified the problem of capacity, and it is something that comes up in the staff report. There are various aspects to the question of capacity for a small economy. It goes beyond the technical capacity of how to implement reforms. It is the problem of uncertainty and apprehension. Some of the recommendations that we make on public debt and reserve management may seem obvious to us (although on some issues there can even be disputes among us, such as on whether to publish the composition of the exchange rate basket), but to Vanuatu these recommendations are not only about technical capacity, but also about asking the authorities to move beyond the comfort zone. We have to recognize that we are doing this when we make recommendations to these very small economies, where the capacity is very thin.

In this context, I appreciate the views of Directors who emphasized the importance of continued international assistance and donor support. Vanuatu is very appreciative of the technical assistance they receive, and they are putting it to good use. The International Banking Act, which will bring the offshore banking sector under tighter regulatory control, is a tangible outcome of that effort. This is a case where we can see positive results from the technical assistance that has been given.

On the question of copra subsidies, income disparity is a major problem in Vanuatu, and it is important to address this issue in the context of maintaining social order. Maintaining social order is a real problem with many of the Pacific economies. Copra is the main source of income in the outer islands, and there is a very large income disparity between Port Vila and the outer islands. Without the means to support the outer islands, the copra subsidies have been a means to reduce these income disparities, so there is a social aspect to this subsidy. But the authorities recognize the problem, and they are trying to target the subsidies to make them more effective.

It is pleasing that the authorities have agreed to publish the report, and I would just like to conclude by thanking Mr. Cowen and his team very much for their efforts.

The Acting Chair made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended Vanuatu for maintaining macroeconomic stability and making progress on structural reforms under difficult economic and political conditions. Inflation has remained subdued, the external debt is manageable, and the fiscal situation has improved. However, Directors observed that Vanuatu's recent economic growth performance has been lackluster—especially in view of the rapid population growth. They acknowledged that Vanuatu's susceptibility to external shocks and natural disasters, its fragmented geography and small size, and recent political developments have affected this performance. Nevertheless, they noted that persistent fiscal and structural weaknesses have led to a relatively high–cost production structure and inadequate basic infrastructure, which have eroded Vanuatu's competitiveness vis–à–vis neighboring countries. They recommended that prompt action be taken to remove these weaknesses, including through continued implementation of the Comprehensive Reform Program. Noting that international donors play an active and important role in Vanuatu, Directors stressed the importance of better aid coordination and consistency of policy advice by the international community.

Directors welcomed the overall improvement in the fiscal situation, but emphasized that more needs to be done to boost revenue and redirect spending toward infrastructure and the provision of social services, with the objective of achieving a lasting fiscal consolidation. They therefore supported the authorities' cautious approach to formulating the 2003 budget, which aims for a current budget balance. On revenue, Directors encouraged a broadening of the tax base and strengthening of VAT and customs administration. They supported current plans to adopt new excises on alcohol and tobacco in the 2003 budget, which they viewed as essential to improving revenue performance. On expenditure, Directors suggested stepped–up efforts to improve expenditure control and debt management, including strict limits on supplemental appropriations. They emphasized the need to control the wage bill and to further shift spending to the social sectors and infrastructure development, but also to increase the effectiveness of spending on education. They supported higher capital spending within the framework of a well–designed public investment program with coordinated donor support.

Directors welcomed the progress that has been made in strengthening budget procedures under the government's Comprehensive Reform Program. However, Directors stressed that government subsidies, including those to copra farmers, need to be scaled back and better–targeted given more critical spending priorities and prevailing market conditions.

Directors considered that monetary policy has been generally restrained, and that it should continue to be so in order to keep inflation low and support the external position. They urged limits on the use of central bank advances to finance the public sector, in order to avoid undermining fiscal discipline, and called on the authorities to develop the capacity to use treasury bill auctions instead.

Directors viewed the adjustable peg exchange rate arrangement as broadly appropriate, but stressed that it needs to be backed up by sound macroeconomic and structural policies to enhance external competitiveness. Most Directors were of the view that any significant weakening in external performance would call for a more flexible exchange rate management, and, in this respect, were pleased to note that the authorities are willing to consider a widening of the trading band. Some Directors also recommended greater transparency regarding the composition of the currency basket. Others, however, expressed concern that this could lead to destabilizing speculation on the exchange rate. Directors supported the authorities' request for technical assistance in the area of foreign reserve management.

Directors welcomed the progress made in strengthening the regulation and supervision of onshore banks, as well as the recent passage of the International Banking Act to improve the oversight of offshore banks. They advised the authorities to strictly enforce the new legislation. Directors stressed the need to effectively regulate non–bank activity as well in the offshore sector, to ensure effective controls against money laundering and terrorism financing in line with internationally agreed standards. Some Directors suggested that the authorities undertake a comprehensive study of the costs and benefits of the offshore financial center.

Directors commended the completion of restructuring of the National Bank of Vanuatu and the National Provident Fund, and cautioned that close supervision is needed to ensure that these two institutions remain financially sound. They called for a more aggressive approach by the Asset Management Unit on non–performing loan recoveries, given delays so far and limited budget resources.

Directors stressed that additional structural reforms are needed to bolster medium–term growth prospects and address the high–cost production structure. They encouraged the development of a strategy to commercialize and privatize remaining state–owned enterprises, as envisaged in the original Comprehensive Reform Program. Directors also urged timely implementation of trade commitments and a reinvigorated effort at WTO accession, to improve market access, reduce costly barriers, and attract foreign direct investment. In this regard, they expressed concern about the high share of trade taxes, and suggested that the Fund might consider providing technical assistance to address these imbalances. Directors noted that private investment would also benefit from a more transparent legal and regulatory framework and fewer administrative barriers, and that tax exemptions to investors should be limited in scope and applied uniformly.

Directors welcomed the recent steps taken to improve the accuracy and coverage of the national income accounts and balance of payments statistics. They looked forward to a further strengthening in these areas, including through continued support from the Pacific Financial Technical Assistance Center. Directors also encouraged Vanuatu's timely participation in the Fund's General Data Dissemination System.

It is expected that the next Article IV consultation with Vanuatu will be held on the current 24–month cycle.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/02/115 (11/20/02) and EBM/02/116 (11/22/02).

4. FEDERATED STATES OF MICRONESIA—DESIGNATION OF DEPOSITORY

The Fund accepts the Bank of Guam, Pohnpei Branch (in place of the Bank of Hawaii, Pohnpei Branch), as the new depository, under Article XIII, Section 2(a), for all of the Fund's holdings of the currency of the Federated States of Micronesia. (EBD/02/151, 11/14/02)

Decision No. 12886-(02/116), adopted
November 21, 2002

5. REPUBLIC OF THE MARSHALL ISLANDS—DESIGNATION OF DEPOSITORY

The Fund accepts the Bank of Guam, Majuro Branch (in place of the Bank of Hawaii, Majuro Branch), as the new depository, under Article XIII, Section 2(a), for all of the Fund's holdings of the currency of the Republic of the Marshall Islands. (EBD/02/151, 11/14/02)

Decision No. 12887-(02/116), adopted
November 21, 2002

6. GRENADA—ARTICLE IV CONSULTATION—POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance Over Exchange Rate Policies, " attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board decides that the period for completing the next Article IV consultation with Grenada shall be until the date indicated in EBD/02/152 for such country. (EBD/02/152, 11/14/02)

Decision No. 12888-(02/116), adopted
November 21, 2002

7. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 02/71, and 02/77 are approved.

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors, by an Advisor to Executive Director, and by an Assistant to Executive Director as set forth in EBAM/02/145 (11/19/02) is approved.

APPROVAL: February 10, 2003

SHAILENDRA J. ANJARIA
Secretary