August 20, 2002
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 02/53

10:00 a.m., May 29, 2002

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Executive Board Attendance

H. Köhler, Chairman
E. Aninat, Acting Chair
S. Sugisaki, Acting Chair
A. Krueger, First Deputy Managing Director

Executive Directors	**Alternate Executive Directors**
S.M. Al-Turki	A.S. Alosaimi
	A.S. Al Azzaz, Temporary
	T.P. Nguema-Affane, Temporary
	E. Pinto Moreira, Temporary
I.E. Bennett	F. Vermaeten, Temporary
	P.H. Whitehall, Temporary
	D.C. Guinigundo
	N.J. Davidson, Temporary
R.F. Cippà	W. Szczuka
	T. Skurzewski, Temporary
K. Bischofberger	R. von Kleist
	J.N. Santos, Temporary
	D. Lombardi, Temporary
D.I. Djojosubroto	Low K.M.
	H.E. Phang, Temporary
	R.A. Jayatissa
	J. Prader
	K. Sazanov, Temporary
	B. Andersen
	A. Fidjestøl, Temporary
	M. Lundsager
	N. Epstein, Temporary
	J.W. Ralyea, III, Temporary
P. Duquesne	S. Boitreaud
	S. Boucher, Temporary
	M. Daïri
	S. Rouai, Temporary
	A. Lushin
	H. Oyarzábal
T. Scholar	A. Stuart, Temporary
M. Portugal	V. de los Santos, Temporary
C.D.R. Rustomjee	G.M. Campos, Temporary
A.S. Shaalan	M.B. Chatah
	Wang X.
	Liu, F., Temporary
J. de Beaufort Wijnholds	N. Yertisyan, Temporary
K. Yagi	H. Toyama
	T. Komatsuzaki, Temporary
A.G. Zoccali	G.R. Le Fort

S.J. Anjaria, Secretary
A.S. Linde, Acting Secretary
A. Mountford, Acting Secretary
Z. R. Ahmed, Assistant
Y.P. Chia, Assistant
S. Maxwell, Assistant

Also Present

ECB: G. Grisse, Permanent Representative. IBRD: H. Dinh, Africa Region Office; L. Promisel, Financial Sector Strategy and Policy Department. African Department: A. Basu, Deputy Director; J. Fajgenbaum, Deputy Director; R. Chembe, S. Hossain, A. Kammer, N. Kirmani, K. Kostial, J. Mathisen, M. Nowak, J. Reitmaier, R. Sharer, K. Thugge. Asia and Pacific Department: Y. Horiguchi, Director; T. Callen, J. Ostry. European I Department: B. Banerjee, R. Corker, A. Gagales, C. Klingen, A. Leipold. European II Department: S. Tiwari. External Relations Department: T.C. Dawson, Director; G. Bhatt, D. Hawley, J. Hayden, K. Roesser, O. Stankova. Fiscal Affairs Department: K. Mathai. International Capital Markets Department: G. Haeusler, Director; H. Tran, Deputy Director; C. Adams, W. Alexander, T. Becker, C. Blitzer, P. Breuer, P. Dattels, B. Drees, M. Edmonds, A. Ilyina, C. Kramer, D. Mathieson, C. Medeiros, D. Ordoobadi, E. Psalida, R. Ramaswamy, J. Roldos, C. Schnure, S. Seshadri, K. Srinivasan. Legal Department: Y. Liu, M. Luedersen, G. Rosenberg. Monetary and Exchange Affairs Department: V Sundararajan, Deputy Director; S. Geadah, A. Gulde-Wolf, P. Hilbers, H. Mehran, M. Moretti, T. Olafsson, G. Sensenbrenner. Policy Development and Review Department: M. Ahmed, Deputy Director; R. Kincaid, H. Monroe, M. Ronci. Research Department: D. Robinson. Secretary's Department: C.M. Watson, Deputy Secretary; L. Hubloue, T. Turner-Huggins.Treasurer's Department: E. Brau, Treasurer; B. Arnason, M. Kandil. Western Hemisphere Department: A.M. Jul, L. Perez, M. Villafuerte, E. Williams. Office of the Managing Director: S.B. Brown, A. Mazarei, R. Moghadam, A. Tweedie. Advisors to Executive Directors: I. Ábel, M.A. Ahmed, S. Antic, E. Azoulay, S.A. Bakhache, A. Baukol, M. Beauregard, W.-D. Cho, J.A. Costa, P.R. Fenton, J. Jonáš, K. Kanagasabapathy, M. Kabedi-Mbuyi, K. Kpetigo, D.H. Kranen, P.A. Nijsse, L. Palei, Y. Patel, A.A. Tombini, A. Törnqvist, R. Villavicencio. Assistants to Executive Directors: S. Alcaide, Cao L., M. Di Maio, N.H. Farhan, R. Gauba, C. Harzer, F. Haupt, Jin Z., N. Joicey, T. Koranchelian, I. Kupča, J.K. Kwakye, Y. Lissovolik, R. Maino, T. May, T. Moser, K.S. Oo, J. Sipko, D. Vogel, S. Vtyurina, D.B. Waluyo.

1. GLOBAL FINANCIAL STABILITY REPORT

Documents: Global Financial Stability Report (SM/02/156, 5/20/02)

Staff: Häusler, ICM; Tran, ICM; Mathieson, ICM

Length: 2 hours, 40 minutes

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

At the outset, we would like to thank the staff for producing the second issue of this Report, which we believe should become an important part of the surveillance exercise, in light, as well, of the relatively high frequency with which it is produced. In this regard, we welcome the detailed description provided in this Report of facts and expectations that have characterized international financial markets so far, even though we feel that, on balance, the Report fails to fully elaborate on such information and to draw the resulting implications. This is all the more surprising, given that we all are used to the excellent daily Global Markets Monitor newsletter.

The reason for publishing this new series of Report is primarily to sharpen the exercise of surveillance by focusing on important elements that may affect global financial stability. As a result, we would have liked to see a stronger forward-looking component in this Report, something we hope will be present in future issues.

In particular, we believe the present issue of the Report should have elaborated on the following points: short- and medium-term prospects for the stock market on the basis of the current trend; an analysis of the U.S. dollar outlook, given its relevance for international financial stability; and on the appropriate policy implications arising from the growing importance of the insurance sector.

Since the second half of the 1990s overall corporate profits have not increased, despite a steady rise in share prices. As a result, if expectations for higher profits do not materialize, price corrections will be likely to occur. The resulting lower return on equities will also mean that consumers will need to save more, as capital gains will not be there any more to finance steady consumption expenditures.

On the other hand, we also note that share prices have embedded a substantial acceleration in productivity growth. Again, if such expectations do not materialize, lower productivity growth—as opposed to what was expected—will imply lower real interest rates. Consequently, capital expenditure decisions may be affected. Investment plans may also be affected by the uncertainty surrounding such expectations. Therefore, equity markets are likely to experience some vulnerability, following these developments.

If this scenario is plausible, what are the implications for the different classes of assets? Overestimation of productivity growth may lead to inflation risks, thus affecting both equity and long-term bonds. What is the staff's assessment in this regard?

We are surprised that only a very limited discussion on the dollar outlook is presented in this Report, though its implications are of fundamental importance for global financial stability.

In particular, we are concerned that expectations of higher returns on the U.S. financial markets, which have driven huge capital inflows so far, may be cooling down. Data available for 2002 already show that capital flows to the United States have slowed down compared to the same period last year. Furthermore, the composition of these flows has also changed, with bonds being the most important component now. This may have important implications for the U.S. balance of payments insofar as this debt has to be serviced and, therefore, fewer resources might be available for internal investment and consumption.

Despite positive news regarding GDP and productivity growth in Q1, markets have not translated this news into higher prices. Does this mean that investors begin to realize that the U.S. stock market cannot deliver on their earlier expectations? What is the staff's assessment in this regard?

The tragic events of 9/11 have highlighted the importance of the insurance sector in the international transmission of shocks. Moreover, the survey contained in Chapter III confirms that the divide between the banking and the insurance sectors has become blurred as many of their respective products substitute each other.

However, the chapter falls short of drawing the resulting policy implications. For instance, does the growing importance of financial activities in the insurance sector suggest a revision in the supervisory framework adopted in the advanced economies? From this chapter, the reader certainly concludes that the prevailing framework is quite outdated. Given the relevance of the U.S. financial markets, what would the appropriate reforms be in the supervisory framework? Has the staff any thoughts on that?

Mr. Kelkar submitted the following statement:

We commend the impressive staff report. The report has intricately brought out the interplay of equity, bond, insurance, and credit markets. The observations in the GFSR should trigger preventive policy actions.

The pertinent questions and issues raised particularly of policy remain open ended. It would be helpful if specific attention of authorities were drawn to such pertinent issues.

High volatility in asset prices and inadequate pace of regulatory response are the major sources of risk. While multilateral surveillance as of the GFSR is important, we reiterate the need for strengthening domestic financial systems at the national level.

Unlike equities market that appears to be overvalued in mature economies, the response of government bond markets is conservative and asymmetrical in easing and tightening cycles. What is the implication of this for counter cyclical policy?

The issues pertaining to both corporate debt and bank credit have been addressed mostly from the demand side. To what extent the low saving rate in industrialized economies contributed to choking of liquidity?

In analyzing the foreign exchange market, it would be useful to address the implication of the misalignments amongst the major currency valuations for other financial markets.

What is the implication of the recent upsurge in Asia equity issues? Does it portend faster revival?

Given the problems surfacing in insurance industry, we agree with the staff in seeking to collect more information. This may be addressed as part of Data provision for surveillance and the associated need for Technical Assistance.

Negative equity premium in emerging equity markets is explained by currency depreciations and the consequent decline in economic activity. Recent changes in reserves and exchange rate management policies of these economies combined with structural reforms should lead to better investment flows with more stable returns.

Given the extensive interest, can the staff consider an accompaniment in the form of an 'Issues Paper' for wider dissemination?

We commend the Director of the International Capital Markets Department and his team for bringing out an impressive second Global Financial Stability Report (GFSR) rather closely competing and improving upon the first. The report has rightly broad based its analysis 'calling attention to potential fault-lines in the global financial system' highlighting sources of risks in mature markets as also emerging markets and local equity markets. The study has focused both upon vulnerabilities and opportunities. The report has brought out intricately the interplay between equity, bond, insurance, and credit markets throwing light in a significant manner on the lurking and potential vulnerabilities in the financial system. We believe that a serious attention to observations in the report should trigger appropriate preventive policy actions both by national regulatory authorities and the IFIs. The report should also help major market players build their expectations in a credible manner, leading to smoothening of price movements and financial stability. With these initial remarks, we would like to offer some general comments and later some specific comments on the report.

The report succinctly brings out the weaknesses arising out of segmentation of markets and regulatory gaps and overlaps leading to arbitrage opportunities and imperfections. In a fast integrating global financial market, while 'arbitrage' in markets should promote efficiency, if such arbitrage opportunities arise out of asymmetric information and market segmentation or regulatory arbitrages caused by weaknesses in regulatory structures and institutions, they could become sources of instability and disruptions in market operations. The report points to some precautions in particular of the expanding activities of insurance companies, misalignment of equity prices and imbalance in credit markets in mature economies. The report also identifies opportunity for reduction in global risks by developing the domestic securities markets in emerging economies. Chapters III and IV cover these issues. However, the pertinent questions and issues raised particularly of policy have been left open ended. It would be useful if pointers for action and who should take the lead were articulated in the report. It would help drawing specific attention of authorities to such pertinent issues. We welcome the staff's comments on this possible approach.

In essence, two types of risk seem to persist in the functioning of the international financial system. First is the high volatility in asset prices including those in currency markets, due to uncertain and enormous cross border flows, disproportionate to the size of economic activity in regions or potential risks in individual economies. While an element of volatility is a positive sign of market development, a very high volatility and huge spreads in cash and forward markets are definitely signs of imperfections. It can perhaps be reduced only by improving market access to better information and promoting orderly market operations. Concerted efforts both by national authorities and the IFIs are required in this respect. Second is the incompatible and inadequate pace at which the regulatory system and institutions respond to kaleidoscopic changes in the marketplace, leading the process of global integration. This emerges rather as a more serious issue as highlighted in the third chapter with respect to insurance industry. While improvements in multilateral surveillance as of the GFSR is definitely helpful, it reiterates the need for strengthening domestic financial systems and markets at the national level. We invite the staff to comment on how best this could be monitored in the interest of effective crisis prevention.

Overall, the recovery is led essentially by robust consumption, while investment spending showing continued weakness. The assessment about the global equities appearing to be overvalued and mispriced and the risks of a possible price correction has been well brought out. However, the picture for the government bond market is somewhat different, as shown in Box 2.3. The government bond markets' response is more conservative and adjustments are asymmetric between easing and tightening cycles. What is the implication of this finding to counter-cyclical public policy? We invite the staff's comments.

The stress on the banking sector and credit markets triggered by shrinking of commercial paper market has been analyzed well. Linking this to substantial decline in syndicated lending to emerging markets, brought out later in the GFSR, raises another critical question. The issues pertaining to both corporate debt and bank credit have been addressed mostly from the demand side. While the demand pressure is understandable, can the staff clarify to what extent the low saving rate in industrialized economies contributed to choking of liquidity from the supply side, despite easy monetary conditions?

In analyzing the foreign exchange market, it would be useful to address the implication of the misalignments amongst the major currency valuations for other financial markets.

The vibrancy of equity market in emerging economies and factors influencing balance of risks have been analyzed thoroughly in Box 2.5. The observation that local retail investors in emerging equity markets have shown greater signs of participation, particularly in Asia, is interesting. In our view, this is a very positive sign for securities market development, recommended by the report later in Chapter IV, for reducing global risks. What is the implication of recent upsurge of Asia equity issues? Does it portend faster revival? We welcome the staff's comments. Refinancing has dominated loan flows both in mature and emerging markets. Little demand for investment capital and lower tier borrowers in Asia remaining excluded are really causes of concern. As we mentioned earlier, this issue has to be equally addressed from the supply side factors.

The revival of insurance industry dominance in the institutional infrastructure is a very significant development and well captured by analysis and charts in Chapter IV. In our view, insurance companies along with pension funds, with their medium to long-term portfolio objectives have a significant role to play in stabilizing markets, albeit their being a sign of growing risks associated with financial services. Having said this, we share very much the regulatory concerns expressed in the report emanating from newer financial activities of insurance companies. This is a very timely signal to markets and regulators alike. This raises also the issue of coordinated supervision and adequacy of regulatory structures. We agree with the staff report, seeking to collect more information from the insurance industry. This may need to be addressed as part of data provision for Fund surveillance and the associated technical assistance recently discussed in the Board.

We very much welcome and encourage Chapter IV as the first of three studies on the securities markets in emerging economies. There are some incongruities observed in the findings of the study relating to market behavior. Despite strong recent performance, unlike mature markets, the equity premium had been negative over the period 1990–2001. This does not reflect generally the faster growth of emerging economies observed in recent years and the possible earnings potential of investments. The report seeks to explain this phenomenon, mostly pertaining to the second half of the last decade, attributing it to currency depreciation and the consequent weakening of economic activity in these economies. A mitigating factor in the current circumstances is the perceptible change in reserves and exchange rate management policies of these economies, reducing currency volatility after the crises. We believe that this issue will appropriately be further addressed in the forthcoming paper on exchange rate systems. Combined with this, structural reforms in equity and bond markets could contribute to better investment flows into these economies with more stable returns leading to positive equity premium. We invite the staff's comments on this perception.

We welcome the report as a significant contribution. The report is equally a product of extensive research and sophisticated technical analyses. Given the extensive interest, can the staff consider an accompaniment in the form of an Issues Paper addressing vital emerging policy issues for wider dissemination?

Mr. Wijnholds submitted the following statement:

The staff has produced a well-written and appropriately policy-oriented global stability report. In its second edition, the report seems to come closer to meeting our expectations and is indeed taking its place as an important tool for strengthening Fund surveillance. I broadly agree with the staff's views and main conclusions. Regarding the report format, I welcome its more forward-looking stance and elaboration of two important topics with potential risk to the stability of the international financial system—namely the financial market activities of insurance companies, and the relatively underdeveloped channel for equity issuance in emerging markets—and I encourage the staff to move further in this direction.

With some sense of drama, it can be said that the global economy is now in a typical Schumpeterian phase of creative destruction. What seems to be different in the current market, coming from the boom in financial markets in the nineties, is much stronger discrimination by investors between good and bad risks. The recent developments as put forward by the staff, support a positive view: there is hardly contagion from the Argentine crisis, risks in the Japanese banking system are reflected in an underweight position of investors in Japan, and credit availability for higher-grade companies is improving (on the back of a decreasing number of investment-grade defaults).

The report rightly points to the quality of corporate profits as an important risk for global financial stability. The discovery that quality of profits is sometimes doubtful has created serious uncertainty about equity valuations, especially in U.S. markets. However, a deeper analysis of the different profit measures would be helpful, as equity prices seem much more overvalued if measured against reported earnings compared to operating profits. This difference is largely explained by write-off costs owing to uneconomic investments. During the boom years, investors were content with return measures (like Ebita) that overstated current profitability, because they had high expectations about prospective returns on investments and acquisitions. In current market conditions, expectations have not only been scaled back, but falling market prices have also required massive write-downs. Investors now discount such costs into equity valuations and prefer profit measures that include them. This change in market conditions is clearly illustrated by the staff's observation that companies in the S&P 500 that were most active in mergers and acquisitions underperformed the index by 15 percentage points in the first quarter of 2002. For these companies the boom-bust cycle has been most pronounced.

The uncertainty concerning corporate profits is reflected in reduced profit growth expectations and higher equity risk premia. Both factors have been a drag on equity prices this year. Moreover, the ongoing balance sheet restructuring often puts stockholders at a disadvantage compared to creditors. This is the case if firms de-leverage by converting debt into equity on creditors conditions. The diverging trend in equity prices (declining in 2002 ytd, both in the United States and Europe) and corporate bond spreads (tightening in 2002 ytd) supports the perception that creditors are better off in current market conditions than stockholders.

As noted, markets discriminate more keenly in the current upturn. On two points I would be interested in an elaboration of the staff's views. The first concerns an assessment of differences between Europe and the United States in the current upturn. Monetary conditions have been more or less equivalent in the euro area and the United States. Looking at the Financial Conditions Index, however, financial conditions in the United States have stabilized since September 12, whereas financial conditions in the euro area have improved slightly. In addition, ingredients indicating monetary conditions, being the short-term real interest rates and the effective exchange rates, the Financial Conditions Index, originating from Goldman Sachs, includes equity market indices and the yield on corporate bonds. How does the staff assess the differences between financial conditions in European markets and U.S. markets; is there a difference? Secondly, the staff points to the better performance of cyclical funds compared to defensive funds. In comparison with the previous upturn of the nineties, the relative valuation of cyclical funds is higher now than in the aftermath of the 90/91 recession. What is the explanation? Does this reflect market anticipation of a firmer recovery in the current situation than in 90/91?

The volatile conditions in the commercial paper market imply that bank lines are more heavily drawn upon. The staff observes that banks increasingly hedge these exposures in the derivatives markets. The decline of syndicated lending to emerging markets is another defensive reaction of banks to deteriorating credit risks in their home markets. Nonetheless, the question arises whether this is not an overreaction. Declining sovereign bond spreads in emerging markets, together with an increased risk appetite of capital market investors, indicate that the risk-return trade-off has turned out in emerging markets´ favor so far this year.

The report pays little attention to the U.S. dollar exchange rate and the risk of a sharp weakening. In recent weeks, we have seen a somewhat sustained trend of depreciation of the U.S. dollar, suggesting that a rebalancing process is taking place. Diminishing portfolio flows into the United States could be one trigger. Besides, reduced merger and acquisition activities, which have been an important source of capital inflows to the United States, might also undermine the dollar. Given the combination of an underperforming U.S. market and a declining dollar, foreign investors are benefiting less from their U.S. exposure and may have now reached a saturation point regarding their dollar-based holdings. Thus, the correction of the dollar value, which the Fund and financial community started discussing extensively more than two years ago, has perhaps finally appeared. I believe that its implications should be examined carefully to determine whether the gradual weakening of the dollar could turn out to be a more abrupt, disordered correction leading to the materialization of the so called hard-landing scenario. A loss of faith by foreign investors raises the risk of a self-reinforcing liquidation cycle that could cause a sharp weakening of the dollar, accelerate inflation, lead to higher interest rates, and put further pressure on U.S. equity prices. A declining dollar may also have serious consequences especially for Japan as foreshadowed by the Bank of Japan’s recent initiatives to stem a rise in the yen. Japanese financial institutions are in a very weak position to cope with currency losses on their substantial net foreign assets.

The report notes that negative spillovers from a Japanese banking crisis may come about through three channels and that the overall effect of such a crisis should be limited. Recently, sentiment seems to have turned more positive toward investment in Japan. The underweight of Japanese assets in U.S. portfolios for instance seems to be bottoming out. The staff has not considered a fourth channel of contagion: hedge funds. Could the staff comment on the extent and the risk of foreign institutions using the low Japanese interest rate for funding loans outside Japan?

The report clearly shows that insurance companies are loss making in their main business, judging by the insurance loss ratios and the expense-to-income ratios. In the nineties, profits were dependent on investment returns. As these have deteriorated over the last two years and new high-risk activities (like credit default swaps) are not very promising anymore, it has become more urgent to assess the financial solidity of insurers. I therefore agree that better information on the financial activities of insurers is urgently needed.

It is striking that while the Nasdaq stock index has declined 23 percent in the 12 months to the first quarter of this year, the benchmark index for emerging equity markets (S&P/IFCI Composite) rose 11 percent over the same period. Usually, mature ICT and emerging market equities are perceived to be in the same (high-risk) asset class. It seems that high yield investors have reallocated part of their investments from mature high-risk markets to emerging markets, especially in Asia. This relative performance of equity markets could be explained by underlying uncertainties on corporate governance and transparency, which were topical in Asia several years ago (1997/98) and are recognized to be a problem in mature markets this year. Reforms in many emerging markets, of which increased transparency has been fundamental, are now being rewarded by the relative outperformance of emerging stock markets.

Developing local capital markets is crucial to reduce the risk of a credit crunch, as it enables firms to diversify their funding away from bank loans. Furthermore, local financing makes firms less prone to external crises, as it reduces the risk of corporate defaults related to exchange rate depreciation. For these reasons, I highly value continuing the staff's analysis and subsequent Board discussions on the extent to which diversification of financial sources is indeed important and can be promoted by policymakers.

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

No imminent threats to global financial stability appear to exist, but important elements of risk and uncertainty remain in both mature and emerging economies.

The Enron collapse generated many adverse spillover effects both in mature and emerging financial markets.

Corporate profitability in mature markets is central to determine the strength of the global economic recovery. Market discipline is being swiftly exercised on overvalued stocks and highly leveraged corporations, but further corrections in corporate profitability and equity prices in mature markets remain a concern.

If there is further deterioration in Japan's financial system, it is likely to hurt further emerging market economies.

Vulnerability assessments aimed at preventing balance of payment crises should have their focus amplified to cover financial crises in general and substantial cross-border adverse externalities and have their coverage extended to mature markets.

Increased awareness on credit quality in mature markets has sharply reduced gross capital flows to emerging markets in the first quarter of 2002, especially syndicated loans.

Renewed bouts of contagion from Argentina cannot be ruled out if economic and financial conditions deteriorate further, highlighting the urgency of a Fund program.

Developing local security markets to provide a more stable source of funding to their public sectors and corporations should be a main priority for emerging markets and should be supported by the Fund.

The poor equity performance of emerging market equities in the 1990s seems to be associated with the financial crises of the second half of the decade, and the volatility of returns may have also been increased by the opportunistic behavior of crossover international investors.

Increased regulatory and supervisory oversight over the insurance and reinsurance industry and harmonization of treatment to avoid regulatory arbitrage may become necessary.

We wish to thank and compliment the staff for another very good Global Financial Stability Report. The report provides, in a systematic fashion, selected empirical information about main developments in the equity, sovereign bonds, corporate debt and foreign exchange international markets, in both mature and emerging economies, as well as insightful analysis of inter-linkages of these various markets and of national and international financial events. The special studies on the insurance industry and on equity markets in emerging economies have helped to shed light on important, fast growing but less-known segments of the financial sector. Overall, the report contributes to better coverage of a major aspect of the Fund's multilateral surveillance.

Our main suggestion to improve the usefulness of the report is that, similarly to what is already done in the WEO, it would be important to spell out more clearly and systematically the implications of the analysis in terms of the expected policy responses by member countries, the Fund, and the IFIs.

We agree with the staff's assessment that global financial conditions seem to have improved since the last report, and that imminent threats to global financial stability do not appear to exist. Equity and bond markets of mature economies have stabilized further and emerging markets maintained access to international finance, regained after the virtual closure of international capital markets to them during September-November last year. There are, however, important elements of risk and uncertainty in both mature and emerging economies.

The staff points to two main sources of risk in mature economies' financial markets: the quality of reported corporate profits and cross-border spillover effects of the persistent weaknesses of the Japanese financial system.

The accounting frauds that marked the collapse of Enron highlighted weaknesses not only in corporate governance, disclosure, and accounting procedures of large corporations but, more importantly, a failure of outside checks on corporate management supposedly provided by external auditing firms. This situation has sparked a wave of uncertainty about the quality of reported earnings of major corporations, especially those that are highly leveraged or that have been involved in mergers and acquisitions.

The staff has pointed to important inter-linkages of these events with developments elsewhere in financial markets, including increased risk aversion and flight to quality in the corporate sector, mild contagion of European corporate spreads out of accounting concerns in the United States, a drawdown of bank credit lines by corporations unable to place commercial paper leading to bank credit retrenchment to emerging markets, and even a weakening of the U.S. dollar in recent weeks.

Market discipline has been swiftly exercised upon overvalued stocks and highly leveraged corporations. However, stocks in mature markets, which already appeared to be overvalued, now face a further risk of downward correction. If corporate profitability becomes subject to substantial downward revisions in the period ahead, this will negatively affect equity prices. A decline in profitability, a main determinant of corporate investment expenditures, may also affect the speed of the current consumption-led recovery of the U.S. economy. As the report clearly spelled out, corporate profitability in mature markets is central to determine the strength of the global economic recovery.

The other main source of risk posed by mature economies' financial markets is the possibility that the long drawn problems of Japan's financial sector generate more serious cross-border spillover effects, for instance, through a disorderly repatriation of Japanese assets abroad, or adverse impacts on foreign investors holding Japanese assets. We agree with the staff that these risks are low, as large-scale capital repatriation seems unlikely and foreign investors have reduced their exposure to Japanese risk. However, while the aggregate situation seems manageable from a systemic perspective, cross-border spillover effects on large individual foreign financial firms and investors cannot be ruled out in case of further financial market turmoil in Japan. In addition, a weakening of the yen could have repercussions, especially for Asian emerging economies, despite their improved macro-economic fundamentals. The Samurai bond market has virtually closed down, limiting an important source of financing for emerging markets.

The events, risks, and vulnerabilities analyzed in the report provide illustration of the point made by many Directors during the last discussion of vulnerability assessments that these exercises should be suitably extended to include in addition to balance of payment crises in emerging economies, financial crises in general and substantial cross-border adverse externalities that may arise from events and policies in major industrial countries.

Despite the reopening of international markets to emerging market risk, gross capital flows to emerging markets have continued to decline. During the first quarter of the year these flows have been 16 percent lower than the equivalent quarter of last year and 12 percent lower than in the previous quarter, reflecting a sharp decline in syndicated bank lending. While the EMBI+ spread adjusted for Argentine risk has compressed during the quarter, it remains well above the pre-Asian crisis level.

The main risks in the period ahead seem to be increased contagion from Argentina and a slower than expected recovery in the major industrial countries.

While overall short-term contagion from the Argentine crisis seems to have been contained, it has been severe in the case of Uruguay. Also, the effects of Argentine crisis on the longer-term risk perception of emerging markets, including in relation to FDI flows and to specific investor bases, are yet to be fully assessed and would depend critically on how the situation evolves. If economic and financial conditions in Argentina deteriorate further and the peso experiences an even more precipitous fall, renewed bouts of contagion cannot be ruled out either. These circumstances point to the urgency of the Argentine authorities finalizing an emergency stabilization program that can be quickly supported by the Fund.

We fully agree with the view that emerging market economies need to develop local security markets that can provide a more stable source of funding to their public sectors and corporations than it is the case with international capital markets. Some emerging economies have, indeed, started long ago along this route and have made considerable progress in some segments of financial markets, such as the sovereign bond market. However, much more needs to be done in other segments of the financial sector and to make existing markets deeper, more liquid, and efficient. We, therefore, welcome this sequel study of local equity markets as well as the announced forthcoming analyses of bond and derivative markets. The Fund needs to pay higher attention to this issue in its surveillance program and technical assistance activities and, most of all, it needs to avoid adopting policies that can hurt the development of local securities markets and the formation of domestic savings.

The approach adopted in the current essay of focusing on issues of relevance to the formation of an international investor base is important. However, if the objective is to foster genuinely domestic security markets, even more important would be to understand how best to develop a domestic investor base.

As shown in Table 4.1, between 1990–2001, average returns on emerging market equity have performed quite poorly compared both to returns to mature economy equity and to emerging market bonds. The data also show a striking difference when the first half of the decade is compared with the second half. During the first half of the 1990s, prior to the spate of financial crises that affected emerging markets, average returns to emerging market equity were twice the returns to mature economy equity. This was especially the case of Latin America, where returns were almost three times higher. It also shows that volatility of emerging market equity returns increased substantially in the second half of the decade.

Like market participants, we believe that the major factor behind this poor equity performance has been the financial crises of the second half of the 1990s, which resulted in sharp devaluations of exchange rates and severe contractions of economic activity. The staff suggests that microeconomic factors and structural weaknesses, such as asymmetric information, poor corporate governance, lack of accuracy and transparency about corporate earnings, and poor protection of minority shareholders, may have a role in explaining poor performance as well. We accept that there is still much to be done in all these areas in many emerging markets and agree with the staff's recommendations of augmenting disclosure of information and enhancing corporate governance. However, we have difficulty in considering these issues as explanatory factors of poor performance over the last decade. All these issues were already present in the first half of the 1990s when emerging equities performance outstripped that of mature equities. Moreover, during the second half of the decade there were improvements in many of these issues compared to the first half.

The staff has also suggested that the sustained poor performance of emerging market equities has sharply altered the profile of the global investor base, increasing the role of crossover and tactical investors that focus more on opportunistic trading. However, this is not clear from the data. Indeed, the opportunistic behavior of crossover international investors could be viewed either as a result or as an additional cause of increased volatility. To further clarify this question, it would be interesting to look at what were the market shares of international investors in emerging market equities during the first and the second half of the decade, and in particular at what were the shares of crossover international investors.

Regarding the growing importance of American Depository Receipts and Global Depository Receipts, we are not clear as to whether the staff sees a positive role for these instruments in fostering local equity markets. The staff highlights the liquidity reduction in local markets and the problem of de-listing from local exchanges associated with ADRs and GDRs, but also underscores that these instruments could play a significant role in fostering transparency and corporate governance.

As indicated in Chapter III, insurance and reinsurance companies have now become major, but imperfectly regulated, players in mature financial markets. While these companies are not subject to runs on their liabilities, as depository institutions are, many market and credit risks are similar to those affecting other financial sector participants, and the inter-linkages among the various markets in the financial sector have been on the rise. So far, market discipline and the current level official oversight have been sufficient for an early detection of problems and to avoid systemic risks from unfolding. However, as the distribution of risks in financial markets become increasingly more complex, a main policy question is whether it will be necessary to increase integration of the regulatory and supervisory oversight, and especially to harmonize treatment in relation to other financial sector players so as to avoid regulatory arbitrage.

Mr. Shaalan submitted the following statement:

Let me start by noting that the report before us strikes me as being considerably more reader friendly than the previous one and I commend the staff for that. I will have a modest suggestion later on a possible change in the format of the report that could enhance its focus. First, however, let me comment on some issues of substance and raise a number of queries.

The report happily observes that in the near term there are no imminent danger signs threatening financial stability. This conclusion is apparently based, in large measure, on the robust recovery reflected in the recently released GDP data for the first quarter in the United States. This may well be true, but there are a number of caveats that need to be highlighted. On a general level, the question can be asked whether the authors of the report are looking at the rearview mirror rather than the windshield when reaching their conclusion. It is well known that the first quarter numbers are inflated by one-off factors mainly centered on inventory replenishment and defense and security expenditures. Taking account of these factors as well as any potential shift in the relatively strong consumer outlays could slow down the economy considerably. The impact on consumer expenditures could materialize as a result of a slowdown in economic activity, a steep decline in equity prices or a host of other factors, in particular, the ongoing revelations on corporate ethics. It should also be noted that equity valuations had a built-in price premium based on a sustained growth in the economy. This appears to be unraveling now causing equity prices to correct. Of course, there is no way of forecasting the potential occurrences or impact of these events, but they certainly should make us more sanguine in coming to the conclusion cited in the report regarding the near-term outlook.

The report does rightly identify a major uncertainty, namely, the outlook for corporate profitability, which has been unusually depressed for the past year. The quality of earning is also cited. The consequent impact on the depressed level of capital expenditures has long been recognized. This state of affairs, the report contends, represents a risk to global stability through the banking and insurance sectors. All this is well known. Another set of issues needs to be addressed to get a better understanding of the corporate outlook. Specifically, why has the current economic recovery, contrary to the norm in other economies, not been accompanied by a parallel increase in corporate profitability? Could the erosion of pricing power, which is widespread in the corporate sector, coupled with the limitation on further cost cutting, constrain profitability, and what impact has the strong dollar had on the weak pricing power? I would be grateful for the staff’s views on this phenomenon and, in particular, on the reasons behind it and its implications for earnings prospects and the resulting consequences for global stability.

Addressing the quality of corporate profitability, which is probably also prevalent in major markets outside the United States, will undoubtedly serve to adjust profitability downward. On this score, the report apparently does not accord sufficient risk of this consideration to global financial stability. The report concludes that the markets through harsh punishment will introduce incentives for self-correcting actions. In addition, regulatory changes currently contemplated will solve the problem. Undoubtedly, and for obvious reasons, some self-corrective measures by the corporate sector will materialize, but before coming to any judgment we need to assess the measures taken by the corporate sector. Similarly, we should await action taken by regulatory bodies. Here, in a recently televised interview with Arthur Levitts, the former Chairman of the Securities and Exchange Commission clearly raised serious reservations about the 30-odd bills before Congress or congressional committees, which, if passed as proposed, will only address the fringes of the accounting and reporting problems of the corporate sector. I, therefore, find the staff conclusion that these initiatives, within and outside the corporate sector, will indeed permit a better evaluation of risks somewhat premature. I would be grateful for the staff's comments.

On corporate profitability and the financial sector in Japan, the report leaves the reader up in the air with regard to the global ramification of the weak position of the Japanese banking sector. It is not clear how concerned we should be about the weakening position of Japanese banks and the extent to which they constitute a source of vulnerability to the international financial markets. On the one hand, concerns are raised about the spillover effects of a further weakening of the banks. On the other hand, the report clearly concluded that mitigating factors make for a manageable situation in terms of spillover effects. Can the staff tell us what subtle differences exist between these two observations?

An emerging risk to financial markets that the report correctly identifies arises from the increasing role and size of the insurance (and reinsurance) sector in the financial markets. This factor combined with the relatively low level of regulation, beyond issues of solvency related to consumer protection in macro markets, would suggest the need for surveillance of this sector. Additionally, their cross-border activities that render regulation more problematic and the increasing complexity of analyzing the proliferation of derivatives and with it risk assessments only underscores their importance in global financial markets. Further disclosure beyond what is currently provided is required if the sector is to be regulated in a broader sense. I am far from comfortable with the proposition in the report that credit-rating agencies are viewed as the de facto regulators for insurance and reinsurance. They neither have the expertise nor the knowledge. In any case, the paucity of information and disclosure renders any attempts at assessment virtually meaningless. There are international agencies that are currently involved with addressing regulatory issues. The question that should be of concern to us here is the extent and the nature of Fund involvement. More importantly, if indeed this sector could destabilize the international financial system, then there needs to be a firm international and cooperative effort to address a framework for preventive action. Naturally, account must be taken of special interests that will stand in the way of adequate disclosure and supervision, particularly of the reinsurance sector. What clearly appears to be happening is that global financial markets are developing with considerably more speed than the progress in putting in place a regulatory and supervisory machinery. This could be a potential source of vulnerability, which, to a lesser degree, is present in other financial institutions and needs to be addressed. In this connection, the role of the FSAP in mature markets should be underscored.

Finally, on the section on emerging markets equities, I look forward to the next two installments on the subject and hopefully the analysis will focus on measures that could contribute to the development of domestic equity markets in order to reduce what appears to be a highly leveraged position of the corporate sector in many emerging markets.

On the format of the paper, we see the possibility of dividing the report in two parts—a short main report supplemented by a background paper as an appendix. This could result in a more focused report.

Mr. Varela and Mr. Beauregard submitted the following statement:

We thank the staff for preparing a second edition of the Global Financial Stability Report, which includes interesting insights on insurance and reinsurance activities, and emerging equity markets, besides the general analysis of financial markets. This is the second report after the first issue published in the first quarter. While recognizing the efforts that are being done by the staff in its preparation, we still feel that the report needs a more thorough assessment and probably some modifications in order to respond to the expectations created by this publication. We have several comments, both on the form and substance of the report.

On the structure of the report, as this is a quarterly publication, it would be easier for the reader to find a systematic presentation based on a format that is repeated in each issue. We would offer the following suggestions:

The overview, which is quite comprehensive in this occasion as it should also be, in the future could be a separate section at the beginning of the paper without constituting a whole independent chapter. A short presentation could then be added to explain the rationale of each chapter in the report. This is already partially done in the current report, but perhaps could be done more thoroughly.

The evolution of the global financial markets should be the main body of the report encompassing two or three chapters. One devoted to recent developments—the current Chapter II, perhaps in a more compressed version—and another one or two chapters to take care of the main financial risks and outlook in the financial markets. It would be also interesting to add a section on the interactions between the real economy and financial markets, as it was done in the first part of Chapter III of the first GFSR (Financial Market Implications of a Subdued or Delayed Recovery).

Finally, the report could contain as annexed sections the specific essays selected for a more in-depth treatment in each particular issue—the current Chapter III and Chapter IV.

The report should strike a difficult balance between the Fund function of surveillance and its role in crisis prevention and resolution. In other words, between maintaining an independent view on the evolution of financial markets without loosing credibility, and at the same time trying to avoid raising excessive concerns of market participants on the evolution of certain variables that could seriously affect members of the Institution.

In this regard, we think that the report could benefit from a stronger coordination among departments within the Institution and complementarities with the WEO. The initiative by the staff to enhance its coordination on the coverage and analysis of topics included in the GFSR and the WEO that was mentioned during the discussion of the Work Program is most welcome.

The report makes valuable contributions on highlighting the main trends of financial markets and also on the main current source of uncertainty, namely the recovery and quality of corporate profits in mature markets, which is also the main underlying theme of the report. We wonder whether the report could increase its added value if the description of the evolution of main variables in financial markets would be shorter and then to concentrate on other aspects related to future developments in financial markets, as well as the areas where weaknesses are more evident and possible policy actions to tackle those weaknesses.

As the report is going to be published with a lag of at least two months from the period that is being analyzed, i.e., the first quarter in this occasion, it will be more interesting for potential readers if it concentrated on possible risks and future trends, as well as suggested policy actions regarding financial markets, instead of mainly focusing on recent developments.

We think the distinction between mature and emerging markets is correctly done and it should remain as a main feature in future reports. The reference to weaknesses in Japan's banking sector is appropriate, but it could constitute the base of an additional chapter focused on main risks and outlook, as suggested above.

I concur with Mr. Padoan and Mr. Lombardi that the dollar outlook could receive more attention in the report. Another area that needs more attention is FDI flows. Given that availability of data in this regard could be of some constraint, perhaps the report could include a section on FDI every two issues, for example. In any case, it is an aspect that should be analyzed to the maximum extent possible. Offshore financing flows may have significant systemic effects and they should be also taken into account and carefully analyzed in future GFSR.

On a more specific note, the staff affirms on page 23 that there is a potential for a renewed bout of contagion from Argentina. While this is always possible, it is counterfactual with what we have seen so far. The effects of contagion from Argentina have been very limited by financial or trade channels. Moreover, the evolution of the Argentine currency so far does not provide sufficient support to the insinuation that it could go into a free fall. We think this paragraph should be deleted or modified to strike a more balanced view of the situation in Argentina and the real risks of contagion at this stage.

The third chapter of the GFSR provides an interesting overview of the role of insurance and reinsurance companies on global financial markets. The chapter draws some concerning conclusions, notably the potential risks derived from the regulation and transparency weaknesses of the insurance sector. From a systemic point of view, these risks would be offset by the control of insurance companies through the market and the small relative size of their higher risk assets.

We have particularly appreciated the forward-looking approach of the chapter with an assessment of the potential risks derived from the growing financial investment of insurance and reinsurance companies. We believe that it is precisely this kind of orientation what should set the tone of the GFSR, "calling attention to potential fault lines in the global financial system" as the preface points out.

This being said we have missed on the report a wider geographical analysis, we find it overly concentrated on G-7 countries. We also find that in its effort to draw general conclusions, the report misses an opportunity to make a more detailed cross-country analysis. It would have been interesting to have a deeper analysis of the implications of aspects such as the different shares of institutional investors in the market, the different capital structures of insurance companies, or the different regulatory environments of the insurance sector.

On a general comment on the subject, we consider that pointing to the vulnerabilities of the insurance sector in the GFSR is useful in the context of a selected issues approach. This kind of format allows for grater flexibility on the tone of the article. In this case, the GFSR can point out to the potential risks of the insurance sector without entering into specific recommendations, which would rather fall under the expertise of the International Association of Insurance Supervisors (ISIS).

The study on the potential contribution that securities markets could make to provide a more stable funding for the sovereign and corporates in emerging markets is key to better understand the driving forces behind investor's resource allocations. Although the policy implications of the conclusions drawn in this chapter are important, they are not new. In particular, local securities markets will be developed only if corporate governance practices, transparency, and the regulatory and supervisory frameworks are improved. These weaknesses have already been identified as the main causes of the malfunction of local securities markets and both, the international community and local authorities, have been working through different fronts to correct them. However, although it will take time to complete the reforms, what needs to be highlighted is the recognition of such weaknesses and the need to tackle them. The increasing participation of member countries in ROSCs and in the Financial Sector Assessment Program is a clear evidence of such recognition.

Furthermore, the study unveils an issue that was highlighted in the last WEO discussion and that is closely related to the development of local securities markets: the need to boost national savings, particularly in Latin America. The link of these two subjects highlights the strong interrelationship that exists between the Research Department and the International Capital Markets Department, an issue recently discussed during the last Work Program session and that could be exploited even more in future reports.

One of the most important challenges emerging market economies face is to broaden the investor participation base. Two types of investors have been identified, dedicated investors, which have a more long-term investment horizon, and tactical investors, seeking high absolute returns through market timing. From these two groups, clearly the first one can offer emerging market economies better financing prospects in the long run. Thus, all efforts should be directed toward attracting this group of investors. In this regard, the necessary conditions to attract this type of investors are macroeconomic stability and the successful implementation of structural reforms. Only through them, productivity levels will be increased on a permanent basis, boosting national savings and making investments more attractive and less risky.

The emerging market crises that took place in the second half of the nineties revealed serious deficiencies in the way local markets operate, such as lack of transparency and weak corporate governance practices and supervisory and regulatory frameworks. The migration of listings of the top quality corporates to mature markets is explained by the difficulty and high cost to attract investors in local markets.

Finally, an important issue noted in the chapter is the impact that the large depreciations of national currencies had in the returns of investors during the major crises of the nineties. It highlights the importance of the development of well regulated and supervised markets to hedge exchange rate exposures. Thus, the development of these types of markets is key to enlarge local markets, a conclusion that can be derived from the report but that is not explicitly there.

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

After the strong surge ahead of recovery of the world economy as represented in sharp rises in stock prices in both mature and emerging markets and in reopening of capital flows into emerging economies since last fall, capital markets have recently seen investors' attention increasingly floating around among various instruments amid heightened uncertainties over the course of corporate profits. It would be safe to characterize these market movements as seeking an appropriate range commensurate with the pace of the above-mentioned recovery, for which views of market participants have been slow to be narrowed down. It is a concern, however, that portions of the market—the U.S. Commercial Paper market and the Samurai bond market for emerging market issuers, to name a few—have become paralyzed owing to the collapse of such well-known companies as Enron, as well as by the Argentine crisis.

From our observation, it is timely that the second issue of the Global Financial Stability Report focuses on prospects for corporate profits in mature markets as a cyclical issue and on the implications of the Enron collapse, risks in insurance and reinsurance companies, and an overview of emerging equity markets as structural issues, respectively. It is also appropriate that the paper presents some policy implications, such as the need to enhance disclosure by insurance companies and the need to strengthen governance in emerging economies. For these proposals to be effective, it would be important to convey to individual authorities the messages tailored to the specific situation of their economies in addition to publicizing the paper.

Before commenting on specific issues, we have one suggestion. The draft text includes a number of technical market terms, making it difficult for ordinary readers to understand. While we can easily imagine that those terms are most convenient for expressing market phenomena precisely, we wonder if the staff might find it worthwhile to prepare notes or a glossary, in order to attract more readers than only those acquainted with market technicalities.

U.S. stock prices have been volatile and stagnating since the beginning of this year. To the extent that the sharp rises of last fall reflected excessive expectations, an adjustment at this time by dropping such excess would mitigate the risk of a sudden sharp fall and increase the flexibility of monetary policy. If stock prices had retained last fall's momentum to pick up further, monetary authorities might have felt the need to pour cold water on the stock market despite the remaining uncertainties over the recovery pace of the real economy, thrusting them into a serious dilemma. That said, maintenance of the current price level hinges on whether corporate profits will achieve as rapid a recovery as currently envisaged in the market. With some shock to the market, the view that such a scenario would be hard to realize would gain ground, and a rapid decrease in stock prices could easily be triggered.

As listed in Box 2.1, the impacts of the Enron collapse are being more widely and deeply recognized in the markets now than what was felt at the time. Corporations perceived to have engaged in practices similar to Enron now have a hard time meeting their liquidity needs, while markets for financial transactions with a complicated structure have become shallow. In this regard, we appreciate the self-help efforts of those corporations to wipe out market concerns, and we welcome the prompt responses by U.S. and European authorities as well as by international standard setting bodies.

Regarding the impacts of a hypothetical further deterioration of Japan's financial sector on the regional and world financial systems, the staff concludes that they seem manageable, on which we can agree. However, Japan's financial sector remains one of the most important channels for funds flowing to and from the largest net capital exporting country in the world; the staff's reference to "the increasing insulation of Japan's financial system" is an oversimplification of ongoing developments. We would like to see more narrative explanation using economic terms in the published version of the paper.

At any rate, under the strong resolution of the Prime Minister that the Japanese Government should take whatever measures are necessary to prevent a financial crisis from occurring, the anti-deflation package last February made it clear that:

- should financial institutions meet funding difficulties owing to rumors or other reasons, the government will request that the Bank of Japan take all necessary measures to maintain a sound credit order, including providing ample liquidity; and

- should the risk of a financial crisis arise and should it be judged necessary in light of the relevant laws and ordinances, any and all necessary measures will be implemented, including capital reinforcement, thereby ensuring the stability of the financial system.

In addition, with the conviction that an early resolution of the NPL problem is essential to recovery of confidence in the financial sector and to the economy as a whole, the government has been strongly urging financial institutions to carry out early disposal of NPLs through regular and special inspections. The lifting of blanket deposit guarantees would not have been smooth without these intensive efforts.

While we do understand the staff addressing concerns over financial stability in Japan, we would like to suggest that they should also call attention to the recent bright signs for Japan's corporate and financial sectors, such as:

- stock prices have been on an upward trend to the highest range since the beginning of this year. Behind this surge is said to lie increased inflow of overseas investor's money, pushing up stock prices of wide-ranging industries; and

- a number of corporations that have undertaken intensive corporate restructuring are projecting sharp recovery of profits for FY2002.

The staff asserts that the rise in Japanese equities is partially derived from government-supported measures, including a crackdown on short selling and the purchase of shares by government controlled funds. We do not deny that the buying back by speculative investors who had attempted to cause a self-prophesied crisis occur in response to the strengthening of the short sale regulations contributed to this rise to some extent. However, we believe that the recovery of stock prices primarily reflects the view that the Japanese economy was bottoming out and that corporate profits would be recovering. Otherwise, the recovery would have been merely temporary.

Indeed, the short sale regulations were toughened by introducing U.S. uptick rule-type regulations in response to several securities companies' manipulating stock prices by circumventing the then existing regulations. As such, these regulations were not meant to sustain stock prices. In addition, the government had never decided that public funds should be invested in stocks to sustain their prices.

We do not think it is appropriate for the staff paper to describe the above analysis as the Fund staff's view rather than as market participants' perception. We urge the staff to pay utmost care in formulating descriptions in light of the significant impact made by any Fund paper.

While the default of Enron and the Argentine crisis still leave bank loans inactive, preference to risk-taking in bonds and equities has recovered. We welcome that many emerging countries have completed the necessary financing for 2002 and have conducted debt management operations to contain interest rate risks. While favorable prospects for recovery of the world economy have picked up growth expectations for emerging economies, regaining access to the international capital markets should be primarily ascribed to the recovery of risk-taking activities among investors in mature markets. That said, emerging countries should not be dominated by the passive way of thinking that a change of circumstances in capital supplying countries would unavoidably toughen the conditions for, or even close access completely, and they can do nothing about it. Unless a shock as paralyzing to the overall markets as the terrorist attack of last year occurred, given the enhanced discrimination among emerging economies as evidenced by the limited contagion effect from the Argentine crisis, we wonder if emerging economies now have a better chance to alleviate the adverse impact of a change of circumstances in mature markets by making further efforts in conducting sound macroeconomic management and advancing structural reforms, such as by improving governance. As the staff points out in Chapter 4, these efforts are essential for nurturing domestic equity markets, which in tandem with such efforts would stabilize capital inflow to emerging economies.

We appreciate the staff's efforts to present an overall picture of the financial situations and financial activities of the insurance and reinsurance industries focused on the whereabouts of risks and implications on the overall markets, which have not been well known despite their large presence in the markets. It is reassuring that the majority is of the view that the failure of an insurance company is not likely to cause any systemic repercussion. However, the analysis as to what kind of risks insurance companies are exposed to and how they are controlling these risks seems no more than a list of qualitative descriptions. A mere list of issues underpinned only by anecdotal episodes would not send an effective message to readers. In addition, we have noted that excessive generalized observation about institutional framework or supervision with less attention paid to differences among countries considerably sacrifices accuracy. We think the Fund paper would be more appealing if it focused on areas within its own expertise, such as the role of insurance companies in international capital flow and its development, and discovered concrete policy implications in these areas.

Mr. Al-Turki submitted the following statement:

I thank the staff for a comprehensive review of financial market developments and prospects. I also welcome the staff's assessment of a number of possible risks including the increased role of the insurance industry in financial markets. The staff's extensive discussions with various market participants add to the richness of the review. Here, I will add a few comments.

I welcome the continued improvements in the global economic outlook. While this improvement has not yet been reflected in improved mature markets equity prices, owing to concerns regarding the integrity of both financial results and stock analysts recommendations, I am hopeful regarding the prospects. Indeed, the accounting problems are being addressed, inflation remains at bay, and corporate profits are expected to rebound. The increase in the ratio of up/down earnings revisions is an encouraging sign. Moreover, as the staff notes, the markets have already severely discounted share prices of companies that have questionable accounting or whose growth is seen as unsustainable. Therefore, while risks clearly remain as detailed by the staff, these risks will likely shrink with the improved economic outlook and the strengthening consumer confidence. Nevertheless, it is essential to remain vigilant and take all the necessary steps to fully restore confidence in the integrity of corporate financial reports.

In both the United States and Europe, the increase in stock prices of the banking sector reflects the view that banks are generally in good financial shape, and that profitability will improve as the global economy strengthens. That said, increased incidence of bankruptcies, the decline in mergers and acquisitions fee income, and the variation between individual institutions underscore the need for continued vigilance. Meanwhile, stock prices of Japanese banks have underperformed the broader index, owing to continued concerns regarding the performance of this sector. The weaknesses that emerged in the banking sector following the burst of the bubble economy are yet to be fully resolved. In this connection, the improvement in the Japanese equity market broader index could enhance prospects for banks. It is important, however, to continue efforts to implement the reforms needed to put the banking sector back on track.

The recent performance of emerging equity markets is welcome. The sharp increase in equity prices in emerging Asia underscores the progress made by this region since the 1998 crisis. The gains in Latin America's stock values, despite the Argentine situation, highlight not only the improved resiliency of these economies, but also the increased differentiation in financial markets between countries. The increase in net flows into emerging equity markets is evidence of the improved confidence and bode well for the future. That said, the underperformance of the emerging equity markets over the past decade is an important issue and I found the staff's analysis instructive in that regard.

The strong performance of the emerging bond markets is further evidence of increased confidence in those economies. The decline in the interest rate spread in the first quarter should help facilitate economic management and enhance growth. However, the staff is right to point out that the increase in allocation by crossover investors could raise the risks of a sharp reversal of these inflows. Turning to syndicated lending, the staff notes the decline in this area owing to lenders' heightened awareness of credit risk following the Enron debacle and increased caution after losses suffered in Argentina. Here, I will be interested in the staff's elaboration on the reasons for the divergence in the assessment of and appetite for risk between syndicated lenders and bond investors. Indeed, the staff notes on page 5 that "Risk appetite is at its highest level in two years".

I am reassured by the prevailing judgment that the systemic risks associated with the financial market activities of insurance companies are relatively limited. That said, I agree with the staff that a collapse of a large insurance or reinsurance company could affect the financial stability of a major financial institution. This risk could increase as insurance companies move further into newer and more complex financial activities. Indeed, both the Lexington and the JP Morgan surety bond cases underscore the risks and the complexity of the issues. Considering all these factors, there seems to be a case for taking a fresh look at insurance company supervisory frameworks.

Mr. Bennett submitted the following statement:

The staff deserves to be commended for its good progress up the learning curve for the Global Financial Stability Report (GFSR). This report has a clearer focus than the inaugural report, and has a better balance of analysis and assessment than its predecessor. I am looking forward to next quarter's report, which should allow the staff to take full advantage of the possible synergies with the WEO. I would also encourage the staff to consider restricting themselves, in usual circumstances, to one special topic per GFSR, which is treated in reasonable depth with the policy implications fully developed.

I agree with the staff that financial market conditions improved in the latest quarter and that the most important issue for near-term developments is the evolution of corporate profits in mature markets. The pace and quality of profits, relative to current expectations, will determine the extent to which, if any, equity values and risk premia in corporate bonds will have to be reassessed. As well, the relative trends in profitability that emerge across countries will have important implications for the direction of net capital flows and the configuration of exchange rates.

Given the importance of the issue, we would have welcomed a more in-depth exploration of the profits issue, including some discussion of recent productivity and wage data for the large advanced economies. While it is too early to predict with much confidence what will be likely to happen to profitability, the latest data do raise some interesting issues that will warrant close monitoring.

Beginning with the United States, one can be fairly confident that the recovery will continue; the main question is whether it will be less vigorous than usual. Here there are competing theories. To this point, the data have generally contained positive surprises, that is, have generally been stronger than the consensus forecast, which is a welcome development. At the same time, non-farm business productivity has generally been stronger than usual for this phase in the recovery. This is also a welcome development in that it bodes well for profits. However, it might mean that employment and household income will recover more slowly than usual which will lessen the recovery in aggregate demand. This might be compounded by the fact that there is less pent-up demand than usual as the vigorous and early action by the Federal Reserve helped maintain the level of expenditures on housing and automobiles during the slowdown. Thus, the global economy might be confronted with a U.S. recovery that is less supportive than usual of demand growth in other countries. As the staff report notes, financial markets have recently factored-in substantial improvements in sales to the United States for several countries. Markets might have to reassess this.

The recovery in the euro area is giving signs of being less robust than hoped by some observers and wage demands are strong, especially in Germany. This does not bode well for the profitability, dynamism, and potential growth of these economies. It will leave European capital markets more fragile than otherwise would be the case and underlines the urgent need for structural reforms, especially in the larger euro economies.

If these recent developments continue, they could have important implications for the global distribution of growth, capital flows, and exchange rates. Any shifts in capital flows that might stem from the above developments do not have to be disruptive, however, provided risks are appropriately managed. It will be important for regulators, supervisors, and public debt managers to stay on top of developments and make prudent decisions. In this regard, it would have been helpful to have had more information on the ability of banking systems in key economies to cope with significant negative surprises in corporate profitability going forward.

This chapter provides a useful service in putting the expansion of the financial market activities of insurance companies in recent years in perspective. I agree that stronger disclosure of the financial activities of insurance and reinsurance companies is needed. At the same time, I take note of the fact that supervisory frameworks for insurers and reinsurers have been under active discussion in the official community, including by the Joint Forum of banking, insurance, and securities supervisors. I also take comfort from the apparent strength of the self-correcting mechanisms inherent in financial markets as evidenced, for example, by the movement of some of the major global banks away from using insurance instruments for managing financial risks. Nevertheless, I think that this review underscores the importance of all Fund members participating in the Financial Sector Assessment Program.

Finally, we think that indigenous capital markets can make an important contribution to growth and financial stability in emerging markets. Accordingly, we welcome the decision to include three studies in the GFSR on local securities markets. This first study, which examines the factors that have influenced the contribution of emerging equity markets to financial sector stability, provides a good starting point. Nevertheless, I would have welcomed more discussion of the role of domestic policies and institutions in the successful functioning of local securities markets. Some case studies of different country experiences would have been helpful in drawing and emphasizing the key lessons. In light of the remarkably strong performance of

U.S. equity markets in the 1990s, it might also have been worthwhile to have compared the performance of emerging markets with mature markets other than the United States.

Mr. Barro Chambrier submitted the following statement:

I welcome this second issue of the GFSR, which I find very informative. As a general comment I would like to note that given the importance of this report for the Fund's surveillance exercise, it should have been more forward-looking, and present clear messages on policy implications of developments in financial markets. This is not an easy task, given the very nature of issues to be covered, but it is needed to strengthen the report's value added, particularly regarding crisis prevention.

It is encouraging to note that financial market conditions improved, benefiting from the nascent recovery in the global economy, and that the near-term outlook is also promising. I found developments in the emerging markets particularly positive: many countries were able to cover their financing needs, Peru was able to access international capital markets for the first time since 1928, the fallout of the financial crisis in Argentina has been contained so far, and the impact of weaknesses in the Japanese financial system are deemed manageable. Nevertheless, sources of vulnerabilities and uncertainties exist, including the quality of corporate profits in mature markets, which could strain the international financial system.

The report highlights markets reaction to the Enron scandal, particularly for highly leveraged firms, and for corporations that had been active in mergers and acquisitions. This reaction has hard-pressed the corporate sector to take necessary steps to increase transparency in financial accounts, strengthen balance sheets, and be more prudent in risk taking. I hope that good practices in these various areas would be developed and implemented in a sustained manner. In the same vein, I welcome measures taken in the United States and in Europe, aimed at strengthening the regulatory framework for capital markets, as outlined in Box 2.1 of the report. These steps are important in the current environment, where it appears that equities in mature markets are overvalued relative to historical averages, and that a risk of price correction is not ruled out.

Developments in mature bond markets also seem to be giving mixed signals. Although U.S. futures markets appear to be pricing in a rate hike, it is not clear whether this is in expectation of higher interest rates in the U.S. or higher inflation. Mixed signals are also coming from movements in the corporate debt markets. While financing for U. S. consumer spending and mortgages appear less affected, this does not seem to be the case for business investment financing. Is it an expectation of lower profits? If this were the case, what would be the implications for future growth? The staff's comments will be appreciated.

Continued weaknesses in the Japanese banking sector are a source of concern. I therefore welcome the fact that the Japanese authorities have agreed to participate in the FSAP, and I look forward to its findings and recommendations. I also hope that the latter will usefully contribute to the Japanese authorities' efforts to decisively address difficulties facing the financial sector, as outlined in Messrs Yagi and Toyama's statement.

The analysis of the weakness in Japan's banking sector is interesting. However, the message that comes out of the analysis is not clear. First, the staff notes the intensification of global concerns over financial stability in Japan, and convincingly presents transmission channels for a possible Japan fallout. Then the staff concludes that "any potential fallout on the region and global financial system seems manageable," in view of the fact that economic fundamentals have improved in many emerging Asian economies, and also that foreign investors and financial institutions have reduced their exposures to the Japanese financial system. However, in the last paragraph of page 19, the message that comes out is confusing, as the staff seems to imply that important risks remain. Could the staff clarify its position on this issue?

Related to the above is the impact on exchange rate markets. While the paper describes recent developments, it does not draw any conclusion for future prospects, on the different scenarios that could come about owing to developments in other markets. Given the importance of exchange rate developments in our Surveillance exercise, I would have liked to see some analysis regarding implications for the major currencies. Perhaps, the staff could address this issue in the future.

I welcome the analysis on the financial market activities of insurance and reinsurance sectors. As companies in these sectors have become major players in the financial markets, issues raised in the report regarding their operations have to be addressed effectively, including the lack of information on important aspects of the regulatory framework under which insurance and reinsurance companies operate, and the evaluation of their solvency and capital adequacy, relative to their financial and insurance risks. Recent developments in financial markets have shown that market discipline alone, without appropriate and well-enforced supervisory and regulatory frameworks is not enough to prompt "healthy" behaviors in corporate governance, risk taking, and transparency. I therefore support efforts underway by the Association of Insurance Supervisors, and by the EU through it "Solvency" Directives to strengthen solvency requirements for insurance and reinsurance. I hope that increased attention will continue to be devoted to these sectors, with the aim of providing policy makers with needed tools to be proactive and prevent crisis.

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

Recovery of corporate profitability is the key risk to financial stability and it is important for the report to look further into the factors driving it.

It is crucial for the Fund to make the various elements of its multilateral surveillance functions fit together; the report could have been enhanced by more focused macroeconomic analysis.

While stability is consolidated in mature markets, there are growing concerns about commercial profitability and orderly adjustment in international capital flows.

A more stable macroeconomic environment is necessary to improve performance in emerging markets.

Financial reinsurance could reduce the transparency of the financial accounts of insurance companies.

We are grateful to the staff for its work on the second issue of The Global Financial Stability Report (GFSR) which gives a good overview of developments in mature and emerging markets over the past quarter and identifies potential systemic weaknesses that could give rise to crisis. This is a key component of the Managing Director's repeated call for intensified vigilance in anticipating and managing vulnerability in the global economy.

What then, were the important messages we should take from the report? Are there other concerns that should make us worry because we failed to pick up the signals?

The recovery of corporate profitability is identified as the key risk to financial stability. In fact, it was considered to be the main common theme shaping the major issues in the present report. The lack of it accounts for the lack of capital expenditure, which is identified as the missing component in the ongoing recovery. The decline in corporate profitability has weakened the balance sheets of banks and insurance companies. Finally, sharp changes in the expectations of corporate profitability also have the potential to precipitate disorderly adjustment of international capital flows and cause potential risk to overall financial stability.

The report could have perhaps benefited from looking further into the factors driving corporate profitability in the period ahead and how these relate to the way we expect the global economy to move forward.

One of the key risks to continued economic expansion at the end of the 1990's identified by several commentators was the sustainability of productivity growth. Among other things, ongoing productivity growth was thought to be the key to sustaining expectations for corporate earnings growth and therefore robust equity prices. One of the unusual aspects of the current U.S. economic cycle is the maintenance of high ongoing productivity growth. Yet, even with ongoing productivity growth, corporate profitability has slowed sharply.

Elsewhere, high equity valuations are weighing down mature markets and private debt levels continue to be high. Does the answer involve significant lags between economic recovery and financial recovery? Does financial recovery require a critical mass of economic growth to drive balance sheets from red to black? In sum, if the lack of capital expenditure is the missing element in economic recovery, what is the missing element in the recovery of corporate profitability?

In this context, we wish to raise the same issue covered in the recent work program discussion; that is, how to make the elements of the Fund's multilateral surveillance fit together better. While we realize this report comes from a capital markets perspective, in our view it would greatly enhance our understanding of these issues if the market-based analysis were coupled with a more organized and focused regular macroeconomic analysis, such as savings-investment imbalances, international investment positions, etc. Additional focus on the macroeconomic aspects of financial markets would differentiate the report from investment banks' regular flagship publications on global markets.

While it is true that the recent economic recovery has helped consolidate stability in financial market conditions, more recent developments highlight concerns about ongoing commercial profitability and the early signs of orderly adjustment in international capital flows.

The box on the shrinking U.S. commercial paper market was particularly interesting. It is a potential source of vulnerability in the banking sector as a number of commercial paper issuers have begun to access standby liquidity credit lines with banks as a substitute. The analysis points out this risk factor. It would be particularly interesting to see a deeper analysis of the prevalence and the size of these contracts and their potential effect on banks' liquidity position in case of a further decrease in demand in the commercial paper market.

The report notes that the fall-out from potential financial market instability in Japan seems manageable. Insignificant impact is now expected from the repatriation of Japanese assets in view of Japan's reduced international exposure. While we agree with this statement, we consider that further reform of the Japanese banking sector would have additional benefits for emerging markets and, in particular, the East-Asian region. While the report is comprehensive, we would also note that the elements of its analysis present a static picture of how financial difficulties would affect the international system. In reality, situations of financial crises are dynamic, with expectations and feedback effects that are generally difficult to anticipate and model. These two factors give added emphasis to the need for timely financial and corporate sector reform in Japan.

This section highlights the overwhelming influence of financial crisis on emerging equity markets in the second half of the 1990s.

In this regard, a more stable macroeconomic environment should go a long way to improving performance in these markets. Aside from this predominant factor, there are probably more similarities than differences between the challenges faced in emerging equity markets and those equity markets outside larger financial centers around the world. The phenomena of market de-issuance, increased reliance on offshore listing, the dominance of indices by several companies or sectors, and low liquidity, are typical of smaller equity markets and related to international consolidation of equity markets. Local efforts in emerging markets to increase activity by improving transparency and governance, while welcome, may find it difficult to offset these wider trends.

We agree that it is important to develop the local capital market. It will be useful if the report in a box were to show us how this is going to be pursued. In the first instance, there were warranted concerns about the quality of corporate balance sheets given the still-weak financial and corporate profitability.

The development of strong and viable equity and bond markets will be dependent on getting the basic infrastructure in place. For example, the successful development of local equities and bond markets rests on a number of factors such as an effective legal framework, reliable accounting and disclosure rules, and efficient and reliable clearing and settlement rules. In addition, the emerging markets' ability to strengthen their banking systems is important.

We would be interested to know whether the staff intends to examine the level of corporate and financial infrastructure in emerging markets, and the ability to establish such infrastructure, in looking at the main policy issues associated with the development of local securities markets.

Overall, we think the issues raised in the paper are interesting and timely. Recent experience seems to suggest that a key issue in this area is the role that financial reinsurance can play in reducing the transparency of the published accounts of insurance companies. This reflects lessons learnt from the failure of HIH, whereby financial reinsurance contracts entered into by the insurer were subsequently found to have had a material impact on its reported results.

The section dealing with the appropriate level of oversight and market disciplines focuses predominantly on questions regarding whether the amount of capital reflects the underlying risk. However, the key issue often relates to whether the underlying risk is being measured accurately.

We suggest that further work is needed within the appropriate bodies in order to understand the extent to which derivatives are used by insurance companies for hedging risks over a longer horizon versus short-term trading activity. This will affect the appropriate risk management systems and may explain why these are not always as sophisticated as those of the banks.

Mr. Wang and Mr. Jin submitted the following statement:

At the outset, we would like to express our appreciation to the Director of the International Capital Markets Department and the staff for their diligent work in preparing the well-written and insightful report, demonstrating the Fund's increasing commitment to monitoring the wide-ranging global financial stability issues. I will make some focused comments in the order presented in the report.

In the mature market several issues deserve special attention. One is the seeming overvaluation in the major equity markets and the associated risk of a price correction owing to earnings disappointments. As the overvaluation has been an issue over the past few years, it would be more informative to learn whether the overvaluation will be corrected or continue in the forthcoming months

The second is the possible impact of the disorderly withdrawal of Japanese banks' loans from abroad. Although the total magnitude of the possible withdrawal seems limited from the global point of view, we do not have information on the country composition of these outstanding loans. If some small countries are overexposed to Japanese banks' loans, a disorderly withdrawal may also hurt the macroeconomic stability of these countries.

The third issue is how to understand the reasons behind the unexpected strengthening of the Japanese yen. As the report mentions, the markets were near unanimous at the start of the year that the yen would weaken significantly, especially as the authorities of the Euro area, Japan and the United States seemed ready to permit this. However, the report fails to further explore the reasons behind these inaccurate judgments. The staff's comments are welcome.

In the emerging market section, the staff points to some important phenomena. It is noteworthy that since 1997 the spreads in some emerging market economies have kept widening (Table 2.5). This reveals investors' concern about the fragility in relevant emerging markets and deserves the Fund's special attention.

It is also interesting that the Argentine default continues to have a negative impact on the receptiveness of euro- and yen-based investors to new issuance from Latin American borrowers. This has highlighted the vulnerability of Latin American issuers to any abrupt market closure in the dollar segment.

It is not clear why the euro and yen creditors are reluctant to lend to Latin American borrowers while U.S. creditors are more willing to do so. Do they perceive a different risk and benefit trade off? Or does the latter have greater interests at stake? The staff's comments are welcome.

It is informative to learn from the report that the "combined ratio" of non-life insurers in most countries is above 100, implying that on a cash-flow basis and excluding investment returns, insurance underwriting is loss making (see last paragraph in Page 38). It would be more informative if we can learn the "combined ratio" of life insurance. To our understanding, although the high combined ratios illustrate the risks involved in the insurance companies and the potential to become more efficient, it may nevertheless be the beauty of today's insurance business. It shows that insurance clients could not only benefit from pooling their resources to cover unexpected individual risk, but could also benefit from insurance companies' asset management in the global financial market. Therefore, a negative underwriting result (Table 3.2) may not necessarily indicate a worrying scenario, while a positive underwriting result may not guarantee a success story.

The report indicates that during the 1990s, insurers' more active asset portfolios management was in "response" to an environment of lower real premium growth (third paragraph on page 46). It is true that insurers in the euro area, the United Kingdom and the United States increased their investment in corporate equities; it is also important to note that Japanese insurers cut their investment in high-risk equity and loans (Figure 3.6-3.7). It is unclear whether this difference in portfolio management has been linked to the different performance of equity markets in the above regions. However, it may be more reasonable to argue that insurers' portfolio management and equity market performance are mutually enhancing. A bullish equity market may attract insurers to allocate more assets into equities, while a bearish equity market may discourage insurers from reducing their holdings of low-risk assets. It is still early to assume the insurers in the euro area, the United Kingdom, and the US will continue their increased holdings in equities if the equity markets in the three regions become bearish in the following decade.

Given the mutually enhancing nature of the relationship between the insurers and the equity price, the inverse portfolio adjustment of the insurers may generate significant impact on the global equity market.

By examining the performance of the emerging equity markets over the past decade, this chapter makes several important observations that could be very helpful for policymakers and investors both at home and abroad.

The analysis could be further advanced in several aspects. One possible direction is to distinguish between open and closed emerging equity markets. In fact, most of the analysis has been made from international fund managers' point of view, and only those open markets are relevant to this kind of analysis. However, on a few occasions, some relatively closed markets have been included in analysis without proper distinction and generated inappropriate conclusion. For example, the recent pick-up in some open emerging equity markets, especially in Asia, may be associated with attractive valuations, but the depressed equity market in China is less likely to be subject to the influence of international capital flow. In our view, the recent performance of China's equity market is mainly influenced by domestic factors.

There seem to be some missing parts in the discussion of domestic equity as an alternative source of funding. We are interested in the following question: should equity market financing gradually grow and dominate bank lending in the long run? What are the advantages and disadvantages of direct financing on emerging markets? The distinction between a closed versus open emerging equity market is also important in this section. The emerging equity market almost always starts from a closed one and gradually opens to international capital flow at a later stage. The initial function of the emerging equity market is mainly not to absorb foreign capital inflow, but rather to develop direct domestic financing for the corporate sector as an alternative to domestic indirect financing. Therefore, emerging equity markets may have dual functions—internal versus external functions. However, the external function could be secondary and only emerges when it becomes necessary and feasible. Therefore, we may further conclude that if the domestic market function has not been fully developed or the number of qualified domestic companies is limited, the over-rapid expansion of ADRs or premature capital market liberalization will become a problem for the emerging market.

Mr. Andersen and Mr. Törnqvist submitted the following statement:

We find the second Global Financial Stability Report quite informative and we look forward to increased complementarity between the GFSR and the WEO, which would strengthen Fund surveillance. In addition to current market developments, the Report provides useful assessments of several new topics, some of which will be further addressed in later issues. We welcome that the second report is more balanced in its coverage of countries and country groups than the first one. We note that the report is mainly of a descriptive nature and does not draw many policy conclusions. It would have been helpful if the report had been more explicit in the latter respect. We endorse the main conclusion of this report that financial market conditions have improved and that the near term outlook is mostly stable. We would like to make the following points.

The report indicates that interest rates are likely to rise in the third and fourth quarters. We hope that continued low inflation in the United States will allow the current accommodative stance to be unwound gradually. Rapid interest rate hikes could depress already weak equity markets further. In addition, a rapid rise in interest rates would be likely to slow down FDI to emerging markets and create a flight to quality.

Like Messrs. Padoan and Lombardy, we would have liked to see a more detailed assessment of the outlook for the U.S. dollar. We concur with their comments on profit expectations. The increased uncertainty in this respect are likely to have increased the focus on other weaknesses in the U.S. economy, in particular the large current account deficit and the weakening of government finances. Against this background, we are very much looking forward to the forthcoming analysis of the potential consequences for financial markets of a significant rebalancing of global capital flows and in particular the policy implications of such an event.

We appreciate that the staff has responded to the call of the Executive Board to look more deeply at Japan. The results of the analysis are encouraging to the extent that potential international fallout from Japanese financial instability appears to be manageable. Nevertheless, it is of course a cause for concern when the world's second largest economy has been underperforming for a decade. In addition to the negative impact on the world economy and in particular on Asia, a side effect appears to be that the Japanese financial system is becoming increasingly isolated from the rest of the world. We look forward to the result of the FSAP and hope that it will help Japan in its urgent task to address fully the problems it its financial system

Emerging equity markets have been performing well in the first quarter of 2002, especially in Asia. Although the past good performance in periods of economic recovery and monetary tightening is an important indicator, further development of emerging equity markets will not necessarily follow past trends. It is clear that financial crises and concerns about corporate transparency and governance have had a negative impact on these markets. It demonstrates that Fund policies at the macro level that aim to prevent or mitigate financial crises can make a significant contribution toward increased efficiency and strength of emerging equity markets. We agree that the development of local securities markets should be encouraged, as they can be an important source of capital, especially for small businesses. Local securities markets would also promote a more balanced mix between foreign and domestic savings. Integration of regional capital markets should also be encouraged, as that will increase market efficiency and intermediation. Internationalization of equity markets should not be seen as an obstacle to local market developments but rather as a complement.

A potential source of instability according to the report is the level of corporate profitability in mature markets. This has implications, inter alia, for the profitability of U.S. banks. If the level and quality of corporate earnings do not improve, a major correction of equity prices could occur, which could jeopardize the recovery of the U.S. economy and weaken the situation of U.S. banks further. Continued market reforms and keeping the momentum in promoting better corporate governance and transparency are therefore very important. On the other hand, we wonder if the high valuations of mature equity markets might be explained by structural breaks in the P/E ratios that are not captured in the historical means. The development of the global financial markets has, for example, led to lower transaction costs and increased diversification both of which will affect the P/E ratios. Therefore, the overvaluation of mature equity markets might not be quite as large as it looks in a historical perspective. The staff's comments would be welcome. Although we can agree with the analysis of the potential effects on financial stability we would like to point out that a correction of equity prices could force companies to rationalize their operations to increase efficiency and augment their profit which would in turn increase equity value. Moreover, an unrealistic level of corporate profit can be a sign of market inefficiencies and lack of competition that needs to be addressed.

The report highlights that the relative magnitude of insurance companies and reinsurance companies in the financial markets has been growing. Less is known about the financial activities of these entities than that of commercial and investment banks. We welcome the attempts to identify issues that may have medium-term implications for financial stability and/or efficiency in this sector. It is encouraging to note that the study finds that systemic risks associated with the sector are relatively limited in comparison with the banking sector, although there seems to be some inconsistency between the introductory part of the report, where insurance companies are seen as a source of potential vulnerability for global financial markets, and the less critical tone in the concluding discussion in the chapter on insurance and reinsurance. At the same time, the report, in our view, takes an overly negative approach to the financial market activity of insurance companies. For instance, the report fails to mention that the increased security market participation of insurers has replaced their direct loan operations to a considerable extent. The net effect of this may well have been to reduce overall financial stability risks. Furthermore, regulations with a focus on the solvency of insurance claims to a large extent will give sufficient guidelines for asset allocation. Nevertheless, there are gaps in our understanding of potential risks associated with the sector and it seems that further study is warranted, especially on the size, extent, and nature of reinsurance cover and the potential for a critical mass failure of major reinsurers. The discussion concerning the capital quality of Japanese insurance companies could have been more exhaustive, especially regarding the treatment of deferred tax credits and next year's income. This discussion of insurance companies prompts the thought that it might be useful to examine pension funds in mature markets from the point of view of financial stability.

The report also states that the decoupling of Argentina from the rest of emerging market sovereign credits continued in the first quarter, but it warns of a renewed bout of contagion if conditions in Argentina deteriorate and the currency goes into a free fall. Such a development would negatively affect trading partners and sour international investor sentiments to emerging market assets. Needless to say, this prospect underlines the importance of adopting a coherent economic policy in Argentina. The fact that markets to an increasing extent distinguish between countries in the form of relatively low interest margins on countries with good policies should demonstrate to the Argentine authorities the potential benefits of achieving consensus about a strong and sustainable set of policies.

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

We thank the staff for this second issue of the Global Financial Stability Report. By identifying recent trends in financial markets and potential systemic weaknesses, this work can increasingly contribute to the exercise of active multilateral surveillance and to improving the quality of policy responses. We share the main thrust of the analysis–including the discussion on international systemic risks associated with insurance companies and the examination of factors determining events in emerging equity markets. Our comments relate to several aspects that, in our opinion, require special emphasis.

Notwithstanding the absence of imminent threats to global stability noted in the report, the emerging bond markets vulnerability and the still declining financing flows to emerging markets point to the significant risks of perpetuating a low growth scenario for these economies, with significant consequences for the projected global recovery scenario. In this regard, we still miss an analysis based on net flows, to provide a more accurate assessment of financial resources flowing into emerging markets, which are key for the recovery of domestic demand and hence growth in open economies.

According to the report, one of the main messages to be drawn from the present quarterly review is the improvement in financial market conditions linked to the recovery that started in the first quarter of 2002. Nevertheless, the global slowdown -albeit softer than previously anticipated- coupled with a deteriorated level of corporate profitability in mature financial centers have exerted a painful blow to emerging market economies in general, that remain highly vulnerable to sudden changes in capital flows. The global recovery scenario includes a significant acceleration next year of growth in developing countries in general and emerging market countries in particular. However, in our view, this scenario is unlikely to materialize without a rebound in net financing flows to emerging markets, lest the risk of contagion of crisis to other developing countries, more realistically defined than in the report, increase significantly.

The intensive use of ADRs and the migration of the listings of top-quality emerging market corporate to major mature market financial centers, cited by the staff on page 70, describes the low liquidity with which emerging equity markets are functioning today. In this regard, there is a need for expounding on the role of FDI in developing countries, as well as its role in crisis countries and the future prospects of FDI as a source of external financing. The form and characteristics of foreign investment tie into the necessary development of local capital markets in emerging market economies, a task that in some emerging countries is already over a decade old. In this regard, it would also be desirable to analyze the role and prospects of pension fund systems based on capitalization of individual accounts, as a pillar for the development of local capital markets.

Uncertainties around a possible equity price correction in mature capital markets and the volatility among major currencies also threaten the potential recovery in emerging markets. As described in Box 2.2, market equity valuations in the United States and Germany are high relative to historical averages. The risk of a price correction, given overvalued global equities, and amid high volatility in mature countries' currencies, entails the potential for generating systemic financial market instability. Box 2.5 clearly underlines the sensitivity of returns on emerging markets to sudden variations in the market risk premiums in mature markets. In this connection, given the possibility that credit events may spread across institutions and markets at a time when corporate defaults are at record levels, efforts to support growth should be consistent and widespread among all the major economies, and not just in the United States.

Dubious accounting practices and higher risks associated with highly leveraged firms—in the wake of the collapse of Enron—are evolving as major events in international financial markets. These risks are being propagated throughout globalized markets thereby undermining the confidence in institutions that are allegedly well supervised and observing best practices and standards. The Enron event, highlighted in Box 2.1, raised different concerns regarding the effectiveness of one of the main pillars of the proposed Basel II banking supervision accord based on greater transparency and associated private market discipline.

The Enron event, still unfolding, has also triggered uncertainty regarding of aversion for corporate credit risk, thus inducing wider spreads during much of the quarter. Effective corporate governance and enhanced financial disclosure, among other issues, highlight the need for an appropriate regulatory framework including adequate accounting, clear audit rules, standards and codes and effective supervision of over-the-counter derivatives. Keeping in mind the existence arbitrage conditions and the extensive use of credit risk instruments, this event highlights the unfinished task of adapting standards and codes worldwide—and not exclusively geared to addressing emerging market concerns.

In this setting, growth in most emerging markets is expected to remain low during the second half of the present year, most especially in Latin America. Although growth projections improve markedly for 2003, deteriorating external financing conditions in developing countries, continue to impose severe restrictions on their demand policies.

While financial markets have priced in a recovery in economic activity and in corporate earnings during 2002, the underlying banking and financial conditions, in terms of credit quality and balance sheets of households, corporations and financial institutions are exhibiting prospects of uncertainty. The staff report provides a worrying picture of the risks related to the spillover effects of corporate financial performance on the banking sector with poor revenues, credit provisions and a slow pace of cost reduction in wholesale banking. As the staff has adequately highlighted, these developments reduced net banking flows to emerging market countries.

The deterioration of corporate and financial sector balance sheets in Japan—in the wake of the persistent failure to rekindle aggregate demand—is rightly noteworthy in connection with potential financial-market spillovers, given the interlinkages between the second largest economy in the world and international financial markets. The analysis on Japanese risks seems to omit the linkages and spillover effects from balance sheet deterioration to the insurance companies. The latter, when worked through, might be significant. The staff may wish to comment further on the potential impact arising from this and other potential Japan fallout on the global economy

Data provided on corporate and bank restructuring in Japan shows that it has been insufficient to cope with bad debt. Keeping in mind that the Japanese economy has been a sustained source of external savings for many countries in recent years, we see merit in closely monitoring the changing attitudes of Japanese investors, and possible currency effects. The spillover effects associated with exchange rate volatility should not be downplayed in as much as events in this area could be directly transmitted into emerging markets. In particular, from a regional perspective, an uncontrolled weakening of the yen could deeply affect some of its main trading partners.

Currency turmoil, during the contractionary phase of the cycle, could impose further damage on emerging market economies. Sharp movements of the exchange rate could entail the need for additional external financing to cope with the adverse fiscal impact stemming from public debt denominated in foreign currency. In addition, currency mismatches may also weaken the balance sheet of corporations and the financial system. The availability of official external financing during cyclical contractions could help to alleviate pressures and give needed additional flexibility to emerging market policies. In this sense, tackling the trade-off between maturity and currency mismatches points to the advantages for the private sector of developing local capital markets an access to international markets, including medium- and long-term financial instruments in emerging market currencies.

The spillover effect of the Argentine crisis referred to in several passages of the document is very much a definitional issue. More specifically, the measure of contagion used in page 23 involves a narrow definition of the impact of the Argentine crisis without considering the real economy channels and other financial risks effects including in the equity and foreign exchange markets and on the size and composition of financing flows.

It is clear that several emerging economies need adequate financial and technical support from the international community, most especially from the Fund, to overcome financial and real sector fragilities in the aftermath of the Argentine event. The amount of official assistance should be increased accordingly. As importantly, mere financial assistance will not be enough for these countries to fulfill their development objectives unless it is complemented by enhanced access to developed countries´ markets and a more level playing field including in the areas of price support and farm subsidies and other non-trade barriers.

The analysis in Chapter IV on Emerging Equity Markets, eloquently points to the considerable costs for the countries directly affected by systemic crises and other spillover effects when markets and policy instruments are not readily available. In this regard, comprehensive assessments of debt sustainability and the balance sheet approach for resolving financial crises should be seen as a priority in order to define the conditions for the access to Fund resources for member countries facing financial crises. The latter is a critical exercise, which requires realism to create the conditions for the recovery of confidence. The pro-cyclical nature of the behavior of capital markets underscore the importance of advancing options which preserve adequate and timely access to Fund resources.

Finally, the poor performance of local emerging market equities over the last decade, and the limited diversification benefits associated to this asset class, have been the result of recurrent and severe financial crises during the second half of the 1990s, that culminated in sharp real depreciations and contractions of economic activity. This performance has profoundly altered the global investor base for emerging market equities. However, the issues of the past do not by themselves determine the future. The lessons learned by all, policymakers in the affected countries and in the large systemic economies, and the international financial institutions should all help to put together a renewed international framework to adequately cope with this enhanced vulnerability to crisis.

Mr. Cippà submitted the following statement:

Like other Directors, I welcome this second issue of the Global Financial Stability Report, which displays a number of steps in the right direction. The single chapters are more closely integrated under a common theme, and the report has been streamlined. I still see some room, however, for further focusing the central messages and working out recommendations.

The report thoroughly presents current challenges to the financial markets and the relevant vulnerabilities. Although the staff sees largely no imminent threats to global financial stability in the near term, some of the mentioned vulnerabilities pose significant risks: a prospective correction of the apparent overvaluation of mature equity markets and the U.S. dollar, growing pressure on the banking sectors, increased crossover inflows into emerging bond markets, a greater vulnerability of Latin America owing to a further deepening of the crisis in Argentina, weak regional growth prospects, and increased political uncertainties.

As highlighted by the staff, major market equity valuations still appear to be high by historical standards. At the same time, uncertainties that financial markets are facing have recently increased (concerns about corporate profits, new accounting regulations, threat of further terrorism, tensions in the Middle East). Against this background, a significant rebalancing of global capital flows is a potential risk. The recent weakening of the U.S. dollar against the major currencies seems to suggest that the dollar has peaked. This weakening is all the more remarkable as it occurs during a period of heightened political uncertainty, which usually tends to strengthen the dollar. The two important questions are, of course, how fast the U.S. dollar would adjust, and toward which assets capital flows would be redirected.

Another and maybe even more worrying development is the apparent rising pressure on the mature banking sectors, particularly in the United States. Following the economic downturn and the bursting of the high tech bubble, banks are already suffering from high outstanding loans to weak creditors, and the recent activation of backup credit lines has further increased this exposure. Increasing pressure could also tempt some institutions to take greater risks. The fact that banks are increasingly hedging their exposures in the derivatives markets bears additional dangers, as the distribution of risks becomes less traceable. In this context, the high concentration of risk in the two U.S. government-sponsored institutions, Fannie Mae and Freddie Mac, and their high derivative counterparty risk exposures in particular, seems to deserve special attention.

Regarding Japan, risks of financial spillovers from the banking sector have already been discussed on earlier occasions. The staff suggests that any potential fallout on the regional and global financial system would be manageable. I am a little bit more cautious. The forthcoming FSAP will help to improve information and make the situation more transparent.

Regarding developments in the emerging financial markets, the renewed interest of crossover investors has facilitated access to international capital markets, but it also increased vulnerability to abrupt corrections. An indication of a possible downside risk is that, according to figure 2.2., risk appetite may have reached a turning point, where risk aversion is going to increase again. Additionally, vulnerabilities seem to have increased in Latin America. With poor figures for industrial production and exports during the first quarter, a further deepening of the crisis in Argentina, recent contagion to Uruguay, as well as higher political uncertainties in a number of other countries, the outlook seems to have worsened.

As to emerging equity markets, the regression analysis provided in box 2.5 displays some surprising results, in particular, the low impact of changes in commodity prices on returns. Although the coefficient for the 'terms of trade' risk is found to be "statistically" significant, as highlighted by the staff, the value of the coefficient is practically zero, indicating that the impact of this variable is in fact (economically) insignificant. The main result from this analysis seems to be that the impact of 'market timing' risk dominates all other risk factors.

Concerning the growing financial market activities of insurance and reinsurance companies, I agree with the staff that transparency needs to be increased, and I thus welcome the respective chapter in the report. The conclusion of the staff, at least at this stage of the analysis, seems to be that the main risk for international financial markets arises from counterparty risk. This would bring the burden mainly back to the banking sector and its credit risk management. A different question is, however, how financial market turmoil would affect the insurance sector, given their increasing exposure to credit risks.

The section on emerging equity markets lists the relevant problems. An additional issue for discussion, however, would be the possible dilemma that emerging markets face when they do reform and become more liquid, as they might experience increased volatility and contagion effects as a result. Past experience has shown that highly-liquid markets are the first to experience sell offs in times of crises. At least, this seems to have happened to Hungary and Brazil in the wake of the Russian crisis in 1998, and it also seems to mirror the experience of the South African market, which repeatedly comes under pressure in times of crises.

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

I found this to be a very good report, and would like to compliment the staff for its efforts. It is, of course, still a process in development, but it is converging toward a really good product, and I am very pleased that we have it.

Several suggestions have been made by colleagues concerning the format. My personal preference is for perhaps a somewhat more elaborate overview in the document with a somewhat less descriptive content on recent developments, followed by one or two special chapters. It is fine that the report is quite an elaborate document, but not overly elaborate as it is possible to get through it in one day, and this is important.

There was also the question coming up in statements from colleagues on how forward looking and how policy oriented this document should be, and personally I think the balance was struck correctly. Some colleagues were a little less positive about this, but I do see something of a problem in the sense that if we go much further by way of, say, providing projections of stock market developments, we will become involved a little too much in the business of the private sector, and this is, after all, going to be a published report, so there are limits to what we can do. I do think that we should benefit as a Board from the views of the staff as to where it thinks things are going, which is very important, but there is perhaps more scope for really getting very candid views on this in the soon to be expanded world economic and market developments (WEMD) informal sessions. Therefore, it is good that the staff comes out with clear views, but I can imagine that we are not going to do what markets do in the sense of saying, well, we think stock markets are going to do this, we think currency rates are going to do that, and so on. However, let us bring out particularly the risks and let the reader draw conclusions from that. That would be my feeling.

At the same time, I would warn against trying to edit out too much from the content of this good report, and here I would just mention that there is a suggestion that comes from Mr. Varela and Mr. Beauregard to be very careful on what we say about the potential for new contagion coming from Argentina. This is a reference to a paragraph on page 23 where the staff mentions the decoupling of Argentina from the rest of the emerging market sovereign credits, and shows that according to the measure used by the staff that there is a very low risk of contagion, which is very useful. However, the staff then goes on, on the other hand—as one should do in this institution—to say that there is potential for a renewed bout of contagion, and I thought the staff's approach was correct. I also noticed that Mr. Portugal highlighted the risks of contagion, and so there are some different views, but frankly I think the staff got this one very right and should not exaggerate in either direction, and I agree with this approach.

I do agree with those who said that perhaps a little more could have been said about the situation with regard to major currencies, and of course, we are particularly thinking about the dollar, and the dollar vis-à-vis the euro and the yen, and you cannot cover everything in every report, and I understand this. However, perhaps next time somewhat more in-depth analysis would be useful so that we can look at some of the possible consequences if there is not a gradual wind down of the dollar, assuming, of course, that what we are seeing at present does signify a beginning of a process of reducing some of the overvaluation of the dollar. Unfortunately, this process comes a little too late to counteract some of the protectionist tendencies that we have seen, but I think it is important that we do have a look at the possible ramifications of a possible faster fall in the dollar exchange rate.

Finally, maybe a word on emerging markets. This is always one of the richest parts of this document and is extremely helpful. I was struck by one thing, and that is that we see quite a buoyancy in the first quarter in terms of issues of bonds by a number of emerging market players; surprisingly buoyant I would almost say. This is in contrast with what is happening in the syndicated markets where banks are still pulling back, and it is a rather striking contrast. Does the staff consider this an overreaction by the banks? However, all in all, I think we are talking about a very good and potentially quite successful product.

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

I would like to thank Directors for their interest and the constructive comments on the content and on the direction of this report going ahead. My team and I all appreciate that, and of course, by definition we appreciate also your favorable comments and your support in this. We also received after the first report positive feedback from capitals and from market practitioners, but we also received suggestions that we want to take on board going forward, and of course we want to take on board as many suggestions that we possibly can from the 15 statements that we received yesterday.

Let me organize my introductory remarks as follows. First, I would like to address some of the more general remarks that were raised in the statements about the format of the report, and then I would like to provide an update on the most recent developments in financial markets, which could, because of the cutoff date, not be fully captured in the report. Then I would like to make a few more remarks on related issues. Third, I would like to address issues and questions raised regarding the Japan section and the insurance sector. Lastly, I would suggest that some of the technical questions could be referred to my colleagues.

Turning to the first issue, the way that I see it is that there were largely four types of remarks as to the general format. One is that the report should be more forward looking in its assessment of risks and vulnerabilities, and Mr. Wijnholds a moment ago referred to some of those remarks. Second, some Directors said that there should be perhaps more policy implications and policy recommendations regarding national policy and regulation in financial markets, and that those should be spelled out more clearly and concisely. Third, some Directors suggested that perhaps more coordination should be done with the World Economic Outlook. Fourth, and Mr. Wijnholds alluded to that also a moment ago, that there should be more comments on the U.S. dollar exchange rate and global imbalances.

Regarding the issue of being more forward looking, we are trying hard already now to be as forward looking as we possibly can. For example, with regard to the insurance chapter, we did in a way look ahead and try to see what is happening in the insurance sector in order to understand this trend of insurance companies engaging in nontraditional business, such as financial markets business. In addition, with regard to the situation in Japan, we looked at potential ramifications going forward for the international system. Lastly, the profitability theme, which is the main theme of the report, is also forward looking.

As Mr. Wijnholds was saying, however, there are serious limitations to how much further we can take that. By definition, any remarks about the future are, to some degree, speculative, and in an institution such as the Fund the individuals engaging in this exercise have to be cautious about their credibility. However, at the same time when we look at potential fault lines and vulnerabilities and make our views public, we do not want to be sounding too alarmist and do not want to trigger possibly adverse events by doing so. Therefore, we will always try to find the right balance, but unlike investment banking research we should not make forecasts as to financial markets, how they will develop, and how asset prices may develop in order to preserve the integrity of the report.

Using a forward-looking approach with regard to financial markets may be slightly even more difficult than using a similar approach with regard to the real economy. A commonly used metaphor is that financial markets are a derivative of the underlying real economy. As such, like a derivative, the vagaries and the volatility of financial markets owing to expectations about the real economy may be more pronounced than in the real economy, and changes may take place therefore more abruptly. Therefore, I am a bit wary to enter too much into the forecasting business.

As to the issue of policy recommendations, we shall do what we possibly can and maybe we have been a bit implicit at times and a bit cautious at times in order not to go stomping forward too quickly. However, in the insurance chapter there are some explicit recommendations, and I will come back to that in a moment when I tackle some of the issues that were raised with regard to that chapter. However, one has to bear in mind that the addressees of any policy recommendations are by definition national authorities, and therefore we have been a bit careful with such a new report in not being too forceful in addressing these issues. In addition, there is another issue that we must be aware of if one wants to make any recommendations: that the addressees can be reached either through this report or they can be reached through other discussions that the Fund is having, such as the Article IV consultation process and the Financial Sector Assessment Program (FSAP), and that there are choices to be made from time to time in this respect. Thus, for a number of countries and a number of issues, my colleagues and I may have strong feelings and may have recommendations for national authorities, and in the case of Japan we do have a view. However, this view will be embedded in the upcoming Article IV and the FSAP discussions. By the way, sometimes in some of the aberrations that one may find in financial markets, the self-correcting forces of markets may take care of those aberrations without necessarily requiring any policies changing.

The third point raised by several Directors in their statements and also in the discussion on the Work Program last week was a request for more complementarity between this report and the World Economic Outlook. I can report to you that yesterday there was a preparatory meeting between the Research Department and the International Capital Markets Department on the next issue of the WEO and the next issue of the GFSR, in particular with regard to how financial imbalances and some of the other issues that have been raised are going to be addressed. The ongoing work on the WEO is also one of the reasons why this report yet again refrained from including too much macroeconomic background, although some Directors had suggested that there should be more. The next WEO and GFSR will address the issue of external financial imbalances and by definition the exchange rate issues associated with it, but it will have to be done after a thorough analysis, and it will have to be done in depth. This is why we felt that we should not be rushing into this exercise this time around. My view on the dollar rate and the forces behind the dollar rate have been expressed around this table in the context of an earlier WEMD sessions.

Those were my general remarks, and I would now like to turn to the general points raised in the statements. I will concentrate and focus on two issues in updating you on recent developments in financial markets. In the mature markets there has been again some uncertainty as to the pace of the recovery of profitability in the United States and elsewhere. There have been downward revisions for 2002 for business investment growth forecasts, and this has also led to a worse than expected nonresidential fixed investment contraction in the first quarter. In addition, the two to five year outlook survey by businessmen—this is not economic numbers, but is a sentiment that can change, especially in the TMT sector—has not been very good either, and there are continued and widespread concerns as to the quality of corporate earnings in the United States. This is a theme that we picked up in the report, but over the last two or three weeks this has been confirmed. In addition, when I came into the office this morning I saw a new quarterly report by the Bank for International Settlements (BIS), and the BIS is even more forceful in its language than we are. There is a chapter in this report, which is available on its website, titled, "Profit warnings and accounting issues abort rally in equity markets."

The events that I was earlier referring to have translated probably to a modest decrease in the global appetite for U.S. assets at the moment, which can be associated to some degree with the recent bearishness on the U.S. dollar and some increased volatility in the markets. In fact, the monthly net portfolio inflows to the United States have thus far averaged less than a third of what they were averaging in 2001, and the composition of these inflows, as far as we know, and I want to be very cautious as to the data, has somewhat shifted away from foreign direct investment and from equities to other asset classes. The common set of risks posed by earning concerns, dollar bearishness, and possible growth disappointments combined with rising indicators of some speculative positions in the markets have caused an increased correlation between the stock market, the bond market, and the currency market in the United States. Having said that, despite the recent weakness of the dollar, there have not yet been really firm signs of a major rethinking by asset managers of their longer run positions and of their thoughts on the growth and productivity prospects of the United States compared to other major markets. As I said before, I am in the camp of those who think that productivity and growth differentials and expectations are by and large the major drivers of exchange rates, certainly amongst the major mature countries, and given that this is the case and that there have been no firm signs of any particular shift in that sentiment, I think there is still time to come back to this issue in late August and early September for the next issues of the WEO and the GFSR.

The other issue I would like to update you on regards emerging markets. There have been increasing concerns by investors as to Brazil and as to the presidential elections that are coming up later this year. As you all know undoubtedly, this has translated into a weakening of the Brazilian currency as well as its debt and equities. Brazil's debt structure as well as its high levels of dollar and dollar-linked public debt have led to a certain deterioration in the country's debt dynamics, which are further weighing on market sentiment. In addition, a number of other Latin American countries, probably by and large unrelated, have negatively affected market sentiment and have led to a widening of those spreads. This drop in investor preferences for Latin American assets has been accompanied by an increased preference for Asian and Central European assets. This kind of rotation has been away from Latin America and toward Asia and Central and Eastern Europe, in particular Russia. I do not want to bore you with the numbers on Brazil in particular, but let me just single out the fact that the currency has deteriorated by a little more than 8 percent and the Brazil EMBI+ spread has widened by about 250 basis points. The concerns are mostly political, and are not just related to one presidential candidate, but to some degree they also cover other candidates. The bottom line of all of this at the moment unfortunately is that the European market for Latin American debt, not just Brazilian debt, but Latin American debt more generally, and I should certainly exclude Mexico here, is more or less shut at the moment. Direct contagion from Brazil has so far been very limited, and it is more of a rotation at the moment.

With regard to Japan, several Directors have asked for clarification about the analysis of risks in Japan's financial system and the risk of international spillovers. We discussed the potential for spillovers from volatility in the Japanese financial system because this risk has been the subject of much discussion and debate in the financial community. The risk of a domestic crisis, in my view at least, is well contained in large measure because of the public resources that have been deployed by the Japanese authorities to stabilize the Japanese banking system. However, and this is the point that we made, it comes at a cost in fiscal terms and also potentially through the impact on the JGB market and in terms of policy considerations, and the only way to short-circuit this process would be through aggressive restructuring of the corporate sector.

Mr. Yagi raised a few Japan-related issues as to the prominence of short selling and what it and other policies have contributed to the recent uptick in the Japanese equities market. The way that the market sees it is that the prominence of the short-selling restrictions did lead to the February recovery of the stock market in Japan. However, going forward this recovery had been sustained mainly on improved economic news, particularly the focus on positive news, for example, on corporate profits, though a recent survey found that publicly traded companies as a whole experienced a loss for the first time in several decades. He also raised a few other issues, and I suggest that we deal with those bilaterally.

Mr. Padoan asked the question about whether investors are using the very low Japanese interest rates to fund investments outside Japan. The famous informal term for that, as you well know, is called the yen-carry trades, where one borrows in yen and then invests elsewhere. It is very difficult to assess the size of such operations precisely because we do not have sufficient data for that, but the assessment of my team and the market is that there is a seriously reduced leverage among hedge funds these days, and therefore I think there should be much less of those carry trades taking place today as opposed to the pre-1998 period—the pre-LTCM period, if you like—so I am not at this moment too concerned about it.

Coming to the insurance issues, Mr. Padoan asked for the staff's view about appropriate reforms in the supervisory framework for insurance companies. Well, this report does suggest that enhanced disclosure and transparency is needed regarding the financial activities of insurance and reinsurance companies because these are far less transparent, for instance, than banking and investment banking, and we think that this kind of information could be a first useful input to more detailed recommendations for supervisory reforms at some later stage. In fact, I do think that financial intermediaries, including insurance companies, at this moment in time are far too regulated depending on their status of being a bank, an investment bank, or an insurance company, for that matter. They should be, in my mind, more regulated in light of the business they do according to the old famous saying, "same business, same risks," and therefore there should be more or less the same or similar rules. Thus, an overhaul of insurance regulation may be needed ultimately to bring in line the insurance companies' financial activities with the regulation of other financial institutions in order to create a level playing field.

Mr. Varela, Mr. Yagi, and Mr. Wang suggested that broader and more detailed information on insurance companies should have been included in the report. There are two reasons why we chose to focus that chapter as we did. First, we wanted to respond to the Board's call for a short and focused report and not to add too many details to it. We have been able to supply a few more details, but we felt that it should be focused. However, at the same time—and as emphasized and criticized in the report, implicitly and explicitly—there is limited information about the financial market activities of insurance and reinsurance companies at this moment in time.

The other more technical issues about emerging market countries will be addressed by my colleagues after the next round of interventions.

Mr. Portugal made the following additional statement:

I would like to thank the Director of the International Capital Markets Department for the report. In fact, as I said in my statement, it is a very good report and does a very good job of presenting a lot of empirical evidence on equity, sovereign, corporate debt, and foreign exchange markets. It also highlights the important interlinkages. I agree with most of the things he said today and with the general remarks he made. With regard to one of my suggestions that perhaps we could have the policy implications spelled out more explicitly, I agree that both the insurance chapter and the chapter on emerging markets do have a concluding section where there are some implicit messages. Perhaps that could be more systematically presented and organized. However, as he said, we are still in the second report and experimenting with it, and I would like to recall that with the WEO it took quite a long time until we started really to have policy implications spelled out more fully.

I would also like to make a brief comment on the remarks that he made on Brazil and on the deterioration of some of the financial variables, especially spreads and the currency. We will have an opportunity later this month to discuss Brazil because the third review is coming up, but I agree with the Director of the International Capital Markets Department's interpretation that these market jitters that we are facing do not arise from the fundamentals or from economic policy itself. In fact, if you look just at the main policy and economic performance, they seem to be improving. Economic activity seems to be a little stronger than we initially predicted. Of course, we had in the first quarter a decline in GDP compared to the first quarter of 2001, because the first quarter of 2001 was very strong and GDP grew at that time by more than 4 percent. So there was a small 0.76 percent decline in first quarter GDP this year, but it was a much smaller decline than what was envisaged.

Inflation numbers came up just yesterday, and they confirm the reduction in inflation at consumer level prices, especially market-determined prices. Inflation really is basically being accounted by prices that are administered by contract, which are basically the fees of utilities that are increased according to contractual clauses and do not follow market developments.

On the fiscal side, we had released in April very good numbers. It was the largest primary surplus that we had, I think, in the last three years for the month of April, including in the component of state-owned enterprises, which had a good performance. Thus, the fundamentals and the numbers seem to be fine.

Of course, there is the interpretation of the political situation. In this area, my impression is that markets are, perhaps, overreacting a bit because there is one candidate who is well ahead, and who is the most leftist-oriented candidate, but this is more or less what happened in the three previous elections, where this candidate lost in the end. He has an electorate that is very ideological, so they decide very early for whom to vote. However, 60 percent of the Brazilian electorate is yet undecided. Therefore, I think the opinion polls so far really do not help too much because the campaign has not started yet. From July and August onward is when we are going to see results that are really more meaningful.

The Director of the International Capital Markets Department referred to the composition of the debt as a weakness. On this I am not so sure, because under financial instability I am not sure that one really can cope with it by a change in composition. Suppose that we had all our debt had a fixed interest rate, and we did not have any floating interest rate debt and no dollar-indexed debt. Then the government and the fiscal accounts would be much more protected, but we would be transferring strain and problems to the financial sector and to investors, which in the end would have to be solved. Thus, once there is this volatility and instability, I am still not convinced that only changing the composition of the debt can solve it. For example, we had that experience during the Asian crisis. Immediately prior to the Asian crisis, we had 63 percent of the total debt in Brazil at fixed interest rates. Then because of the Asian crisis, interest rates were doubled overnight from 20 percent to 40 percent, and the government had to exchange all that debt, because if we left that long-term debt with half the market interest rate in the hands of the banks, we would have problems in the banks. We had to conduct an auction to change that, we paid a higher price to place the debt in the first place, and then we had to take it back because it would create a problem elsewhere. Thus, the question of the composition of the debt is more related to where the problem is going to appear, whether it is in the fiscal area, in the state accounts, or whether it is in the financial sector. The real issue is the volatility.

Mr. Jonas made the following statement:

Let me begin by joining other Directors in commending the staff for its very interesting and focused report.

First, I will comment on corporate profits in the United States and the implications for the valuation of equities. The staff notes that uncertainty about the level and quality of corporate profits represents a risk. However, the profit situation in the U.S. corporate sector seems to be quite confusing. Some Directors, like Mr. Shaalan, wonder why the U.S. economic recovery has not been accompanied by a recovery of profits as well. However, a recent J.P. Morgan research note published in Global Data Watch notes that a record rapid growth in U.S. corporate profits characterizes this recovery. Indeed, this is what we should expect, given the aggressive efforts of corporations to restore profit margins that were eroded between 1998 and 2000. Productivity continues to grow rapidly while remuneration for hourly labor is slowing, producing a rapid decline in unit labor costs. These developments suggest that the prospects for profitability are quite positive, always assuming that the economic recovery will remain reasonably robust.

This brings me to my second point, which is the markets' expectations about Fed funds futures. Figure 2.5 on page 11 shows that between April 1 and May 10, the federal funds futures curve shifted significantly downward, suggesting that markets now think the Fed will make considerably fewer interest rate increases than they thought earlier. This is a very important development, and I welcome any comments the staff may care to make. Does this downward shift suggest that diminished concern about inflation is allowing the Fed to proceed more slowly with the interest rate increase, or does it reflect concern that the recovery will be less robust than was earlier expected? It would be also interesting to know if there was a similar downward shift in European futures markets.

Like some other Directors, I think the recent weakening of the dollar is going to deserve more attention, although I understand why the Director of the International Capital Markets Department may now hesitate to make any definitive judgment. In interpreting the dollar weakening, one must look not only at the declining capital flows into the United States mentioned by some Directors, but also at the underlying situation in the global economy. Should we perhaps interpret the dollar's weakening as a signal that the markets now expect a more balanced global recovery that will be less dependent on the U.S. recovery, and more on recovery in other countries and regions?

I have two comments on emerging market financing. First, the staff noted that there has been little contagion from the unfolding events in Argentina. Nevertheless, the situation remains very fluid, as shown by recent developments in Uruguay, and it is too soon to conclude that the risk of contagion is small. During our previous discussion of the GFSR, it was suggested that events in Argentina could reduce FDI inflows elsewhere owing to heightened perceptions of political risk. I think this issue deserves close attention. For countries like Brazil, FDI is an important element in the financing of current account deficits, and any further slowdown in FDI inflows could cause them serious trouble.

On this year's experience with emerging market financing generally, the staff notes that bond issuance during the first quarter was solid, and that many sovereigns have already pre-financed a large part of their annual borrowing needs. This looks reassuring, but when we come to discuss developments in the second quarter, the picture will probably be less positive.

The staff has noted that there is a rotation of exposure from Latin America to other regions; that the issuance pipeline for sovereigns is full; that Brazil faces a high political premium that has increased sharply in recent weeks; and that the euro and yen markets are likely to remain closed to Latin American borrowers.

There is another reason for concern. Mr. Wijnholds noted this morning that there seems to be a disconnect in the behavior of bond markets and banks, with the latter dramatically cutting their new lending to emerging market countries, especially in Latin America. This morning, the press reported a World Bank study noting that large European banks, stung by Argentina's collapse, are cutting back their loans to other Latin American nations, creating the risk of a violent shift like that in 1997 when Japanese banks cut their lending to Southeast Asian countries and helped spread Thailand's troubles to other countries in the region.

Finally, I thank the staff for its analysis of local securities markets. This topic is of great importance, as better-developed local financial markets could play a major role in reducing the traditional vulnerabilities of emerging market countries that arise from their need to borrow in foreign currencies. A better understanding of local securities markets and of measures promoting their development would be an important contribution to crisis prevention, and we are looking forward to further staff discussions of this issue.

Mr. Duquesne made the following statement:

Like others, let me first thank the Director of the International Capital Markets Department and his staff for this very interesting report which strikes, in my view, the right balance between market developments and prospective issues. The well-diversified topics contribute to a dense and dynamic publication. However, like in the first global financial stability report, the section devoted to Europe is almost inexistent which is undoubtedly owing to the staff's positive appreciation of the financial sector in Europe—a fact that I, of course, welcome.

This being said, I cannot be fully satisfied with the procedure: we had only seven working days to work on the report which clearly does not leave enough time to have a meaningful discussion with our authorities. Given that the report deals with topics like the financial situation of insurance companies, which require specific expertise, there is clearly a risk for us not to be in a situation to benefit fully from the material found in the document. This is clearly a source of concern as the next report is scheduled immediately after the recess: given that the first two issuances of the report were provided to the Board less than ten working days in advance, I wonder what Mr. Häusler's plans are vis-à-vis the next report.

Turning now to the substance, it seems that the situation has changed slightly since the last report. While we were expecting a strong worldwide recovery led by the U.S. economy, we have to remain cautious on the outcome and we have to acknowledge that many risks remain and may hamper the nascent movement. The situation of the banking sector in Japan remains a cause of concern and I would like to hear from the staff about the high losses of the Japanese banks and the recent measures announced by the government.

On the stock market, we share the staff's views that the valuations on the mature equity markets are still very high and that we still face a risk of severe corrections on the markets. However, the markets have already absorbed some unpleasant surprises and have weathered relatively well the post-Enron trauma. True, uncertainties remain but market players increasingly question openly the profitability prospects, thereby reducing the risk of additional surprises. However, it remains to be seen how the reevaluation of the profit prospects will affect the different players and in particular the pension fund.

In my view, the risks have shifted towards the foreign exchange market, and questions arising on the transparency of the American financial markets add to the risks associated with the persistence of financial imbalances in the United States. Indeed, the reappearance of a fiscal deficit against the backdrop of fiscal procedures, the strength of household consumption while saving rates are still very low, the level of companies' indebtedness and the depth of the weakening current account do not bode well for the prospects of maintaining such a high level for the dollar. Furthermore, I note that the staff has some concerns on U.S. banking profitability and on the consequences of the shrinking of U.S. commercial papers on banks, which add other risk factors. The recent weakening of the dollar has so far been relatively smooth but it remains to be seen if such a soft landing can be pursued, as Mr. Wijnholds said. I thus welcome the in-depth work to be done on that topic.

Concerning emerging markets financing, it is difficult to have a clear picture of the situation. On the one hand, many positive signs can be found: the prospects of a global recovery, the decline in spreads, a better discrimination on signatures and indeed many emerging countries have already largely covered their financing needs for 2002. On the other hand, I also see signs which should be a source of growing concern: for example, the sharp decline in syndicated bank lending combined with the problems encountered by the foreign banks in Argentina are worrying. Indeed, it is hard to imagine that a bank that suffered from massive losses in Argentina will not take this into account in deciding on other investments in emerging markets. I also note that the increase in crossover inflows, contaminated by the "where to go?" syndrome, has helped to fill the emerging markets' financing gap while the fundamentals have not substantially improved. It is also striking to see that the two recent best performers in the emerging markets, i.e., Ecuador and Russia, have defaulted on their debts in the past five years. The staff appropriately highlights the fact that some market participants believe that spreads have gone too far too fast and I believe that we should remain very cautious on the interpretation of the current situation.

Let me address now the issue of financial market activities in insurance and reinsurance companies. As I am not really an expert and as we did not have enough time to appropriately consult our authorities, I will only make a few general comments. However, we might have to suggest some written amendments to that section. We welcome the attention given to this topic as insurance companies are major players in financial markets and their activities are not as frequently dealt with as other types of investors. I believe that for nonexpert readers, it would have been interesting to describe more precisely what are the characteristics of the insurance companies which could explain how their investment behavior might differ from others, notably from banks as the report makes numerous comparisons between these two sectors. As underscored in the report, the heart of insurance supervision lies in policyholder protection. The more conservative investment policy of insurance companies could also explain the lack of supervisory focus on managing financial markets risks. In the same vein, it might have been interesting to have a comparative look between pension funds and insurance companies. It would have been useful to clearly expose the differences between non-life insurance and life insurance activities as it seems to me that the financial risks they face are not the same. A clearer distinction between insurance and reinsurance would have been welcome. As you know, the supervision of reinsurance companies is a hot topic in Europe and the European Union is preparing a draft directive on the solvability of those companies. The role of credit rating agencies also seems to differ between insurance and reinsurance companies. The staff also questions the use of OTC derivatives by the insurance companies but it is hard to know to what extent these companies are major market players on this market. These are the types of questions that open very promising avenues. The staff appropriately recalls that insurance activities make up part of the scope of an FSAP, given the interesting questions raised by this report. I look forward to the lessons we will be able to draw from the first FSAPs done. Let me conclude by repeating that, in my eyes, Fund's surveillance should pursue its work on the insurance and the reinsurance sectors to check precisely the issues raised by these sectors on the global financial system.

Ms. Lundsager made the following statement:

We welcome a report that is more concise and focused than the inaugural issue. Overall, the report provides a fairly upbeat assessment of financial market conditions: contagion appears limited, spreads are down, and economic recovery seems likely this year in many major industrial countries.

The first paragraph of the report concludes that "the near-term outlook thus appears largely free of imminent threats to global financial stability." It is rare to find such a clear summary statement (let us hope that it is accurate).

Another important recurring theme of the report, just highlighted by the Director of the International Capital Markets Department, is the role that 'market discipline' plays in modifying behavior of market participants. Market pressures have generated improvements in corporate transparency this year, and market valuations have reflected concerns about transparency and financial soundness in some cases, showing the speed at which this discipline can be exerted.

Turning to the first sections of the report, we appreciate the focus on financial market developments, providing a useful complement to the growth analysis in the WEO. The GFSR highlights the recovery and quality of corporate profits as the key uncertainty in financial markets. Profit growth has important implications for asset prices and the recovery in investment. Reported earnings in the U.S. corporate sector have been weak in recent months, but that this reflects, in part, accounting-related write-offs and other charges. Corporate cash-flow appears to have been much stronger. Is the relative strength of corporate cash-flow also an important leading indicator of investment? The staff's comments are welcome.

On Japan, the analysis of potential fallout from Japan's struggling banking sector rightly notes the continued global concern over the further deterioration of Japanese corporate and financial sector balance sheets. We appreciate and agree with the report's cautiously reassuring conclusion that other markets are largely insulated from direct spillover via financial linkages, and that therefore the risks posed by Japanese financial sector weakness appear to be manageable. We note, however, that this should not be grounds for complacency, given the size of Japanese financial institutions and the complexity of international financial markets. Furthermore, the continued weakness of Japan's financial and corporate sectors could pose an indirect risk to international financial markets via trade linkages, as a weaker Japanese economy acts as a drag on global growth. This last point could be made more explicitly in the report, or coordinated with the WEO.

Turning to emerging markets (EMs), the report indicates that financial flows to EMs overall have been fairly steady so far this year relative to last year. Although bank lending is down, bond issuance is at a strong pace, and borrowers are benefiting from relatively low spreads. Foreign bank lending is still fairly low, but the IIF attributes this result to lower demand as private sector banks and corporations in EMs are turning more to domestic borrowing rather than foreign currency bank borrowing. Equity issuance also has picked up owing to large privatizations. Going forward, we would encourage additional analytical work in trying to break out FDI flows from broader equity flows.

The report includes a lengthy discussion on insurance companies. First, it appears that insurance regulation in the United States is relatively robust, with re-insurers facing the same oversight as primary insurers, and capital requirements focusing also on the asset side of the balance sheet. Despite the large losses in the insurance industry from September 11 that have affected insurance profits and capital, there appears to have been limited systemic fallout.

Second, it is encouraging that the report (page 54) concludes that "insurance company insolvencies would be unlikely to have systemic effects on financial stability", reflecting in part market discipline and official oversight. This result is worth highlighting in the summary paragraph on page 3. We note that the summary section states that "stronger disclosure and regulation of the financial activities of insurance and reinsurance companies is needed". This sentence appears too categorical and does not appear to reflect the more differentiated analysis in the text of the report.

We appreciated the section on equity markets in emerging markets and look forward to the studies of fixed income and derivative markets in EMs. The Fund has done a good job in recent years in focusing on banking sector developments in developing and emerging markets, but much less attention has been paid to capital market developments. As noted briefly in the box on the U.S. commercial paper market, companies in the United States have several alternative markets in which to seek financing, providing significant benefits when one single market dries up for whatever reason. We look forward to the policy recommendations that will come out of this study and hope that this will help inform Fund surveillance work going forward, as well as technical assistance efforts, but I will come back to that.

Turning to the specifics on equity markets, a key and unsurprising conclusion is that structural weaknesses in EMs related to low liquidity, asymmetric information, limited transparency, and corporate governance concerns have had a dampening effect on their growth. Given these structural problems, it is natural that top-quality EM corporates have shifted to ADRs and GDRs as a significant source of financing. The report implies that this is a negative phenomenon, but it would appear to provide EM corporates with more reliable financing at lower cost. The lesson is that EMs need to address the structural weaknesses that inhibit the growth in their equity markets.

Finally, some general comments on the report. First, I agree with Mr. Wijnholds and the Director of the International Capital Markets Department that we should not be forecasting market developments, for all the reasons they cited. Second, regarding the scope of the report, given that this is a small department with deep expertise in financial markets, I am concerned that preparation of this report is consuming a large part of the staff's time. The staff's time could perhaps be put to higher priority use in providing technical assistance to those members seeking to develop their domestic capital markets, so as to broaden the source of local funding beyond the banking sector. Wider, deeper local capital markets also would help countries and their corporate sectors better weather the changes in global capital markets. This might fold into work on what attracts FDI as well. It would also be useful for the Fund to coordinate with other technical assistance providers to determine which aspects of local capital markets development are best suited for Fund provided technical assistance. Thus, I am concerned that quarterly preparation of this report is much too time consuming. Perhaps we should switch to semi-annual reports, with the WEO or opposite the WEO, taking care not to duplicate work that is prepared by other institutions. The frequent reporting that the Fund has been doing on EM capital flows could continue on a stand-alone basis for publication, and Board discussion could be linked directly to our informal WEMD meetings.

Mr. Scholar made the following statement:

I would like to start where Ms. Lundsager finished off, on the role of the report and the contribution it can make not just to technical assistance, but also to the Fund surveillance effort.

I would like first to repeat our strong support for the work of the International Capital Markets Department and for this document as a publication. I think, like the first edition, this is a very good read, and it is very useful indeed to have a detailed study of financial markets and a systematic look at the links between them and between markets as a whole in the world economy. I would also like to thank the Director of the International Capital Markets Department and his staff for a very open approach to developing this document in the light of comments that have been received as we go along. The objective that it sets itself is, and I am quoting here from the preface, "to identify potential systemic weaknesses that could lead to crises [and to call] attention to potential fault lines in the global financial system." This is a very ambitious mandate; rightly so in our view. Partly for that reason and partly because of the nature of financial markets, I think we would take a different view on the timing of the report. I think it is quite useful to have quarterly reports, as six months is a very long time with respect to developments in financial markets. The document that we have goes a long way to fulfilling this mandate. For it to go all the way we would really like to see a systematic identification of strengths and weaknesses across the global financial system, highlighting countries and sectors that are the most vulnerable and the reasons why, and then drawing from that clear policy recommendations. Therefore, I would put myself in the policy recommendation camp. As I say, I think it goes a long way already to doing that, but there are three areas where I think it could be further developed. First, through more explicit policy recommendations. I think many of them are implicit in the report already, but it would benefit in one or two places from a slightly sharper focus. Second, through more extensive discussion of the links between financial markets and the real economy, and again there is quite a lot in there already. For example, in this report we have a discussion of the links between corporate profitability and investment, but I think again that could go further. Third, as this is a document of the staff, it can afford in some cases to be a bit more opinionated. I quite agree that forecasting is not the way to go, and there are real risks with that, but there is an opportunity here for a genuinely independent view of strengths and weaknesses, and I think that is something that could be taken a bit further. As I say, though, I think it is going very well, and these things will develop over time. I hope that this will help establish it as a key part of what we might call the architecture of Fund surveillance.

Turning briefly to the report itself, I do not have a great deal to say because we find ourselves very much in agreement with the main messages. On recent developments, we can take a very positive message here: that the financial system has withstood some very serious shocks in the last nine months, such as September 11th, the slowdown in Argentina, and the Enron fallout. Although there have been problems associated with each of these, overall the system has held up very well. I think this is in large part owing both to strengthened surveillance but also and most importantly to a stronger policy framework, particularly in many emerging markets. I think there is an opportunity here to put that message across, and it is one that we should put across at every opportunity.

It would be quite useful, as Mr. Duquesne has said, to take a cautious approach to the compression in bond spreads and perhaps to have a slightly fuller analysis—maybe not now but the next time around—of the determinants of those bond spreads and whether the narrowing can be fully explained in terms of changes to the determinants. I know this is an area where judgment is very important, but I think that would be helpful in terms of the overall surveillance effort. We could also draw out more clearly one of the lessons of Enron, which is the importance of corporate governance and transparency and encourage greater use of the ROSC on corporate governance and indeed the OECD code on the subject.

The analysis on Japan is good. I am grateful to the staff for incorporating it as was requested last time around. Personally, I would have preferred to see a slightly more fuller and systematic treatment of it, looking at the internal developments as well as the possible external developments. However, I understand the reasons why it was decided to hold that back for the moment, and of course, we will have an opportunity to come back to that in later discussions. Nevertheless, this is a subject that needs comprehensive treatment, and as Mr. Yagi says in his statement, there are also some positive developments to look at and policy actions the government has already taken, but we can come back to that in future discussions. I am also grateful for the promise to come back next time to currencies, in particular the dollar, which is important.

The chapter on insurance is very useful. This is a sector that is often overlooked, and there is a very important message here: that insurance and particularly reinsurance activities are not as well understood as banking, and we strongly support the call for greater transparency and disclosure, and in some areas such as reinsurance, strengthened regulation. That said, the summary of this section, as Ms. Lundsager said, could be slightly more balanced. A key message that I take from the longer section of the document is that the insurance sector does not have the same systemic role as banks. Banks obviously have, as we all know, illiquid assets and liquid liabilities. Insurers tend to be the other way around, and I think that is a very important message to highlight. The staff could have also emphasized more the benefits of increasing diversification. This actually should help spread risk around the system, making it less vulnerable as a whole to shocks, and indeed from the perspective of financial stability, the more that risks are transferred from this systemically important banking sector to the systemically not significant insurance sector the better. That obviously might have different implications for policyholders and shareholders, but from the point of view of financial stability, that is a welcome development. Thus, it would be quite useful if some of that could be incorporated into the summary. In addition, on this section there is of course a need for further work on regulation, as some people have mentioned in their statements. That is happening in the Joint Forum and elsewhere. I am glad that we will not be too encumbered with the complexities of insurance regulation, as it does seem to me that this is something that will be more about consumer protection than about financial stability, and that is something perhaps to note here.

Finally, on emerging markets. This is also an extremely helpful analysis and very timely. Well-developed markets in emerging markets have a key role to play in promoting stability and growth, and we look forward to the next installments of this. I think again it would be quite useful to draw out explicitly the policy lessons. They are certainly there implicitly, but there is no harm in repeating them. These relate, of course, to transparency, corporate governance, ROSCs, and, as Mr. Bennett said in his statement, the importance of a wide take up of FSAPs. These would be beneficial issues to add. There are two more installments coming up, and I hope that the final one will draw it all together in an overview because there is obviously great scope for substitution and links between various markets.

One final comment about the publication of the summing up. My presumption is that we should publish as many summings up as possible, and I know for the first report last time around there was a decision not to publish because it was a new report. However, this is the second report, and I hope we can quite quickly move to a policy where we do publish our summings up as well as the document itself, and I would be grateful for comments on how and when we might decide to do that.

Mr. Bischofberger made the following statement:

Let me start by thanking the staff for the preparation of the second issue of the Global Financial Stability Report. As I said on the occasion of the discussion of the inaugural report, I am convinced that this report has a good chance to develop into a flagship publication of the Fund and an important surveillance tool. The staff has again produced a focused assessment of the developments and risks on international capital markets. We especially appreciate the clear, rational, and well-balanced description of the existing risks.

Moreover, we note that the Director of the International Capital Markets Department and his team have taken into account many of the recommendations made by Directors during the discussion of first report. The second report is indeed more streamlined and focused than the first one. However, like a number of other Directors, we still see room for even further improvement. Indeed, the forward-looking elements are somewhat scattered over the report and not very easy to detect. Maybe, the staff should summarize the forward-looking questions of general relevance by providing issues for discussions, as we know it from other publications, including the *World Economic Outlook*. In addition, like other speakers, we are looking forward to increased complementarity between the Global Financial Stability Report and the *World Economic Outlook*. The Director of the International Capital Markets Department has already addressed this issue in his earlier remarks.

Before commenting on a number of issues discussed in the report, I would like to make a procedural suggestion. The quality and relevance of a quarterly capital market analysis depends on the timeliness of the data provided, and I therefore understand the relatively short circulation period of the report. However, those chapters of the report, which do not rely on the latest market information—that is Chapters II and III in the current report—could be distributed somewhat earlier. I would suggest at least three weeks in advance of the Board meeting in order to provide our authorities with sufficient time for preparing comments. We have a similar procedure already in place for the WEO, and I think this procedure has been well established and has been proven to be useful. I would be interested in the staff's view on this proposal. I think this proposal could at least partially address Mr. Duquesne's concerns, which I fully share.

The staff states that the fallout from the Argentine crisis appears to have been contained. Given the fact that we just yesterday agreed to consider a sizable augmentation of the existing program with Uruguay, I would like recommend that we change the wording in the respective paragraphs of the Report to reflect this newest development. Having said this, Mr. Chairman, I would like to make a more general comment on the possible contagion effects of the Argentine crisis. Every day without determined measures by the authorities to address the roots of the problems of this crisis increases the contagion risk for other countries. Here, I concur with Mr. Portugal's remarks.

Regarding the staff's comments on corporate profitability and the banking sector, I cannot fully share the conclusion that the difficult situation of some banks in Europe will likely prompt cross-border consolidation. Experience seems to indicate that banks, which are in good shape at the moment, are not so much interested in acquiring ailing competitors in order to grow but rather to invest in their own restructuring.

Looking forward, I would welcome it if one of the next reports could perhaps look more closely at specific developments in two important member countries.

One concerns the United States, where the government sponsored—but at least officially not government guaranteed—enterprises Fannie Mae, Freddie Mac, and Farmer Mac have grown so big, that—according to media reports—40 percent of all U.S. financial institutions hold one to five times as much debt from these agencies as they do capital, presenting a severe contagion problem if any of these institutions would run into troubles. As noted by Mr. Cippà, the concentration of risk in these institutions and their high derivative counterpart risk exposures would seem to deserve special attention.

The other possible issue concerns nonperforming loans in Chinese banks, where the Central Bank has recently admitted that 25 to 30 percent of all bank loans might be nonperforming.

We found the chapter on the financial market activities of Insurance and Reinsurance Companies very stimulating. The staff has clearly described the major changes, which have taken place in this sector during the past decade. Indeed, these questions deserve more attention, and the contribution of the Capital Market Department to this discussion is very welcome. We agree with the staff's call for stronger disclosure and regulation of the financial activities of insurance and reinsurance companies. In Germany, we have already drawn our conclusion from the development that insurance companies, banks, and investment companies are conducting business in the same areas. Since May 1 this year, the former separate regulators and supervisory agencies of banks, insurance companies and investment companies have been merged into one common supervisory authority, the so-called "Allfinanzaufsicht".

Finally, regarding the chapter on the Developments in Emerging Equity, I welcome the production of this first of three studies on the local security markets. Like other Directors, I think the current study is a good starting point. However, even though I do not differ with the staff in the main findings, I was somewhat surprised to read in the conclusions on page 74, that the staff appears to express caution of “tactical investors, whose opportunistic behavior is likely to increase volatility of capital inflows into emerging markets.” Although the observation as such may be correct, the wording may be somewhat misleading. Such a classification of tactical and non-tactical or good and bad investors is in my view not without problems: Investors are generally rational, they respond to incentives and try to exploit opportunities to make money. If we do not like the outcome of investment decisions, we should not blame the investors and their motives but have a closer look at the underlying incentives.

Mr. Rouai made the following statement:

Like previous speakers, I thank the staff and welcome the second issue of the Global Financial Stability Report, which exposes the challenge to financial market stability and potential vulnerabilities. While the staff seems confident with regard to risks in the short term, I tend to agree with those Directors who think that some of the vulnerabilities identified in the report, in particular the seeming overvaluation of mature equity markets and the outlook for the U.S. dollar, should remain under the staff’s constant review. It is encouraging to note the improved financial market conditions in particular for some emerging market economies. Many countries, including Tunisia in our constituency, were able to secure their financing needs for 2002 at rather improved conditions.

On financial market activity of insurance and reinsurance companies, I agree with the staff that stronger regulation and transparency is needed. Like Mr. Shaalan, I am however uncomfortable with the idea that credit rating agencies as the de facto regulator for insurance and reinsurance. To better assess the risks this sector could pose for the stability of the international financial system, I encourage mature market economies to undertake FSAPs. In this regard, Switzerland is a good example. The FSSA highlights the strength of the insurance industry and points to some shortcoming relevant for safeguarding financial stability. Similar exercises could inform the Fund, when necessary, of the need for a coordinated international preventative framework.

I note from the report that the staff has contact with the credit rating agencies, but I am somewhat concerned by the lack of understanding of the role and contribution of rating agencies in global financial stability, or instability for some. The fact that investors rely heavily on credit rating agencies, sometimes even ignoring the Fund signal, is a cause for concern, and ICM should look into this matter in future GFSR issues. The U.S. Treasury encouraged recently low-income countries to be rated. The staff should examine the usefulness and feasibility of this suggestion. Such proposals and the Fund contribution in this process could help low-income countries plan for the post-HIPC/PRGF and to graduate from concessional financing.

I support Ms. Lundsager's proposal to integrate better the work of ICM with the priorities of the Fund, and I have two proposals: first, all Fund initiatives developed under the umbrella of the international financial architecture, like the ROSC, the SDDS, policy transparency, and publication of Fund documents are designed to better inform the market. The GFSR should be developed as a cost-effective vehicle for targeted information of capital market participants and for promotion of Fund activity. The staff publishes a quarterly report on the assessment of standards and codes, and I propose that it be annexed to the GFSR. Second, the staff's visits to member countries should go beyond the need to collect data for the preparation of the report and should constitute an opportunity to better explain Fund policy and initiatives. In this context, the staff should diversify its visits to member countries. For example, my Tunisian authorities appreciate receiving the staff to exchange views and experience, and it would be very helpful if the staff could explain to them the meaning of preventive PSI.

Mr. Campos made the following statement:

Like other Directors, we thank the Director of the International Capital Markets Department and his team for producing the second issue of the Global Financial Stability Report and, therefore, providing the Board with a comprehensive assessment of the global financial markets. The Report rightly highlights sources of risks in both mature and emerging markets and calls attention to potential fault lines in the global financial system. The Report contains important information regarding the market conditions in emerging economies and includes a very useful chapter on emerging equity markets. However, as we noted in our earlier intervention, the Report does not adequately provide coverage of the situation in other developing countries, which continue to struggle to have access to international capital markets. We would welcome consideration of this issue, particularly the challenges these countries face, in future reports.

In general terms, from the detailed discussion in the Report, it is clear that the economic recovery, which began during the first quarter of 2002, has brought improvements in financial market conditions. To this extent, it appears that equity and bond markets in developed countries have stabilized and most advanced emerging markets continue to have access to international capital markets. However, important sources of uncertainty remain, particularly regarding mature markets. As the staff points out there are two main sources of uncertainty: (i) the recovery and quality of corporate profits in the aftermath of Enron's failure; and (ii) the persistent weakness of the Japanese financial system and the risk of international spillovers. As regards emerging markets, the situation in Argentina remains vulnerable.

Enron's collapse revealed also a failure of external auditing on corporate management. These episodes have shaken public confidence in the corporate sector and its conduct, and have sparked a wave of uncertainty about the quality of reported earnings. As a result, companies with highly leveraged prices or that had been involved in mergers and acquisitions have been significantly discounted in the market. In particular, in this current month of May fund managers have increasingly reduced their exposure to U.S. stocks as they grew disillusioned about the prospects for corporate profits according to a Merrill Lynch survey of about 290 fund managers managing more than $700 billion of assets.

We welcome the staff's analysis in Box 2.1 on the lessons learned from Enron's failure. The staff has pointed out that there has been progress in the United States in addressing the relevant issues. However, although some of the most serious recent problems have arisen in the United States, it seems to us that other mature markets are also vulnerable to similar weaknesses, as several other episodes in the 1990s indicated, including Marconi in the United Kingdom and Kirch in Germany. We are therefore of the view that to be effective in today's globalized markets, regulation needs to be implemented to similar standards everywhere. Moreover, part of the solution to problems in any one country is to learn from similar difficulties abroad. Reforms in the United States will have repercussions everywhere as it is the largest developed economy and it is home to the largest concentration of multinational companies by far. However, the necessary post-Enron reforms should be implemented worldwide and this could be an opportunity to take a further step forward in the standardization of financial and corporate regulation. To this extent, we welcome the various international fora that are studying the issues raised by the Enron failure, including the Basel Committee on Banking Supervision and the forthcoming OECD meeting to discuss corporate governance.

As regards the other main source of uncertainty in mature markets, the staff indicates that risks of cross-border spillover from the distressed Japanese banking sector are manageable, as large scale capital repatriation seems unlikely and foreign investors have reduce their exposure to Japanese risk, what we tend to agree. However, the weakening financial situation of Japanese banks continues to be a source of vulnerability to international markets and has already curtailed capital flows from Japan to emerging market economies. A very recent Standard and Poor report on the Japanese banking system discloses that results posted by the major Japanese banks for fiscal 2001 reveal continuing deterioration in their financial profiles. Increasing pressure on the banks' asset quality resulted in large increases in credit costs and further erosion in their capitalization. As pointed out in the S& P report, the results show that the major Japanese banks are still unable to overcome three major fundamental problems: pressured asset quality, weak earnings, and large exposure to market risks. Furthermore, the banks are expected to continue to incur large credit costs for the next few years. Nonetheless, Japan's stock prices have been recently rebounding suggesting that the economy may be recovering. However, like Mr. Barro-Chambrier and Mr. Cippà, we are also of the view that the weakness of the Japanese banking sector continues to be a source of concern. We, therefore, welcome the fact that the Japanese authorities have agreed to participate in the FSAP, which might help to improve information and make the situation more transparent.

As regards recent developments in emerging markets, we note that broadly, emerging bond and equity markets have strongly rallied in the first quarter of 2002 while bond spreads have declined. Emerging market currencies have also performed well during the quarter, including the Turkish Lira as the authorities continued to implement the Fund-supported program. However, despite this encouraging environment, there remain many challenges in Argentina and contagion effects have been severe in Uruguay. In this regard, we commend Management for promptly respond to the Uruguayan authorities' request for an increase in Fund financial support. In addition, like Mr. Tombini and Mr. Portugal, we urge the Argentine Authorities to finalize an emergency stabilization program that could be supported by the Fund.

Finally, as highlighted in the staff report, insurance and reinsurance companies play now an important role in financial markets. As a result, they are becoming more exposed to market and credit risks and therefore more vulnerable to financial shocks. In particular, profits have deteriorated over the last two years and new high-risk activities are not anymore very attractive. We therefore agree with the staff that stronger disclosure and regulation of the financial activities of insurance and reinsurance companies is needed, and urge the staff to work in this direction.

Mr. Lushin made the following statement:

Let me begin by thanking the staff for an interesting report describing the latest financial market developments. It makes an important contribution to multilateral Fund surveillance by identifying potential systemic weaknesses in the global financial system. This said, there is still room for improving the GFSR both in form and substance, and a number of interesting proposals have already been put forward in this regard by previous speakers and authors of preliminary statements. Let me just reiterate some of them. First, the report could be somewhat more orderly structured, and Mr. Varela's proposals seem to be appropriate in this context. Second, we agree with Mr. Padoan and some other Directors that the report could benefit from being more focused on analysis and policy implications of the ongoing events. Third, like many other Directors, we think that the analysis of financial markets could be more fruitful if put into the appropriate macroeconomic context and being more complementary to the WEO.

Let me now briefly comment on the separate issues presented in the report.

The major uncertainty in these markets is the high valuation of stocks that is based on potentially overoptimistic assumptions concerning future corporate earnings. As shown in the report, even despite the correction in equity markets since early 2000 and better prospects for global recovery now in place, market equity valuations remain high relative to historical averages. Therefore, the risk of price corrections remains in the case that earnings will disappoint markets. Although we have already discussed this problem intensively in the WEO context, current equity valuations in mature markets remain poorly understood as well as the possible future course of events in this area.

Another problem that has been long debated in this room is the current overvaluation of the dollar. Like some other Directors, we are somewhat surprised that this topic did not receive due consideration in the report. Now that the first signs of the correction in the dollar value begin to appear, it would be quite appropriate to consider its implications, including for the U.S. stock market.

Both in 2001 and Q1 2002 bond and equity markets in the emerging markets economies performed strongly, outpacing global markets in some cases. Concerning the bond market, the staff provides a number of explanations for the current rally. However, the question still remains open as to whether it is caused by a greater risk tolerance of crossover investors or by a substantial improvement in the fundamental outlook. It looks as if both of these factors have played their role. Still, it would be interesting to hear from the staff if it sees any cases of "positive contagion", when fundamentally justified treatment of some countries is then extended by the market to the whole asset class.

The staff report includes a very good chapter on emerging equity markets, which contains many interesting facts and provides the analysis of past developments. Still in some cases the analysis may need to be further refined in future. For example, the staff mentions that liquidity, asymmetric information, and corporate governance considerations have had a negative impact on the performance of emerging market equities during the last decade. This may well be true, however, in 1990–94 these factors did not prevent emerging equities from outperforming mature ones, as pointed out by Mr. Portugal. In addition, the recent steep pick-up in emerging equity markets is attributed by the staff to attractive valuations in aggregate for this asset class. However, during the crisis period of 1995–2000 these valuations may have been even more attractive. Does this imply that in the absence of major crises emerging market equities tend to perform stronger than those in mature economies? We believe that in order to find answers to these questions further analysis may be warranted.

With regard to the insurance sector, we note that more attention could have been devoted in the report to the role of the international financial institutions, including the Fund, in strengthening the sector's regulatory framework. In particular, there may be a need to expand on the role of FSAP evaluations in identifying some of the key vulnerabilities of the insurance sector, as well as the systemic issues concerning possible spillover effects between the banking and insurance sectors of the respective countries.

Another consideration relates to the benefits (and challenges) of liberalization in the insurance sector for its overall stability. The beneficial impact of liberalization for the development of insurance services stems from the regional expansion of investment possibilities for insurance companies, which enables them to diversify their risks as well as to tap some of the higher yielding financial instruments in emerging market economies. This brings to the fore the role of the WTO in fostering greater liberalization in the services sector through the General Agreement on Trade and Services. It also concerns the role of the Fund and the coordination of its activities with the WTO in the context of FSAP reviews, a point that has been raised during the most recent meeting of the WTO Liaison Committee.

Mr. Andersen made the following additional statement:

Allow me just to make a couple of comments on issues that have been brought up during the discussion.

I very much agree with Mr. Duquesne that our authorities had perhaps too little time to give the report the attention it deserves.

I also realize that there was very little time for the Director of the International Capital Markets Department and his team to digest and comment on the wealth of information in the 15 statements received late yesterday, but they did a very splendid job.

Like Mr. Bischofberger, I think we should strive for similar circulation procedures with the GFSR as we have with the WEO, and I think this is of particular importance next time as the report is scheduled to be discussed right after the Board recess, as I think Mr. Duquesne also mentioned. Thus, I support Mr. Bischofberger's suggestion.

On this issue of forward-looking reports, I agree with Mr. Wijnholds and others that the balance is about right. However, I would find it very interesting if the Director of the International Capital Markets Department perhaps in his oral introduction in the future would consider elaborating a little bit more on what he sees as the main risks and vulnerabilities looking ahead.

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

I would like to pick up a few points and then pass on the other issues to my colleagues. I will pick them up more or less in the order that I received them. The willingness of banks to finance emerging markets is a serious issue, and we have picked that up in previous occasions. On the one hand, there are actions countries are taking that may or may not give incentives, in this case to banks, to invest, but on the other hand—and this is very difficult to put into data—the overall profitability problems in the whole financial industry remain, including banking and investment banking going forward, and the fact that nobody expects that the slump in investment banking or in banking in general will end anytime soon weighs on investors. This has triggered a whole lot of strategic rethinking by a number of banks. Maybe with the exception of a half a dozen or so very global banks, the more regional banks are considering whether or not they should be lending to emerging markets, simply on the grounds that from a strategic perspective they might want to withdraw. If European banks do that, they would be just mirroring developments that occurred in the United States already sometime ago where with the exception, if at all, of a very few very large global banks, two or three maybe at the most, they have more or less withdrawn from emerging markets finance.

In addition, let us not forget that developments in Argentina have demonstrated several things. For example, we have now instituted in ICM a risk seminar where practitioners come in to tell us how they practice risk management in their institutions, and what we heard two weeks ago is that in the area of project finance all textbooks are going to be rewritten after Argentina, because the old approach of lending to a country whose credit risk banks may not like but believed that their lending into a project would be insulated because there were dollar revenues being derived from it, and these dollar revenues if properly translated into a contract would insulate them de facto from country risk, is null and void after the Argentina experience. By definition, these banks are looking into the whole portfolio of project finance to the entire emerging market world and examining the half a dozen other small factors that may affect risk. Thus, a mixture of developments in emerging markets, strategic rethinking and reorientation on the part of European banks, and particularly the small incidents I was referring to are not bringing good news, and this is why we think that emerging markets finance more and more is relying on two pillars only: one is bond finance and the other is foreign direct investment. Bond finance presently, as you know, was more or less influenced by the opportunistic crossover investor that was dominating the scene, and this is why I was never as exuberant—although Ms. Lundsager was correctly quoting the reference to clear skies in the report—as some others may have been.

On Ms. Lundsager's issue regarding technical assistance, I fully share her view, and I fully share the view that was echoed by other Directors. Let me just point to the fact, and I did this already last time, that we are doing quite a bit of that. Some of the Directors are fully aware that missions or individuals from my department have very recently come to their countries and have consulted with their authorities. However, if you look at the expertise in my department, I do not think that we are the right people to consult in countries where securities markets are not yet developed. Where the developmental stage is more in the infant stage, I think other departments in the Fund, such as the Monetary and Exchange Affairs Department (MAE) for instance, are better equipped to deal with that. There are countries that are emerging markets but are extremely sophisticated. However, for us to tell these countries about how to tap the euro markets would be a bit far-fetched Thus, there is this layer of countries that are beyond the stage of developing a pure domestic banking system but that are not yet at the stage of Mexico, Brazil, and a few others. We are doing everything we can with the resources that we have to satisfy countries that are in that layer, such as those in northern Africa, the Middle East, and elsewhere.

On the frequency of the report, there are advantages and disadvantages of preparing a quarterly report versus preparing one every six months. A quarterly report is a burden, there is no doubt about that. It is a very time consuming process for everybody involved. However, when we decided to do it on a quarterly basis, we did it for mainly one reason. The previous Emerging Market Financing report was done on a quarterly basis. We felt that the Board and the public were accustomed to that frequency. However, it is a trade-off undoubtedly between the resources as well as the timeliness.

In addition, more than the frequency, we are experimenting in trying to find the right compromise between not duplicating the work of the WEO or the work of other departments, such as work relating to Article IV consultations and FSAPs. However, one cannot by definition simply extract multilateral financial surveillance in a void, and not have a background to it. Finding the right sort of balance is something that we continuously work on, and that goes back also to what Mr. Bischofberger said about the analytical components. We will be discussing further how to smooth, speed up, and streamline the whole production process from the time we come up with an outline and idea all the way until it hits your desk. This is I think in the interest of everybody. We will take on board the idea, but we have to put it into some broader scope. Therefore, you will forgive me for not coming up with the firm answer to whether this is feasible or not. The circulation period was also mentioned. It is clearly a burden for everybody, but on the other hand the clearing process needs the necessary time.

Mr. Scholar said the insurance sector is less of a systemic issue. Therefore, should we not, and I am paraphrasing if I may, be glad that the risk to creditors is being transferred away from the systemic banking system into the less systemic insurance system. I am not inclined to say no to that. However, we do not know for sure that the companies that are at the receiving end of the credit risk know what they are doing regarding pricing the risk, as there is a bit of an uneasy feeling sometimes that those who are selling may know more about the risks that they are selling than those who are buying the same type of risk. Moreover, whether they all know what they are doing or whether at the end of the day both parties may think that none of them has the risk in their hands as we all know was the issue between some financial institutions implicated in the Enron affair. Thus, I am in favor of shifting the risk, but we need to know more. The reason why we picked this up is because I become wary that whenever a company or a set of companies in a particular industry are not profitable enough in their core business, there is always a temptation to earn what you think you should earn, and most of the time you think this slump in your core business is only temporary, and it will go away once the competitors have filed for bankruptcy. These companies would like to bridge that time by moving into something different where the pastures are greener. We have seen that with Volkswagen in the 1980s, where they were thinking that the future lay in derivatives. Therefore, if a company is not making enough profits in its core business, there is to me a fundamental reason to look at and to put a spotlight on the other activities it is involved in. This is why we felt it was the right time now to address this issue.

I would like to comment on Mr. Bischofberger's suggestions as to Fannie Mae, Freddie Mac, and the Chinese NPLs, which are very fascinating issues. However, given the scarce resources that we have, we should be focusing on such financial issues that not only have serious domestic ramifications potentially, but also have international ramifications. At this moment in time, frankly speaking, I do not yet see, even hypothetically, a serious issue domestically as to Fannie Mae and Freddie Mac or the other government-sponsored enterprises nor the Chinese NPLs, and whether any of them have international implications. Moreover, on the Chinese NPLs, we know data is extremely important. For instance, there are a whole lot of arguments on what exactly is the scope of the Japanese NPLs. The market has it one way, the official bodies have it a different way. I think that in the case

> of the Chinese banking system, this would be all the more an issue. For the Fund to collect data in any serious way on the Chinese NPLs is a major problem, and I would rather leave that issue to our colleagues in MAE.
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> On Mr. Bischofberger's remarks about the European banking system and potential cross-border consolidation going forward, the lack of profitability among some European banks is indeed a serious issue. However, and let us be very blunt about it, as one or two Directors invited me to be more blunt in my oral remarks than in the report itself, if the market capitalization of any bank falls seriously below what investment bankers call the sum of the parts calculation--where the sum of the parts is worth more than the market cap, which is a difficult calculation--this bank is in trouble because this would invite investors— and sometimes very unfriendly investors—to try and acquire it, potentially even through a hostile acquisition. This is a function of whether or not in the particular European environment the breakup value of any company, in this case a bank, can be extracted in a halfway certain way, and whether this is likely or unlikely will determine whether these banks will be acquired going forward.

Ms. Lundsager noted that the GFSR should broaden its analysis of emerging markets finance to include foreign direct investment as well as bond finance, as the case of Argentina demonstrated that those engaging in risk management could no longer be certain that their investments were safe because their contracts stipulated that they had to be paid in dollars.

The Director of the International Capital Markets Department (Mr. Häusler) responded that ICM was increasing its contact with risk managers, as those individuals were the ones who were increasingly influencing the parameters for investment decisions.

Ms. Lundsager suggested that a report similar to the previous Emerging Markets Finance report be prepared quarterly, and that Board discussion of that report take place during WEMD sessions, after which the report could be published. In addition, a more comprehensive report could be prepared twice a year with special chapters included.

Mr. Portugal noted that financial markets had become not only the main locus of globalization, but also the main channel by which positive and negative impacts were transmitted across countries. An analysis of the overall stability and workings of those markets, which would be undertaken from a global perspective, was a necessary complement to the multilateral surveillance of the world economy that was undertaken in the WEO. As Mr. Scholar had said, because of the nature of financial markets, where things changed so rapidly, a quarterly periodicity would be more appropriate. In addition, such a quarterly report should always include the overall global perspective.

Regarding the links between the WEO and the GFSR, the issue was really of how best to integrate the GFSR with the WEO, Mr. Portugal remarked. It was not easy to integrate specific multilateral surveillance of financial markets with overall multilateral surveillance. However, as there had only been two issues of the GFSR so far, it would be appropriate to keep refining the format of the report.

Mr. Duquesne agreed with Messrs. Scholar and Portugal. In addition, it would be very confusing to change the periodicity to six months after the first two GFSRs had been prepared on a quarterly basis.

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

> I would like to pick up from where the Director of the International Capital Markets Department left off and address several questions raised by Directors.
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> First, on the issue of corporate profitability, particularly in the United States, and the different impressions or understandings from different sources, let me say that in the fourth quarter of 2001 and the first quarter of 2002, any report on U.S. corporate profits has been subject to an unusual degree of complexity and uncertainty. Corporate profits are reported by using three different methods: by using national income and product accounts, which is done by using the GDP figures, by the Internal Revenue Service (IRS), which calculates corporate profits so that it can tax corporations in the United States, and by financial statements prepared according to the Financial Accounting Standards Board (FASB). The three methods produce different results, and the difference in the fourth quarter of last year was of a substantial degree, and there are many reasons for this. We alluded to this in the text of the quarterly report last time and also this time as one of the sources of uncertainty among market participants regarding their own expectation of future trends.
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> Let me try to simplify the issue. First, under the IRS approach, after September 11 last year, the authorities allowed companies to accelerate depreciation charges on a variety of items, including investment projects and write-offs on a variety of things so that the tax liability reflecting the reported corporate earnings of those companies will be reduced. Consequently, the IRS's numbers indicate lower profits. Second, the FASB method also indicated lower profits, in particular declining in the fourth quarter of 2001 compared to Q4 2000. Third, the GDP figures—National Income and Product Accounts (NIPA)—largely disregard the ruling by Congress. Thus, for the fourth quarter of last year, the GDP figures assume a normal rate of capital consumption or normal rate of depreciation charge, and therefore add back to what they call corporate profits the amount written off by companies as expenses. Therefore, the measure of profitability under NIPA was much larger than other measures of profitability by a very substantial amount. That gave rise to confusion as investors obviously did not really know what was the right corporate earnings dynamics in companies going forward.

At the beginning of this year the FASB came up with another opinion, so-called opinion 142 or FASB 142, which basically disallowed the amortization of goodwill on the books of companies; goodwill being the difference between the price that a company paid to acquire another company relative to the net asset price or the book value of the assets of the acquired companies. Companies will normally amortize goodwill either on a straight-line basis or accelerated basis over the course of many years. However, from January 1, 2002 they were not allowed to do so anymore. Nonetheless, FASB 142 requires a company—when goodwill has been impaired significantly—to write off most if not all of the goodwill in one lump sum. Thus, during the course of the first quarter, we observed a variety of developments. The normal reported earnings are overstated if we compare them with the same quarter last year because in Q1 2001 goodwill was amortized. Q1 2002 goodwill is not amortized, which is a big difference, particularly in certain sectors, like high tech sectors and TMT, where the acquisition of companies plays a very important role in the growth of the sector. However, for other companies, when they have to write off goodwill in a big lump sum, for example when the goodwill has been judged to be impaired, there is a huge difference in what market participants expect the performance will be and the reported earnings. Therefore, all of these variables produce a very opaque, very non-transparent, and very difficult situation for everyone to analyze and compare, and therefore that is why we highlight the uncertainty surrounding reported earnings going forward.

Ms. Lundsager raised the question of given all of these complexities and uncertainties about reported earnings, whether or not cash flow would be a better measure. Yes, in the view of many market participants cash flow has been and is regarded to be a better measure, and even studies in academic literature show that there is a stronger correlation between corporate cash flow and corporate capital expenditure than between profit and capital expenditure. However, the same problem exists to some extent with cash flow. There is simply at this point no uniform definition of what cash flow is, and therefore different companies in different sectors do report cash flow, but they are not comparable. From what we can see at this point, cash flow has yet to play an important role in guiding investor expectation compared to reported profits from what we have seen. That may change when the FASB in particular can come up with some guidelines on more uniform reporting of cash flow.

The second set of issues were concerning the Fed fund futures market and the change in the shape of the futures market curve that is in our report, particularly the latest one showing a very significant decline in expectation of future tightening moves by the Federal Reserve Board. This is nothing more than reflecting the changing expectation of market participants as to the pace and strength of the U.S. recovery, and the latest curve we have there in early May reflects the fact that the expectation has been downgraded or reduced, showing that the expectation of tightening has been delayed and that the amount of tightening in the United States will be less than what was expected during the earlier part of the year. However, while I am on this point, I would like to draw your attention to the fact that the Fed funds futures market is probably not the best indicator of market expectation or indicator of the forecast of the future Fed's fund rate because it embodies quite a large degree of risk premium both as to the underlying outcome of the economy and also inflation expectation.

There are several comments and questions concerning the latest development for Japanese banks. We now have the report from Japanese banks, particularly the major big 5, for the financial year 2001 that ended, as you know, end of March of this year, and they show bigger losses than had been assumed earlier by market participants. They show that NPLs were larger than expected, 27 trillion yen, and this figure is only coming from the five megabanks in Japan. The 27 trillion yen represents a 48 percent increase over the estimate of nonperforming loans at the end of March 2001. Thus, one can say that the financial conditions of Japanese banks have weakened. Going forward, we are cooperating closely with the Asia and Pacific Department on the financial system analysis in Japan, and that will be part of the upcoming Article IV discussion.

On insurance companies, Directors have raised several very interesting points and suggestions, which we are very happy to take on board and look at. The chapter on the financial activities of insurance companies represents a first step in identifying the problem. As we say in the chapter, information on the activities of these companies remains not very plentiful, and therefore as we learn more during the process of talking to chief risk officers from different insurance and reinsurance companies, we will come back and elaborate on the themes we raise here and answer the questions that you have highlighted.

Last but not least, there are several more technical and specific questions regarding the mature markets that I would like to address before turning it over to my colleague who will talk more about the emerging markets. One question from Mr. Andersen and Mr. Törnqvist about whether or not changes occurring in mature markets, particularly for equities, might lead to higher valuation of equities than otherwise could have been the case—changes such as lower transaction costs and the benefit of increased diversification by investors. We would be inclined to agree with that observation. If the cost of a transaction is lower, it makes it easier for investors to invest and diversify.

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

I would like to touch on three items.

First, there is the issue of spread compression that a number of Executive Directors raised. This is an area that we have analyzed in the past, and we are analyzing it on an ongoing basis. However, when we talk about the most recent experience with market analysts, they tend to make four points, about the most recent episode. There is certainly the prospect of improved economic growth overall for the world economy, but they tend to identify three other sort of investor-based issues that in their mind explain the compression.

First, there has been a global chase for higher yields by crossover investors in an environment where nominal interest rates, at least, in mature markets have reached, in many cases, historical lows. Second, there have been improvements in fundamentals in a number of countries that analysts look at, and this has been reflected in credit rating upgrades and other factors, but the general story we received is that by the end of February most of that improvement in fundamentals had been priced into most of the assets. Finally, for dedicated investors there was seemingly a willingness to take on not only greater credit risks, but also what I would call greater duration risks in the sense of holding instruments for longer than they had been willing to hold them in the past. That said, these are issues that the staff will continue to analyze.

On the issue of local securities markets and how we plan to address that, I know a number of Directors raised the issue of looking at local institutions and also looking more extensively at the policy issues associated with the development of these markets. As you can well imagine, the space that we have available to discuss this in the Global Financial Stability Report is limited. Nevertheless, in the next two issues we will look at first local bond markets that have been developing more extensively than equities, and I think the story will be quite different from the one we told in this chapter. Then in the subsequent issue we will look at both the derivatives market and the more general policy issues associated with the overall development of the markets, and we will cover the issues from that respect. We also intend to issue later on in the year a paper for the information of the Board that will include much of the materials that are not put into the report itself in order to keep it brief.

Finally, I just want to touch on the ADR issue. When we discussed this with corporates, banks, and investors in terms of its impact both on the corporates that participate and also on the local markets, they tell us that it is sort of like a two-edged sword story. On the one hand, it is clear that the

> corporates regard these programs as very beneficial for them because they offer a larger investor base, tend to enhance the liquidity of their issues, there is better price discovery in general, and the bottom line for the corporate treasurer is that it is a cheaper source of funding, and that is always very important to corporate treasurers. On the other hand, it does affect the local markets. To some extent there is a loss of liquidity in the local markets. Nonetheless, it is important to note that the pressures that are on local equity markets are not unique to the emerging markets themselves. Equity markets around the world are under intense competitive pressure from other sources of trading securities and from other exchanges themselves, and there is an ongoing search for alliances and mergers. We have seen this in Europe extensively, and one constantly reads that even the London Stock Exchange and the NASDAQ are looking for partners. Thus, the pressures that are being faced by local equity markets are part of that global process, and in some respect it is just a search for the lowest-cost source of trading or the lowest-cost source of funding, and it is an ongoing process, and the equity markets will continue to face these pressures going forward.

The Chairman remarked, in response to Mr. Scholar's comment, that it would be better not to publish concluding remarks until the Board and national authorities had gained further experience with the GFSR. The expectation was that concluding remarks would be published after one or two more reports were prepared.

The representative from the European Central Bank made the following statement:

> The global financial stability report is a well-written report that focuses on the right issues, in particular the aftermath of Enron and corporate profitability. However, the report could differentiate more between the situation in the United States and in the euro area. In particular, price earnings ratios in the euro area have in general returned to their historical average, while that is not the case in the United States. Furthermore, while there is also further work to be done in Europe on accounting and governance issues, the Enron case has revealed issues in the United States that need to be tackled in order to ensure investor confidence. The comments below elaborate on these issues in relation to the report, and can be used in a statement
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> Over a longer horizon, it might be worth noting that since March 2000, when the broad Dow Jones EURO STOXX index peaked, the correction in stock markets has been much more severe in the euro area than in the United States. At the moment, for the euro area stock market as a whole, there does not appear to be compelling evidence for either under- or overvaluation of stock prices. Price-earnings ratios in the euro area seem to have returned close to the historical averages seen over the past 30 years. Therefore, euro area stock markets do not look so vulnerable to further deterioration. However, sector-specific factors still play an important role. The technology and

telecommunication sectors typically are particularly vulnerable to further revisions of growth expectations, also given the high indebtedness of especially the telecommunication sector.

In contrast, price earnings ratios in the United States remain high compared with historical levels. Moreover, following the Enron case, the measure of earnings used in calculations of price-earnings ratios has attracted a lot of attention, as it turned out that current levels of price-earning ratios differ substantially according to which measure of earnings that is applied. Often price earning ratios are calculated according to “pro forma operating earnings”, which typically exclude certain irregular items, for example costs associated with merger and acquisitions or compensation costs related to stock options. However, price-earnings ratios which are calculated according to reported earnings based on General Accepted Accounting Principles and which are audited, result in a substantially higher price earnings ratio. Overall, it seems that the risk of a further stock market correction is higher in the United States than in the euro area.

According to the conventional financial intermediation margin, as measured by the spread between long and short-term interest rates, banks are not vulnerable to a pause in economic growth. For the euro area, banks’ overall interest margin showed a slight increase since August 2001, after declining for some 18 months, while at the same time growth in lending volumes continued to decrease in the last months. Banks faced in 2001 significant reductions in their non-interest rate income owing to the dip in the primary capital markets activity (affecting income from investment banking) and the downward correction in stock prices (affecting income from asset management). Recent tendencies in issuance activity and stock valuations, coupled with continued market uncertainty, suggest that income pressures might continue in 2002. Still movements in bond spreads in the financial sector suggest that market participants view banks in the United States and the euro area as relatively sound.

Broadly speaking, credit risk as reflected for instance by corporate bond spreads significantly decreased in the United States and the euro area in nearly all sectors since their peak around October 2001. Nevertheless, corporate bond spreads in some segments of the corporate bond market were higher in the first quarter of this year than with 2001. This is particularly the case for BBB-rated bonds and the telecom sector in the United States. In addition, liquidity constraints could emerge for companies that have increased their leverage over the last years.

We would like to raise only one point in relation to developments in foreign exchange markets. It is our view that an assessment of exchange rate developments should be based on thorough analysis of economic fundamentals. The recent decline of the U.S. dollar, for instance, materialized amid rising concerns among market participants over the durability of the economic recovery in the United States, concerns about stock market valuation in the United States and the financing of the U.S. current account deficit. In this context, the capital flows, mentioned in the report as a factor for the observed dollar decline, cannot be seen in isolation. This is so because capital flows tend to react to expectations on the future course of economic fundamental variables.

We agree with the assessment of the Fund staff that the relative "insulation" of the Japanese financial system could limit the scope for international financial-market spillovers from a major crisis in the Japanese financial sector. Nevertheless, we feel that risks remain and that vigilance as well as structural reform is still needed to further limit the systemic risk related to the vulnerability of the Japanese financial system.

While indeed the exposure of players to the Japanese financial system has decreased in recent years, at least in terms of traditional financial instruments, the analysis is less convincing regarding other potential linkages between the Japanese and the global financial system, e.g., the role of derivatives and contagion via the confidence channel.

Most notably, a full assessment of linkages would require a more thorough analysis of the role of the Japanese financial system as counterparts in derivatives. The staff report, in the second bullet on page 18, says that "market participants are not particularly concerned about [derivative] exposures". However, even for the most sophisticated global players it has proven extremely difficult to assess their direct and, in particular, indirect exposure to counterparties via derivatives while at the same time the linkages between financial players through derivatives appears to have strongly increased. This interdependence has often been identified as a potential main channel for contagion in the global financial system and it would be very interesting to assess the perceived "insulation" of the Japanese financial system more thoroughly from this side, e.g., based on own research rather than based on statements by market participants.

Another aspect, which has attracted some attention during the highly synchronized downturn the world economy has experienced in 2000/2001, is contagion via confidence. This channel exists partly independent of quantitative linkages but can have a significant impact on markets. In that context, the existence of substantial safety net provisions (around 8 percent of GDP) in Japan could be an important factor. Progress in structural reforms could also be helpful in limiting negative confidence effects as it could increase confidence in the Japanese financial sector in general, thereby reducing the likelihood of a general confidence crisis triggered by the failure of a single market participant.

The section on Emerging Market Developments and Financing is well structured, along the line of developments in prices and quantities for each of the following financial markets: bond, equity, syndicated lending and foreign exchange. However, we would like the staff to elaborate on two potential risks that the report has discussed too briefly.

With long-term spreads falling to below pre-crisis levels, what are the risks of a correction in bond prices in Asia?

In the bond markets section, the report examines the recent compression of EMBI+ spread, focusing on the Latin American and European components. Quite rightly, the former deserves some lengthy discussion because of its relatively heavy weighting in the EMBI+. However, in emerging Asia, sovereign bond yield spreads have also been falling steadily since mid-2001, and rating upgrades in Korea, Malaysia, and the Philippines early this year further supported the trend. Part of the reason for the falling spreads could be justified by the improved fundamentals in the region, for example, Korea reported growth of 5.7 percent yoy in Q1. However, market anecdotes also suggested the fall in spreads was partly owing to the reluctance of banks to lend to the fragile corporate sector. As a result, banks have "bid up" the prices of the relatively safer Asian sovereign bonds, resulting in sharp declines in the bond yield spreads. If the latter is the dominant factor, what would be the implications for Asian banks if there were a sharp correction in bond prices?

With regard to bond markets, we also think the downside risks posed by political factors in Latin America could be better developed. The staff report notes the generalized decrease in Latin American sovereign spreads in recent months, as well as the cases in which this trend has been partly reversed owing to domestic political concerns (specifically, in Brazil and Venezuela). A missing element in the analysis for the latter countries, however, is that increased financial market volatility—reflected in widening sovereign spreads, and hence, higher financing costs—will exacerbate the fiscal challenges already faced by both economies. In addition, the implications of wider difficulties possibly developing in neighboring countries—in both the Andean and Mercosur regions—are largely omitted:

In the Andean region, both Peru and Bolivia suffer from similar—if less dramatic—social problems to those in Venezuela; tensions have already been evident in Peru. Venezuela itself may be affected by increasing instability along its "porous" border with Colombia, where the long-standing civil conflict is likely to take a turn for the worse following the election of Alvaro Uribe—a candidate favoring a military solution to the problem—as President. The political uncertainties in both Colombia and Venezuela—the engine of growth in the Andean Community—may also affect growth prospects in the smaller economies of the region, both directly through trade effects and indirectly through worsening investor sentiment and, hence, declining financial inflows.

In the Mercosur region, the fortunes of the smaller economies within the block—Uruguay and Paraguay—are more dependent than ever before on the performance of Brazil, owing to the poor growth prospects in Argentina for 2002 and 2003. The continued financial market volatility which Brazil is likely to experience in the period leading up to the presidential election in October will only have a limited indirect impact on these economies, as financial market developments are of secondary importance to them. But longer-term growth prospects may be affected by the outcome of the Brazilian contest, particularly in light of the time element required for a newly-elected government—with a higher degree of uncertainty about its policy stance)—to assert its credibility with foreign and domestic agents alike.

In sum, the risk of political contagion has been arguably heightened in the wake of the Argentine crises, and Brazil and Venezuela remain the near-term focal points in this context. But it is worth keeping in mind that the De la Rua administration in Argentina was only the latest in a series of democratically-elected governments forcefully removed from office owing to popular pressure—along with those in Ecuador and Paraguay. In an environment where Latin American institutional and policy frameworks are being challenged by political instability, the coming months will be crucial to show if the progress made during the 1990s is to be sustained.

The main conclusion of chapter III is that despite having a potentially strong disruptive impact on financial markets, financial market activities of insurance companies are unlikely to have systemic effects on financial stability. The first part of the chapter shows how relevant the insurance sector has become through a series of charts and tables based on seven major countries. The following comments refer to the second part of the chapter, where five questions concerning financial efficiency and stability raised by insurers' financial activities are discussed.

The second question focuses on disclosure and transparency (p. 50). It is claimed that there is limited information on insurers' financial risks provided by the reporting insurance companies. However, there is neither a clear reference to what kind of enhanced information is required nor a clear stance is provided on its subsequent use, that is, improvement of disclosure for transparency or for prudential reasons. From a financial stability perspective, it would be important to understand whether there are gaps simply in the disclosure requirements for insurance companies or whether there might be an undercapitalized insurance sector.

The fifth question addresses systemic financial problems (p. 54). The second point argues that insolvency of insurance companies is rarely associated with rapid liquidation of assets. The discussion seems to ignore the contrasting view, defended by many academics and policy makers, according to which systemic contagion through market prices is becoming ever more relevant. The trends towards conglomeration, globalization and greater involvement in OTC derivatives, suggests that the systemic risk posed by financial market activities of insurance companies, even though not so considerable at present, is likely to become significant in the near future. A failure of any major securities market player – or a disorderly winding down of its positions – could severely depress asset prices in illiquid markets. The possibility of disruptions to the financial system arising from the securities field strongly relates to the insurance sector, as it has become an active player in securities markets, as shown in the first part of this chapter.

In the conclusion on paragraph 2 on page 55, “bancassurance” conglomerates are mentioned as a channel through which the failure of an insurance or reinsurance company could affect financial stability. It is concluded however, that their importance should not be overstated as few groups exist that combine a large bank and a large insurance company. Among the EU 15, the expansion of the “bancassurance” business model appears to be a common trend, which has further developed over the period 2001–2002. For example, in Spain, “bancassurance” accounts for more than 80 percent of new business sales in the long-term savings market. In Italy the figure is more than 70 percent and in France around 65 percent (The Banker, April 2002). This contagion channel should not be downplayed.

Finally, the importance of insurance companies as banks’ counterparts will likely increase in the future because of their involvement in the credit risk transfer business, but also because of the recognition of insurance as a risk mitigant in the operational risk area in the context of the new Basel Accord. In the latter case, the involvement of insurance companies in the mitigation of operational risk can affect financial stability as insurance companies become counterparts and operational risk can be replaced by credit (counterparty) risk. The Fund view on this issue would be welcome, given the debate surrounding the eligibility of using insurance for risk mitigation by the banking sector.

The chapter on emerging equity markets analyses the role of emerging equity markets on enhancing financial stability. First, it examines the performance of emerging equities from the perspective of global investors and considers how this performance may affect the scale and volatility of equity-related capital flows. Second, it compares emerging market equities as an alternative source of corporate financing to the more traditional bank financing. It identifies that the recent financial crises in emerging markets, poor corporate transparency and governance and growing importance of Global and American Depository Receipts (GDRs and ADRs) as three main contributing factors to the underperformance of the emerging market equities in the second half of the 1990s. In particular, the last factor—increasing internationalization of equity markets—can potentially hinder the development of local markets as an alternative source of corporate financing to bank lending in emerging markets in the long run.

We fully agree that the poor returns on emerging market equities during the 1990s to a large extent is explained by a number of "structural breaks", including transitional issues in the Eastern European countries as well as the financial crises in Mexico, Asia, Russia, and Latin America. In this light, perhaps it is an exaggeration to argue that the emerging equity markets has performed poorly as an asset class in the long run. With only 10 years of data (covering less than two business cycles and during which a number of specific shocks occurred), perhaps the analysis should rather be characterized as an attempt to explain the impact of the large shocks on the (short-term) swings in emerging markets asset prices.

In addition, the report notes that foreign investors appear to have become more averse to currency risks as a result of the loss earnings associated with recent currency crises. However, since the 1997/98 crisis, many crisis-hit countries in Asia have been committed to open their domestic financial markets to foreign investors, as a result, the share holdings of foreign investors have become relatively more important in some of these economies. What is the staff's assessment on this "supply-side" factor in determining foreign investors' participation in emerging equity markets?

What are the impacts of delistings? In the report it is suggested that the delisting of top-quality corporates from domestic stock exchanges to major financial centers has negatively affected the emerging equity markets as an asset class. In this context we have two questions. First, how has this development affected the domestic economies from a macro perspective? It is easy to envisage a positive effect from the delistings, as the larger corporates would get access to cheaper funds, and as problems with regard to corporate governance and asymmetric information would be alleviated. Second, looking ahead, if the trend of delistings would continue, what is the outlook for the domestic stock exchanges? Is it possible that some of the stock exchanges—especially in the smaller emerging markets—will eventually be closed, and if so, how would this affect developments and prospects for the SME sector in these countries?

We agree with the staff that the relatively small size of the free-floating stocks in emerging markets can act as a deterrent to international investors. However, the much-talked about MSCI re-weightings on the basis of free-floating shares failed to produce any considerable impact on international portfolio flows. What is the staff's assessment of this?

The report mentions briefly that owing to the extensive privatization programs in Latin America and Central Europe, equity market capitalization is much larger than bank credit in the two regions. But the issue will be discussed in detail in a forthcoming Fund Occasional Paper (see footnote 8, p. 72). Given that this chapter is devoted to emerging equity markets while the next two chapters will be on bond and derivative markets, will it be more appropriate to elaborate this point a bit further here? In particular, what are the effects of the privatization proceeds on portfolio flows and foreign direct investment flows?

The Chairman made the following concluding remarks:

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

Recent Developments and Risks

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

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

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

Financial Market Activities of Insurance and Reinsurance Companies

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

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

Emerging Equity Markets

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

The Chairman observed that Directors were in favor of publishing the GFSR after it had been revised to take into account the Board discussion.

2. SWITZERLAND—2002 ARTICLE IV CONSULTATION

Documents: Staff Report for the 2002 Article IV Consultation (SM/02/137, 5/8/02; Cor. 1, 5/24/02; and Cor. 2, 5/3/02); Selected Issues (SM/02/145, 5/15/02); and Financial System Stability Assessment (SM/02/143, 5/14/02; and Cor. 1, 5/28/02)

Staff: Corker, EU1; Hilbers, MAE; Kincaid, PDR

Length: 1 hour, 40 minutes

Mr. Cippà submitted the following statement:

On behalf of my Swiss authorities, let me thank the staff for the constructive policy discussions held in Bern and Zürich in the context of both the Article IV consultation and the Financial Sector Assessment Program (FSAP). I thank them also for the excellent and insightful reports. The date of the Board discussion marks the tenth anniversary of Switzerland’s membership in the Fund. In the past decade, my authorities have learned to value highly the yearly surveillance exercise, which provides them with a frank and comprehensive assessment of the overall macroeconomic situation and policy stance. This year, the assessment is even more comprehensive than usual, as the background documentation is complemented with the results of the detailed analysis performed under the FSAP. Recognizing the macroeconomic relevance of domestic financial systems, Switzerland has supported the FSAP from the outset. Discussions with the multi-institutional team of experts were very stimulating. My authorities agree with the thrust of the assessments in the staff reports and generally agree with the set of useful recommendations made in the context of the FSAP exercise. As in the past, my authorities are looking forward to publishing all the staff documents.

Switzerland was not spared from the global deterioration of the macroeconomic situation last year. After a strong growth performance in 2000, real GDP growth slowed to 1.3 percent and is forecast at 1 percent in 2002. Inflation numbers and prospects are favorable. Last year, inflation was the lowest in Europe at 1 percent and is expected to remain stable. As regards the labor market, we are either at or not far from full employment.

After a sizeable surplus in the general government balance in 2000, the fiscal situation deteriorated markedly in 2001. Both the general government budget as well as the federal budget recorded a deficit of 0.3 percent of GDP. As pointed out by staff, the deterioration of public finances reflected mainly the support for Swissair and decline of revenues from withholding taxes on capital income and stamp duties. The deficit in 2001 at the federal level was slightly above the limit constitutionally mandated by the "Budgetary Target 2001," namely 2 percent of revenues. The federal budget for 2002 is consistent with this limit, which continues to be binding until the new framework, the "debt brake," goes into effect in January 2003.

However, recent developments indicate that the federal deficit for 2002 could be higher than budgeted. The Federal Council has submitted a supplementary budget for 2002 amounting to Sw F 601 million (1.2 percent of total expenditures). Furthermore, fiscal revenues may have been estimated too optimistically, as the economic recovery is taking hold more slowly than anticipated. As regards the use of unbudgeted one-time revenues, my authorities fully agree with staff that they should be used to reduce government debt. Accordingly, the unexpected revenues resulting from the buy-back program of Swisscom shares in 2002 will be used exclusively to reduce the federal debt.

Under the new expenditure rule, the "debt brake," the use of one-time revenues to reduce public debt will be dictated by law. The "debt brake" will require a balanced budget over the economic cycle. This means that extraordinary revenues will not lift the expenditure ceiling, and this will implicitly lead to a reduction of public debt. This can be seen as the logical counterpart of the escape clause that allows for an increase of the ceiling in case of extraordinary spending needs. Although my authorities agree with staff that the budget targets set by the "debt brake" should be achieved on the expenditure rather than on the revenue side, this is not a requirement in the new framework. This point was important in the design of the instrument, because of the stated intention to finance demographically induced future increases in social expenditure by increasing the VAT. This being said, measures on the revenue side will be rare, as federal tax rates are fixed in the constitution. The budgetary competence of the parliament is limited to the expenditure side. As to erratic tax revenues mentioned by staff, my authorities note that the "debt brake" framework contains a "compensation account," which deals with this issue.

As regards staff's comments on Switzerland's tax structure, my authorities do not believe that it would be feasible to burden labor income more heavily. Quite to the contrary, the Federal Council is considering shifting part of the tax burden from labor to energy. However, taxation on consumption is planned to rise. As of January 1, 2004, VAT will be increased by 1 percentage point to finance the invalidity pension system.

My authorities welcome the staff's positive assessment of the monetary policy pursued by the Swiss National Bank (SNB) and the new monetary framework. The staff report contains a good evaluation of the key monetary conditions, which largely coincides with the view of the SNB. Accordingly, I can limit my comment to two points.

The first regards the stance of monetary policy. In the staff's view, the interest rate cuts after September 11, together with the appreciation of the Swiss franc, have eased monetary conditions to a lesser extent than in the view of the SNB (para 5 and para 10). The difference in opinion can be attributed to the fact that the staff attaches more weight to the monetary conditions index (MCI) than the SNB does. The SNB argues that measuring monetary conditions exclusively by the MCI gives an imperfect picture, particularly if the equilibrium exchange rate is changing over time. Long-term comparisons of the MCI are especially problematic. Taking into account additional monetary indicators suggests that the flexible reaction of the SNB led to a strongly expansionary monetary policy after September 2001: real short-term interest rates were very low, the term structure of interest rates turned much steeper and, finally, M3-growth increased substantially.

The second remark concerns the monetary policy framework. The staff report refers to an "intermediate interest rate target," while the SNB regards the target range for the 3M-Libor as being purely operational. The target range for the 3M-Libor should not be confused with an "intermediate target." As an operating target, the 3M-Libor target range serves as guidance for setting the monetary policy instruments, and it is changed whenever the monetary policy stance has to be adjusted. An intermediate target, on the contrary, is fixed over a long period of time and concerns a variable that the central bank considers as a substitute for directly targeting the final goal of monetary policy.

As discussed in previous years and highlighted again in the Selected Issues Paper, explanations for slow trend growth in Switzerland cannot easily be identified. Attention should be paid to labor productivity trends, which were weak already in the 1980s and did not improve much in the second half of the 1990s.

However, it is important to note that growth from 1996 onwards no longer lagged behind other countries quite as much as it did before. The picture would be further improved if other standards for the National Accounts were adopted or if data were presented on a PPP basis. This could close the growth gap with better performing OECD countries by as much as 1 percent per annum. However, my authorities accept that the argument of other countries catching up provides only a partial explanation of the phenomenon and that political measures need to be taken in order to enhance growth in Switzerland. To this end, an inter-ministerial working party was set up this spring. A report, outlining recommendations for specific measures should be available in a year. In parallel to this work, several projects for structural reform are underway. The dominant item on the agenda is the September public referendum on the opening up of the electricity market. Since a broad political consensus was recently established regarding the accompanying regulations, my authorities now feel somewhat more confident about a positive outcome of the referendum. Other steps are also being considered like a follow up on the public debate on the provision of public services in peripheral regions and the liberalization of the milk market as proposed by the government in the project "agricultural policy 2007."

As to competition policy, my authorities welcome staff's encouragement of the ongoing initiatives to strengthen competition. The revision of the competition legislation will soon be discussed in parliament. The draft law allows for direct sanctions against participants in cartels, while current legislation permits sanctions only in case of a violation against a decision of the Competition Commission. The new law is comparable to legislations in other industrialized countries.

Regarding corporate governance, as mentioned by staff, many steps are being taken. In April, the Board of the Swiss stock exchange adopted rules regarding disclosure of relevant information by listed companies. The new rules satisfy minimal standards as defined for EU member countries. Of course, it would be possible to go further and parliament is currently debating whether it would be appropriate to do so.

We recognize that implementing structural reforms in Switzerland is a slow process, due largely to the very particular institutional setting of direct democracy. At the same time, it is encouraging to note that once a sector is liberalized, market dynamics are very effective. In the example of the telecom sector, prices have fallen below the OECD average in a short period of time.

As noted at the outset, my authorities found the FSAP exercise very useful. The FSSA is of high quality and they share the thrust of staff's assessment of the Swiss financial sector and support a large majority of the recommendations. In the following, I would like to highlight some points for emphasis.

Swiss banks' resilience to shocks is high and this solidity is reflected in particularly comfortable levels of capitalization. It is worth underscoring that even under the extreme scenario used for the stress test the large banks would have sufficient capital to withstand the shock without having to use any part of their required capital. Hence, according to the stress test scenario, even a strong deterioration of the economic climate would not lead to an "acute problem," to use staff's terminology.

Despite the overall good health of the Swiss financial sector, it is nevertheless desirable to develop further tools to help assess its vulnerability from a systemic viewpoint, i.e., with a particular focus on the systemically relevant banks. Indeed, steps in this direction have already been taken within the newly established Competence Center for Systemic Stability at the SNB in collaboration with the Swiss Federal Banking Commission (SFBC). The authorities acknowledge the necessity to proceed with a number of reform projects currently under way in the financial regulatory field, which found strong support by staff. These include, in particular, the improvement of the framework for consolidated supervision of financial conglomerates, the strengthening of regulatory sanctioning powers, and the formalizing of a quality assurance program for supervising external auditors. My authorities also welcome the staff's support for the proposed bank reorganization and liquidation framework and introduction of mandatory deposit protection.

The FSSA provides a comprehensive and balanced overview of the insurance sector. By pointing out the lacunae in the current statutes and practice and by suggesting ways to fill them in the context of larger structural change, the FSSA contributes to the ongoing discussions. The currently proposed insurance supervision legislation is particularly relevant, since the draft law addresses several key aspects of supervision such as conglomerate and intermediary oversight, corporate governance, and exchange of information and supervisor co-operation. It also aligns Swiss supervisory provisions and practices with EU legislation, an essential consideration for both the industry and the authorities.

Regarding anti-money laundering issues, the continued enhancement in the legal and institutional framework has been correctly highlighted in the reports. The most significant progress in this regard has been achieved in the area of the non-banking/non-insurance sector. The Money Laundering Control Authority (MLCA) responsible for this sector has more than doubled its staff and adopted an effective organizational structure.

Finally, my authorities welcome the very positive assessment under the IMF Code of Good Practices on Transparency in Monetary and Financial Policies.

Mr. Shaalan and Mr. Bakhache submitted the following statement:

The pick up in economic growth and the overall impressive performance of the Swiss economy in 2000 has unfortunately been thwarted by the global slowdown in 2001 and more recently by the impact of the September 11 events. Some indicators including growth, the fiscal balance, and the current account surplus have indeed weakened. However, the high premium the authorities place on pursuing stability-oriented policies has allowed the economy to absorb these shocks without major repercussions on the overall well being of the economy. This, of course, notwithstanding the Swissair failure and the still outstanding claims on Swiss insurance companies associated with the September events. The staff point out that evidence of a turning point in economic activity is less compelling in Switzerland than in other industrial countries. However, in the past few months, have indicators begun pointing to the potential direction of economic activity? Staff views would be appreciated.

The overall stance of macroeconomic policy has been broadly appropriate. Like the staff, we do not see problems in injecting some fiscal stimulus into the economy, as has been the case in 2001 and 2002. Indeed, counter cyclical fiscal policy may well be desirable given the ongoing slowdown. We would like to indicate that we see important benefits to the new “debt brake” mechanism, that goes into effect early next year, particularly in the context of the Swiss economy where the issue of demographic aging has to be decisively addressed in the period ahead. However, the new debt brake mechanism limits the prospects for pursuing accommodative fiscal policy when needed. In fact, as discussed in paragraph 16 of the report, although there may be room for automatic stabilizers to operate, they are limited on account of the limiting size of the federal government and the unpredictability of the revenues of lower level government units, which on balance could well lead to procyclical policies. We would also like to underscore the importance of relying on expenditure restraints rather than revenues to steer policy in the envisaged direction. At the same time, however, it is important that the implementation of the debt brake mechanism does not result in undue spending cuts in times of economic slowdown. In this connection, we hope the built-in flexibility associated with exceptional circumstances will be used appropriately.

Given the aforementioned new constraint on fiscal policy, there is likely to be an added burden on monetary policy to deal with cyclical fluctuations. We agree with the staff that for a small open economy, reliance on monetary policy for this purpose is the preferred course of action. At the same time, it is important to recognize that the ability of monetary policy to deal with cyclical issues may be limited by the extent to which the policy interest rate can be cut, dictated by their current low level, and hence on their effectiveness as a policy tool. Indeed, this ability is being tested now. In response to growing signs of weakening economic activity in a low inflationary environment, the Swiss National Bank had to reduce the policy rate by 175 basis points in 2001. This however, did not lead to a commensurate easing in monetary conditions due to the appreciation in the Swiss franc. This in turn prompted another 50 basis points cut in May of this year. While we are confident of the capacity of the authorities to keep inflation under control if the recovery picks up momentum, we are less certain of the prospects for monetary policy to shoulder the burden of counter cyclical macroeconomic policy at times of a slowdown.

On the challenges facing the Swiss authorities to promote higher growth, we would like to thank the staff for their informative and timely analysis in the Selected Issues paper. Notwithstanding the issue of income convergence across countries, we see room for the economy to grow faster than has been the case in recent years. Action on a number of areas to address market inefficiencies could well be conducive to faster growth. In our view, it can be reasonably argued that the Swiss economy remains over regulated with widespread restrictions in a number of areas that frustrate competitive forces. However, we also find regulations to be conspicuously absent in areas where regulations are needed to foster competition, as evident by the fragmented domestic markets with entry barriers and informal cartel agreements. It would be important for the authorities to strengthen competition policy and rationalize regulations in key sectors, including telecom, electricity, and agriculture, if efforts to improve the growth potential of the economy are to be made.

On the Financial System Stability Assessment, not surprisingly, the report generally presents a positive picture of the financial sector. Given the reputation of the sector and its importance to the economy, the sector has been operating on sound fundamentals and has, in general, been able to withstand the effect of the recent slowdown. This has been true particularly for the banking sector. The impact of the September 11 events on the insurance sector however, is still to be fully seen and in fact clouds the outlook for the sector. In this regard, we take note of the generally increasing financial vulnerabilities emanating from the insurance sector that are analyzed in the Global Financial Stability report. With regard to pension funds, we concur with the staff that in a low interest rate environment, the mandatory minimum rate of return and payout ratios on pension assets represent a drag on the sector, and need to be addressed.

While the supervisory aspects of the financial system have been effective and strengthened in recent years, there appears to be gaps in the supervisory structure that still need to be addressed. First, the relatively modest size of the two supervisory bodies compared to the substantial size of the sector suggest, or at least gives the impression that the quality of supervision may at times lack the required rigor necessary for effective supervision. The dual approach, which relies on external auditors and self-regulatory bodies to complement the limited capability of the authorities in this area, appears to have worked well. However, there may well be a need to examine this approach and take any appropriate action needed to ensure that the quality of supervision remains high.

Second, there appears to be a gap in supervising large financial institutions that are involved in both banking and insurance. The legislation currently under preparation to increase the coordination between supervisory activities of both the banking and the insurance arms of the institutions, can go a long way in eliminating the possibility for regulatory arbitrage, particularly, as staff indicate, in cases where risks can be transferred within large and complex financial institutions. In today's financial world where complex derivatives appear to be increasingly used in risk management, this aspect should not be underestimated.

Finally, we would like to encourage the authorities to move forward with measures to reduce agricultural subsidies and, while their intentions to increase ODA to 0.4 percent of GNP by 2010 are welcome, we hope more will be done to meet the target set by the UN, especially in view that the country will join the UN soon.

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

The Swiss economy is expected to grow modestly in 2001 and 2002, in tandem with the global economy, after a relatively strong performance in the late 1990s. In 2001, the only component of aggregate demand to show some resilience was domestic consumption, while fixed investment stagnated and net exports contribution did not collapse due to the stagnation of import growth. Consistent with a widening output gap and supported by a stronger Swiss franc and wage moderation, inflation has remained subdued. Unemployment remains low at 2.5 percent of the labor force in April 2002, while shortages of skilled labor are somewhat mitigated by foreign labor.

The economy, as stated by the staff, was significantly hurt by the events of September 11. On the one hand, local insurance companies bore a substantial volume of claims related to the World Trade Center tragedy, which was recorded as transfers abroad, and thereby should reduce the current account surplus in the next few years as payments are made. On the other hand, the sharp shift in risk appetite following the September 11 events led to a flight to Swiss assets appreciating the currency. Indirectly related to the fall events came the collapse of Swissair, along with its fiscal implications and questions related to corporate governance in Switzerland.

Looking ahead, the economy is expected to pick up speed in the second half of the year as the global recovery firms. The macroeconomic policy mix has been supportive to economic activity in 2001, especially since the last quarter. Monetary policy was conducted to counteract the confidence shock, and fiscal policy was proven ex-post to be supportive of economic activity, as the automatic stabilizer were allowed to work and unplanned expenditures, such as those associated with the failure of Swissair were realized.

The recently introduced monetary policy regime focusing on medium-term price stability seems to be serving well the Swiss people. In spite of not defining a point target for inflation, the framework retains the basic elements of an inflation-targeting regime, characterized by constrained discretion. As staff indicates, the monetary regime has allowed the SNB to act in a flexible and forward-looking way to address the latest shocks, and has been an effective instrument in communicating policy decisions. The conduct of monetary policy is somewhat complicated by the safe-haven role of Switzerland, which has led, in a period of heightened volatility in international markets, to an upward pressure on the currency, thereby undoing some of the initial stimulus represented by lower domestic interest rates. In this regard, however, we fully share the SNB's view, expressed in Mr. Cippà's comprehensive statement, that gauging the monetary stance through the use of the monetary condition index (MCI) could be misleading as, for instance, it does not account for changes in the equilibrium exchange rate over time. Notwithstanding the complications brought about by the strengthening of the Swiss franc, the results achieved by the SNB are remarkable in securing price stability and paving the way for an economic recovery in 2002.

We congratulate the authorities for the upcoming introduction of the new fiscal policy framework in January 2003, which aims at a balance budget over the cycle for the federal accounts. This rules-based fiscal regime should enhance transparency and predictability of the macroeconomic framework, while ensuring its consistency with the monetary regime. This so-called "debt-brake" policy is intended to limit the expansion of the debt-to-GDP ratio, which is projected to be at 53 percent of GDP at end-2002. We take note of the staff proviso that gross debt has increased in recent years by more than the deficit because the government assumed the debt and has begun to capitalize the pension funds of public enterprises that were commercialized. We agree with staff's implication that an increase in the domestic debt, which reflects enhanced transparency of the public sector finances, should be qualified.

The highly diversified and developed financial sector has been a cornerstone of the Swiss economy and has strong world performance. It is no surprise that the FSSA has confirmed that Swiss banks are well capitalized and enjoy good asset quality and profitability and that its insurance industry exceeds solvency requirements by comfortable margins. The supervisory system, though of a small size and relying considerably on external auditors and self-regulatory mechanisms, has proven effective. The moves towards consolidated supervision, strengthening of supervisory powers and for more integration of banking and insurance supervision currently under consideration by the authorities will further enhance the effectiveness of the supervisory framework.

As the staff has noted, the large size and strong international diversification of the banking sector, whose assets amount to five times GDP with half being held on behalf of non-residents, has allowed the financial sector to function as a shock absorber to the national economy. On the other hand, it can also function as a channel transmitting turbulence in the global economy to the domestic economy, with the main risks for the banking sector arising from a deep global recession. However, the stress tests conducted by the SNB indicate that, while a prolonged world recession could lead to substantial credit and interest rate losses, both the large banks and the cantonal banks would have sufficient capital to withstand the shock without using the required capital.

The report also found that the Swiss financial system is fully or largely compliant with the various financial and codes and standards assessed during the FSAP exercise. Particularly important have been the efforts undertaken since 1998 to combat money laundering, where the Swiss practices were found to be broadly in line with international best practice. We congratulate the authorities on the results of the FSAP and are pleased to learn in Mr. Cippà's helpful statement that they plan to implement the suggestions made by the staff in the FSSA report to further improve the Swiss financial system.

Trade liberalization in Switzerland has been disappointing. Trade barriers and price support mechanisms in the agricultural sector have been significant impediments to foreign competition. Average tariff protection for agriculture is quite high, and as staff indicates for some products it reaches the unthinkable level of 700 percent. We hope for a more positive engagement of Swiss authorities in the new trade round leading to bold liberalization of the agricultural sector to benefit not only the least developed countries, but also the developing countries in general.

While we commend the authorities for their intention to raise the official development assistance, the slow pace of convergence toward the agreed levels of 0.7 percent of GNP is disappointing.

We are encouraged by the recent progress in addressing the availability of economic statistics, but note that significant deficiencies remain and are not convinced that budgetary problems should prevent a country as wealthy as Switzerland to have the highest standard in economic statistics.

We thank the staff for very good reports and Mr. Cippà for his excellent statement and wish the Swiss authorities all the best in their future endeavors.

Mr. Wang and Ms. Cao submitted the following statement:

Notwithstanding the 1.5 percent real GDP growth rate in 2001—lower than the EU and industrial country average—Switzerland still remains a model for other industrial countries as measured by the high savings ratio, stable low-level inflation rate, sustainable current account surplus, favorable fiscal balance and a low unemployment rate. The authorities' skillful macroeconomic management is also highly commendable.

However, as staff points out in the well-written report, the authorities need to attach greater importance to further harmonizing macroeconomic policies, increasing the growth potential and pressing ahead with structural reforms. All these will be conducive to a more dynamic economic growth. Mr. Cippà gives us very insightful thoughts on these points in his statement. I would like to contribute some points for further discussion.

We welcome the authorities' focus on achieving medium-term economic equilibrium. It is astute to manage the medium-term outlook with monetary policy bearing the main countercyclical responsibility, fiscal policy maintaining balance for the aging pressure and keeping the exchange rate flexible.

The new monetary policy framework has given a very clear signal to the economy and has been well received by the market. We support the authorities' use of a range target for medium-term inflation and believe that this will give them more room to maneuver. Regarding the current monetary stance, given the slower than expected recovery, the recent 50 basis points rate cut by SNB is the right move to stimulate domestic demand and respond to the renewed appreciation of the Swiss franc. However, we note that after several interest rate cuts last year, staff's and the authorities' views differ on the monetary conditions. As Mr. Cippà points out, the differences can be attributed to the monetary condition indicator chosen by both sides. We would like to hear staff's response as to what indicators better depict the real situation and, based on the real picture, whether, given the latest rate cut, the authorities need to be cautious about further monetary expansion.

On fiscal policy, the "debt brake" framework to be launched in January 2003 will prepare the authorities for the demographic aging. It is worth mentioning that at the present stage the country's pension funds are well capitalized, which is better than in many EU countries. However, it seems difficult to limit the fiscal deficit to within the 2002 target owing to the weak recovery momentum in the first half of 2002. As mentioned by Mr. Cippà, the Federal Council has submitted a supplementary budget for 2002 amounting to Sw F 601 million (1.2 percent of total expenditures). Therefore, it is encouraging that the authorities fully agree with staff that the unexpected revenues resulting from the buy-back program of Swisscom shares in 2002 should be used exclusively to reduce the federal debt. Nevertheless, it is also important to give room for the automatic stabilizer to play. To this end, we agree with staff's suggestion to build up a reserve in the unemployment insurance fund and harmonize the behavior of lower-level government.

On the exchange rate, the flexible exchange rate regime works well, freeing the authorities' hands when they make monetary and fiscal decisions. However, the safe haven role of the Swiss franc caused it to appreciate several times since September 11. We take staff's point that the real effective exchange rate is now roughly back in line with its longer-term underlying trend and share the authorities' view that it is not a big concern considering the country's strong productivity in financial services and other high-quality exports. Therefore, increasing the nontradable sector's productivity is the right policy orientation.

Compared with other industrial countries, Switzerland has registered a relatively slow growth over the past 10 years, while from 1996 it no longer lagged behind other countries quite as much. By breaking the supply-side rigidity—lack of competition and high prices in some key industries—and encouraging technical innovation to fully utilize the high-tech benefits, the country will earn more growth potential. Furthermore, accelerating economic integration within the EU and other neighboring countries may also generate growth opportunities.

On breaking the supply-side rigidity, it is encouraging to learn that new legislation will be passed removing artificial barriers to competition, which will encourage greater efficiency in the sheltered sectors. At the same time, following the successful liberalization of the telecom sector, a bill on liberalization of the electricity market is waiting to be approved in the September referendum and the government is preparing for liberalization of the gas and postal sectors.

An important task for the authorities is to encourage technical innovation and generate more high-skilled professionals from the sound education system. On accelerating economic integration with EU countries, we warmly welcome from the second quarter of 2002 implementation of the seven bilateral agreements between the EU and the authorities, in the air and road transportation sectors, the free movement of people, access to the agricultural market, elimination of technical obstacles to trade, public procurement, and R&D. According to official estimates, this will raise the country's annual GDP by Sw F 8 billion within ten years of taking effect.

On strengthening corporate governance, the sheltered sectors can learn directly from the highly competitive and the state-of-the-art managed financial conglomerates in the areas of organizational structure and internal control. We also hope that Switzerland's well-developed financial sector can give valuable lessons to other countries on risk management, supervision and surveillance.

Before concluding, we welcome the authorities' initiative to eliminate trade barriers for the poorest countries and encourage them to raise their official development assistance to the UN target.

Mr. Mozhin and Ms. Vtyurina submitted the following statement:

It would be appropriate to join both the authorities and the staff in stating that the short-term outlook for Switzerland could be seen as cautiously optimistic. As in many industrial countries, growth declined in 2001 but is expected to pick up this year and onward. While not disputing this projection, we would, however, agree with the staff's analysis in the Selected Issues paper that Switzerland's growth potential is not completely contingent on the external developments affecting exports and investment but, to a great extent, depends on the resolution of several domestic structural issues.

It is important to distinguish that the new monetary framework, focusing on the medium-term inflation, is bringing noteworthy results, which is recognized by all parties involved. Hopefully, the SNB can share their experience with other countries trying to implement transparent and well-understood monetary frameworks. The SNB should also be commended for dealing appropriately with the significant appreciation of the Swiss franc. It would be important to stay ready to act quickly in both directions, i.e. in case of foreign exchange market turbulence or faster than expected recovery in Europe. As the last interest rate cut showed, the SNB is acting according to this principle, although it needs to be kept in mind that there is not much room left for further monetary easing through interest rate cuts. In the staff view, what could be the authorities' response to further appreciation of the franc, given this limitation as well as strict fiscal policy rules?

Fiscal policy objectives were not fulfilled because of the underperformance of cyclically sensitive revenues and the occurrence of very large unexpected expenditures. The payment for the national airline company in the order of Sw F 1.2 billion, mandated by the parliament, had the most significant impact on the budget. While we note in para 22 that there is no intention to provide budgetary support to the new airline company, it is reported elsewhere that 2002 budget will have an outflow of Sw F 1 billion for this purpose. We would welcome the staff clarification of this point. In addition, a large repayment of withholding tax (a result of last year's abundant inflows) contributed to a much stronger than warranted fiscal deterioration. In the staff view, how this source of vulnerability could be mitigated in the future?

This said, it is rather obvious that countercyclical policy was not part of the original fiscal strategy and the authorities seem to be fully committed to balancing the budget by 2005 as well as restricting public debt growth. Yet, the fulfillment of this goal does not appear to be easy, especially given the latest indications about the slower than envisaged economic pick-up. In this vein, implementing the staff's suggestions for further expenditure flexibility and limiting the practice of revenue earmarking could aid the achievement of this goal. At the same time, building up a reserve fund in the unemployment insurance system and preserving social expenditures during the downturn also seem to be important issues to consider in the near future, as the automatic stabilizers at the federal level may not be enough to deal with large demand shocks.

The FSAP exercise delivered generally positive results on the assessment of the vulnerabilities of the Swiss financial system. The fact that "all three lines of defense – risk management, supervision and surveillance – are well placed and functioning" definitely brings comfort, given the global systemic importance of the country's financial institutions. We congratulate the authorities on these achievements. Nonetheless, precisely because of importance and size of this sector and its "internationalization", the risks and vulnerabilities are even more significant and should be monitored with much greater vigilance. In para 61 of the FSSA report, the staff lists potential channels through which a sharp correction in equity prices as well as their increased volatility could affect the economy. It is also highlighted that the impact of these vulnerabilities on the system will depend on the adequacy of risk management techniques in financial institutions. While these are in place, the staff is still apprehensive about large off-balance sheet exposures that make it difficult to assess vulnerability to shocks from international financial markets. To this end, we would be interested to learn the authorities' plans to address this serious issue.

We note in para 77 that the staff are encouraging the authorities to ask banks to run standardized stress tests on ad hoc basis. While this is probably one of the best possible ways to assess vulnerability, there may be a danger in underestimating the risk since banks' internal risk assessment systems are looking increasingly alike. The last week's Economist survey of international finance picks up on this issue stating that because of this phenomenon the users are responding in similar ways to market's fluctuations, i.e. moving in a herd, thus inducing liquidity problems in the system. The staff recognizes the same point in footnote 3 of Box 4. While this issue is being discussed widely, few suggestions are being made on how to address it, which only underscores the importance of vigilance and the need for prudent practices and strong corporate governance among market players. As to the supervisory institutions, they seem to be limited both in resources and enforcement capacity, especially when it comes to large conglomerates. Thus, we encourage the authorities to make the best use of the staff's helpful recommendations on how to improve the current supervisory framework.

As in some other developed economies, issues of corporate governance in Switzerland have recently become prominent. The failure of Swissair and poor performance of other large enterprises not only identified a particular gap in supervisory framework but also rightly raised questions about the current practices and regulations. Hence, as the staff, we welcome the initial efforts taken to improve corporate governance standards and encourage the authorities to conduct review under the OECD Principles of Corporate Governance.

The Selected Issues paper presented a very interesting analysis of structural issues facing the country in the context of their relevance to growth prospects. As many of these issues are long standing ones, we will not dwell on them. We would just highlight that while the strides made by the authorities in several structural areas (telecoms and general competition policy) are very important, many of the necessary reforms are progressing slowly amid resistance of special interest groups to further liberalization. We continue to encourage the authorities to make more aggressive steps in addressing pressing structural rigidities. At the same time, we welcome the continuation of an open trade regime in several areas. We hope that Switzerland's commitment to trade liberalization and, especially, its promise to eliminate all barriers to imports from least developed countries and the support for initiatives under the upcoming Doha round stay intact.

Lastly, we have to say that we were genuinely surprised to learn that deficiencies in the availability and quality of economic statistics not only persist in Switzerland but that the authorities refer to budgetary constraints as the main reason for not addressing statistical problems more expeditiously. We hope to see significant improvement in this area in the near future.

Mr. Zoccali and Mr. Costa submitted the following statement:

The Swiss economy has been exposed to the ups and downs of the world economy. Its characteristic of being considered a safe haven compounds, in times of crises, the effects of external shocks through the appreciation of the Swiss franc, negatively impacting on exports. This may explain why the evidence of a turning point in economic activity in Switzerland has been so far less compelling than in many other industrial countries.

Nevertheless, the performance of the Swiss economy remains strong with growth expected to gather momentum in the second half of this year helped by a pickup in global activity. Inflation and unemployment remain at very low levels underpinned by moderate wage increases, notwithstanding the shortages of skilled labor. Sound fiscal and monetary policies contribute to the overall strength of the Swiss economy. On the structural front however, the staff reports have done a good job in highlighting the relatively large scope available for raising productivity by removing inefficiencies and fostering innovation and by opening up domestic markets in areas such as agriculture, electricity, gas, retail trade, tourism and health sectors. We concur that it is important to ensure that the underlying growth rate of the Swiss economy could be sustained at the level that staff estimates of about 2 percent per year over the medium term. It is somewhat surprising in this regard, however, that having reaped the benefits of substantive reforms in the manufacturing sector, public support for further liberalization in some sheltered service sectors is weak. Perhaps this may be explained by the fear of unemployment in the wake of the collapse of Swissair. Alternatively, the government may be less successful in convincing people of the benefits of an increased liberalization of the service areas presently under consideration, to which the agricultural sector must be added in view of the excessive level of protection it receives.

With this backdrop, the critical relationship between Switzerland and the EU deserves, in our view, a more detailed treatment than the one given by staff. The Selected Issues paper refers to Switzerland's failure to keep up with the pace of liberalization internationally, which has eroded its attractiveness as a business location. It also adds that the non-ratification of EEA, may have prompted some enterprises to relocate activities to the EU. These developments point to the importance for Switzerland to catch up with the regulatory and trade liberalization environment of the EU before lost attractiveness affects new investment opportunities. Another dimension of this relationship was highlighted in the latest report of the Economist Intelligence Unit which raises the risk that bilateral negotiations between Switzerland and the EU will break down as Switzerland resists EU demands to lift banking secrecy. More analysis of these issues would be welcomed in future consultations.

On fiscal policy, the introduction of the new debt brake framework that calls for a balanced federal budget over the cycle starting in 2003 should afford welcomed predictability to the macroeconomic environment. Nevertheless, it is important not to lose sight of the fact that the federal budget represents only a small share of the general government operations, thus reducing the macroeconomic significance of the new framework. In this regard, we wonder how discussion of tax harmonization issues between the Confederation, the cantons and the municipalities, in the context of the revenue-sharing agreement progressed since last year. Staff comments would be appreciated. Another relevant fiscal issue relates to the fact that notwithstanding the debt brake framework, public debt is expected to increase over the next two years due to off-budget operations associated with the recapitalization of the civil service pension funds and of public enterprises that have been recently commercialized. Staff might wish to provide some comment on how large these transfers could become. On the other hand, the ongoing pension reforms should help to prepare the public finances for the challenges associated with the aging of the population. Finally, we welcome the rejection of tax hikes as an eventual policy tool to meet the requirements of the debt brake. In the same vein, we share staff's position that one-off revenues such as the receipts of Swisscom should be used to rein in the public debt, and welcome the authorities´ agreement with the recommendation as anticipated in Mr. Cippà's comprehensive statement.

On the monetary policy front, the authorities have made good use of the flexibility gained through the adoption of a new monetary policy framework beginning in 2000. The short-term Swiss franc LIBOR interest rate, the policy rate used by the authorities, was reduced on five occasions since 2001. The cumulative 225 basis point drop thus evidences that monetary policy is indeed shouldering the main burden of countercyclical macroeconomic policy in Switzerland. This room for maneuver was facilitated by the benign inflation outlook, with an expected headline, CPI inflation below 1 percent for most of 2002, which is comfortably within the SNBs definition of price stability. With regard to the functioning of the new monetary policy framework, staff acknowledges that it is working well and that financial market participants understand it correctly. It is noteworthy, however, that the SNB's medium-term inflation forecast assumes that interest rates stay at current low levels while, more realistically, rates should be expected to rise over the course of the cycle. We wonder to what extent this possibility has been internalized by market participants and believe that more important than more information on how the framework operates to form expectations, is the actual policy performance in terms of sustaining growth at reasonable levels and reining in on inflation what matters.

Further on structural issues, we have found particularly timely staff's comments in paragraph 22 related to the poor quality of corporate governance in Switzerland. At a time when the consequences of the Swissair debacle are still unfolding, compounded at the international level by the fall of Enron, we attach importance for the authorities to find effective ways to improve corporate governance and transparency.

Given the important role of the Swiss financial system in world capital markets, we welcome the reassuring conclusions of the FSSA report as well as the commitment of the authorities to implement a large majority of its recommendations.

Finally, having one of the highest per capita incomes in the world, it is to be hoped that the contribution of Switzerland to official development assistance can be increased more rapidly than presently envisaged by the authorities.

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

After experiencing sound growth in 1997–2000, the Swiss economy weakened in 2001. As a very open economy, Switzerland was hit hard by the global economic slowdown and the impact of September 11. The authorities responded quickly, however, and the economy seems to have bottomed out in early 2002 and to be on the way to recovery, although there is some uncertainty. For the time being, the authorities should be ready to use monetary policy in either direction to achieve macroeconomic stabilization. In the medium term, maintaining sound growth is the major challenge for this affluent nation with an aging population. Accelerating productivity growth by opening up sheltered sectors is the focus in this respect.

In light of the size, complexity, and importance of the Switzerland's financial sector, both domestically and globally, it is welcome that the FSAP has been completed. The report is comprehensive and spells out clearly the characteristics of the Swiss financial system and its challenges. This chair broadly supports the recommendations made by staff. This was the first FSAP exercise with a financial system of this size and complexity, and we believe it has been a good learning experience for both the staff and the authorities. Other large financial sectors are going to have FSAPs in the next few years, and we hope staff will draw on this experience and have fruitful discussions on those occasions.

The authorities' quick response to the economic downturn in 2001 is commendable. Since the negative effect of September 11 was pronounced in Switzerland, the authorities were warranted in making deeper cuts in the interest rate than the ECB. Looking forward, with the benign inflation outlook, still nascent recovery, and the risk of currency appreciation, we believe the current monetary stance is appropriate, including the interest rate cut earlier this month. Monetary policy should be ready to move in either direction for the time being, depending on how the relevant factors play out. As the recovery becomes more secure later in the year, the authorities should be ready to start raising interest rates.

This chair supports the authorities' principle on fiscal policy; i.e., the priority of fiscal management should be to arrest public debt growth. The new debt brake framework appears to be a workable benchmark for medium-term fiscal consolidation while allowing the automatic stabilizer to work. Further fiscal consolidation is needed to ensure the observance of this framework. This must be achieved through expenditure consolidation, not a tax increase. More flexibility in the expenditure structure would help enhance the quality of expenditures and ensure that necessary expenditures are maintained.

Switzerland faces the challenge of maintaining economic growth in the medium term. This is a difficult task since Switzerland is already a high-income country and is generally expected to grow more slowly. The unfavorable prospect can be offset to some degree by productivity growth, however. This can be achieved by enhancing the workings of a number of product markets. In view of the disappointing pace of regulatory reform in Switzerland, there is ample room for improvement. There is a wide range of sheltered sectors in Switzerland that have achieved only low productivity growth in the past. Productivity must be enhanced in these sectors by opening up the market and putting in place appropriate competition policy and a regulatory framework. Switzerland has already had some success in opening up the market, most notably in the telecommunications sector. This should be followed by other sectors. Opening up the electricity sector, where prices remain high, is a priority, since it would contribute not only enhancing the efficiency of the sector but would also boost activity in other sectors.

It is encouraging to learn from the staff paper that banks in Switzerland are well capitalized and profitable in general, and that they could withstand substantial shocks to the economy and financial system. With the increase in cross-border and cross-sector activities and off-balance sheet exposure especially by two large banks, however, the Swiss financial system has become increasingly affected by international conditions.

With the emergence of financial conglomerates that are active globally in broad areas of finance, financial supervision needs to be strengthened in terms of both quantity and quality. Given the increase in cross-sector financial conglomerates between banking and insurance and the existing obstacles to information sharing between insurance supervisory authorities and banking supervisory authorities, the envisaged structural changes to integrate the banking and insurance supervisory authorities are welcome.

Mr. Daïri submitted the following statement:

Key Points

- Prudent economic policies have placed the Swiss economy in a good position to take advantage of the projected upswing in global activity;
- Fiscal and monetary policy should remain supportive of activity, although fiscal policy will be constrained by the strictures of the "debt brake" framework;
- The conduct of monetary policy has been exemplary, and the new monetary framework has worked well. Nevertheless, there is scope to further expand the information provided to markets;
- While competitiveness does not appear to be of immediate concern, the continued trend increase in the real effective exchange rate could pose problems over the medium term;
- Despite the strength of the financial system, the environment remains challenging and calls for prudence and strengthened cooperation among financial regulators;
- Durably improving growth performance will require stepping up the pace of structural reform in the sheltered sectors and a more powerful Competition Commission.

We thank the staff for a clear and concise report and an excellent Selected Issues paper, and Mr. Cippà for his thoughtful statement. As Mr. Cippà notes, the Swiss economy was not spared the effects of the deterioration of the global economic environment. After strong performance in 2000, economic growth slowed sharply in 2001, and is forecast to remain at a modest 1 percent in 2002. Nevertheless, in view of the authorities' pursuit of stability-oriented macroeconomic policies, the economy is more resilient to shocks than in the 1990s and in a good position to take advantage of the projected upswing in global activity. Inflation has remained very low, underpinned by prudent monetary policy and moderate wage increases.

With output below potential and evidence of a turning point still unclear, fiscal and monetary policy should provide appropriate support to activity. However, we agree with staff that the role of fiscal policy should be limited, and monetary policy assigned the responsibility for countercyclical macroeconomic policy. The weaker-than-expected fiscal position in 2002, mentioned by Mr. Cippà, should not be problematic from a cyclical perspective, but it will require stronger fiscal adjustment when the new framework—the debt brake—goes into effect in January 2003. We welcome this new framework whose strictures should go a long way to ensuring lasting fiscal consolidation and reining in public debt. While measures on the tax side have not been ruled out completely, the requirements of the debt brake will call for greater expenditure flexibility and efficiency. Despite questions of political viability, we encourage the authorities to consider subjecting earmarked revenues to sunset clauses so as to increase spending flexibility.

Monetary policy has been conducted in an exemplary manner and has responded promptly and appropriately to changes in the cyclical position of the economy and exchange rate developments. The new monetary policy framework appears to have worked well. Nevertheless, there is scope to expand further the information provided to markets, and we encourage the authorities to do so with a view to lending greater clarity to their policy pronouncements. The recent appreciation of the franc seems to be consistent with the large current account surplus and the trend improvement in terms of trade. Although competitiveness is not seen as a concern at present, a continuation of an upward trend in the real effective exchange rate will call for vigilance in the period ahead.

Switzerland's financial sector is highly developed and well capitalized with state-of-the-art risk-management systems and a capacity to react swiftly to changing market conditions. Despite the existence of large off-balance sheet exposures, the recently concluded FSAP suggests that banks' overall resilience to shocks is quite satisfactory. Nevertheless, the risks in the current challenging environment are not insignificant and call for continued prudence, including strengthened cooperation among financial regulators. In this regard, we welcome the decision to set up a single supervisory authority and introduce a quality assurance program for external auditors. We support the authorities' ongoing efforts to guard against money laundering and track terrorist financing.

As the illuminating Selected Issues paper on Growth suggests, boosting the economy's growth performance remains a key challenge for the authorities. This will, however, require durably raising total factor productivity growth by addressing skill shortages and eliminating the drag on potential growth that emanates from the inefficient, sheltered domestic sector. The staff notes that the pace of liberalization in this sector has been slow. Nevertheless, we welcome the authorities' initiatives in the area of competition policy, including the proposed new Competition Law, and hope that the Competition Commission will be provided the necessary resources to ensure vigorous enforcement. We are pleased to learn that prospects for the referendum on the opening up of the electricity market are good. A positive outcome should help garner the support needed to move forward the process of liberalization in the gas and postal services. Significant benefits to consumers would also accrue from an early phasing out of the many distortions and barriers in agriculture.

We join staff in commending the authorities for adopting higher standards of corporate governance in light of questions raised by the dramatic collapse of Swissair. The authorities' commitment to remove all barriers to imports from the least-developed countries by 2006 and their intention to gradually raise ODA as a percent of GNP are welcome. We encourage the authorities to move more vigorously toward meeting the UN goal for ODA.

Mr. Rustomjee submitted the following statement:

We wish to thank the staff for the detailed set of reports and Mr. Cippà for his useful statement. As we are in agreement with the thrust of the analysis and recommendations in the reports, we shall limit our comments to only a few issues for emphasis.

Switzerland's economic performance during 2001 reflects the resilience of a very open economy in the face of external shocks. Although economic performance slid in response to the global slowdown and the aftermath of the September 11 terrorist attack, other economic indicators manifest the stable condition of the economy. For instance, the inflation and unemployment rates remained low at 1.0 and 1.7 per cent respectively, while the external current account surplus soared to about 10 per cent of GDP. We also note in the Staff report and in Mr. Cippà's statement that the economy's labor market is flexible and that this has contributed to the low unemployment rate. In addition, we commend the authorities for sustaining the low inflation rate, the lowest in Europe, through an appropriate interest rate policy. It is also noteworthy that the overall monetary policy framework of the Swiss National Bank, which focuses on medium-term inflation, has helped the Bank to respond to last year's business cycle and exchange rate developments.

Although fiscal consolidation remains a major issue in Swiss' medium-term economic program, we welcome the new fiscal framework enunciated in the "debt brake" arrangement, which requires the federal accounts to be in balance after adjustment for the economic cycle, and also allows the use of one-time revenues to reduce the public debt. The latter objective becomes very pertinent when viewed against the fact that arresting the growth of public debt is one of the main priorities of the authorities in the years ahead. However, we urge the authorities to implement the debt brake in a manner that would prevent shortfalls in erratic revenue items, such as withholding tax and stamp duty revenue, from forcing the authorities to apply expenditure cuts at times of weak economic activity. We also support the recommendation by staff for a reduction in the policy of earmarking revenues for specific projects, in order to enhance flexibility in reshuffling expenditure items and to restrain expenditure growth in the medium term.

In the same vein, we note in Mr. Cippà's preliminary statement and in the staff report, the legal steps and structural reforms taken and proposed by the Swiss authorities to enhance competition in the economy, an issue that has been a lingering problem in the economy's growth strategy. The reforms, especially in the competitive provision of public social services as well as corporate governance, to ensure improved medium-term growth performance for Switzerland, are welcome. We urge the authorities to urgently strengthen the legal and structural reforms for improved competition, especially those that relate to a rebound of exports and investment, which constitute Swiss' major sectors where competition is currently lacking. Similarly, reforms in the months ahead will be essential in education to address skill shortages as well as in corporate governance to engender transparency in corporate business. Addressing these remaining challenges are particularly important because they are key to the achievement of the medium-term objective of higher growth and low inflation for Switzerland.

We are encouraged by the commendable FSSA report on the Swiss financial system as well as the efforts of the authorities to address the identified areas of weakness in the banking and insurance sectors through the establishment of relevant supervisory bodies and adoption of appropriate legal and regulatory reforms. In particular, we commend the authorities for their commitment to anti-money laundering activities and their efforts to track terrorist financing

Finally, we note the authorities' reaffirmation of their intention to raise official development assistance from 0.3 to 0.4 per cent of GDP and urge an urgent implementation of this policy. We also note Swiss' policy of open trade regime and its active involvement in international liberalization initiatives, but urge the authorities to remove the remaining high protection on agriculture, which still has an average tariff protection of about 34 per cent. This step will be imperative if its commitment to eliminating all barriers to imports from the least developed countries by 2006 is to have any meaningful impact.

We wish the authorities the very best in their future endeavors

Mr. Oyarzábal and Ms. Alcaide submitted the following statement:

At the outset, we thank the staff for the well-written report on the 2002 Article IV Consultation of Switzerland and the accompanying background documents, which present an insightful analysis of the country's recent economic development and policy issues. We also thank Mr. Cippà for his enlightening and very useful preliminary statement.

The Swiss authorities are to be commended for their skillful macroeconomic management over the last years, which led the country to impressive economic results in terms of very low rates of inflation and unemployment, sizable current account surpluses, nearly balanced fiscal accounts and an appreciating trend of the safe-haven Swiss franc. Last year, economic development lost considerable momentum in Switzerland as a result of the global economic downturn, but its sound position has allowed it to weather the new conditions well.

Notwithstanding Switzerland's appealing features for economic growth, such as a small public sector with law taxes, a highly qualified labor force and a substantial openness to external trade, among others, and the positive recorded economic outcome, it seems that its relative institutional advantages have been eroding over the last years, when other industrialized areas have considerably enhanced the implementation of structural reforms. As a result, Switzerland's GDP growth has been relatively low and a faster pace of structural policies conducive to remove market imperfections and uncompetitive behavior will be required if the country wants to improve its attractiveness as a business location and achieve higher longer-term growth.

Since we broadly agree with the staff's appraisal and recommendations, we shall limit our comments to some points on monetary, fiscal and structural policies.

We share the staff's view that monetary policy is working well and is satisfactorily understood and accepted by financial markets. The recent move to the new framework with policy decisions based on a medium-term inflation forecast and the setting of an operational target range with a spread of one percentage point for the three-month LIBOR rate has proved efficient in maintaining price stability. The easing of last year's stance was appropriate in view of the benign inflation performance, the widening of output gap, the weakening of economic activity, and the appreciating pressure over the franc. Price stability was also underpinned by low oil prices and moderate wage increases. In the short term, we support the authorities' intention to adopt a wait-and-see posture to adjust the stance to developments in economic activity and exchange rate.

Last year's federal fiscal balance slightly failed to comply with the balanced budget constitutional mandate, but that was mainly caused by unplanned expenditures associated with the collapse of Swissair and lower than anticipated receipts from erratic performing revenue items. For the year 2002, the staff rightly points out—and the authorities share the view of—the importance of devoting one-off revenues such as the receipts from the buyback Swisscom to reduce public debt, avoiding a further fiscal impulse through new spending or tax cuts. This will be particularly important in view of the possible worse federal balance outcome and lower revenues mentioned by Mr. Cippà in his preliminary statement. We applaud the authorities' objective of building up a reserve in the unemployment insurance fund to avoid procyclical changes in contribution rates. We strongly welcome the additional step to strengthen macroeconomic stability through the new debt brake framework taking effect from 2003 onwards, and its priority to reduce public debt growth.

The relative low rates of productivity and GDP growth mainly caused by the slower pace of implementation of structural reforms were mentioned above.

Despite the continued real appreciation of the Swiss franc, external competitiveness is not judged a matter of concern. The export sector is indeed well adapted to the upward trend of the real exchange rate and the export competitiveness is given by technological quality rather than product prices. Competitiveness depends also upon the evolution of productivity, wages, and prices of goods and services not exposed to real competition.

We concur with the authorities that the best way to improve competition would be to implement product market reforms in the sheltered sectors, such as electricity, gas and agriculture, rather than depreciating the franc, something which would undermine the SNB's objective of price stability and the interest rate advantage. The liberalization in the telecommunications sector is a very good example to show the beneficial effects of competition over the substantial reduction of prices for households and businesses. The process of structural reforms needs to be supported by reinforcing the Competition Commission's ability to sanction the operation of cartels. In this regard we welcome the revision of the competition legislation pointed out in Mr. Cippà's preliminary statement. We also applaud the steps taken to enhance corporate governance.

Finally, in view of the importance of Switzerland as a major international financial center, we strongly welcome the recent undertaking of

the FSAP exercise, which has shown an overall robust Swiss financial sector. Nevertheless, we concur with staff that financial supervision plays a relevant role in the current uncertain environment. In this regard, we welcome the proposed reform to create an integrated financial supervisory authority.
Mr. Kelkar and Mr. Jayatissa submitted the following statement:

Key Points

- The staff is to be commended for the rich and comprehensive analysis of key economic policy issues (para 1).
- The cautious optimism about the medium-term outlook for growth appears reasonable. Would the output gap remain for long, given the recent stagnation of investment? (para 2).
- A case for any tightening of monetary policy is not on the horizon (para 3).
- We endorse staff recommendations on fiscal policy. It is encouraging that the budget law has safeguards against fiscal laxity when there are one-off revenue gains (para 4).
- Although the financial sector remains strong, we agree that greater flexibility in the determination of minimum rates of returns and pay-off ratios on pension accounts would be necessary to strengthen further (para 5).
- Raising growth potential in the future depends largely on the speed of introducing competition in the sheltered sectors and productivity enhancement. We see a need for faster consensus building towards a more open and competitive product markets (para 6).

We thank the staff for the high quality report and the background documents and Mr. Cippà for the very helpful preliminary statement. We note the rich and comprehensive coverage of major economic policy issues in the report, which has also incorporated the findings of the detailed analysis done under the FSAP. Mr. Cippà's statement has been particularly helpful, as it has further elaborated authorities position on fiscal and monetary policies. We commend the authorities for the skillful management of the economy and their commitment to medium-term fiscal consolidation and addressing the remaining structural impediments to higher growth.

Sound macroeconomic policies have made the economy far more resilient than in the past. Given the slower than anticipated recovery compared to other industrial countries and the continuing uncertainties, particularly with regard to oil prices, the cautious optimism about the short-term outlook for growth is well justified. While the economic growth is expected to gather momentum during the second half of 2002 with a pick up in the global economy and also benefiting from the monetary easing in 2001, it is somewhat disheartening that the output gap would continue for another two to three years. However, we remain somewhat less convinced that an output gap remains for long, given the expected decline in investment in 2002, after stagnation in 2001. We would appreciate staff comments.

We welcome the forward-looking approach in monetary and fiscal policies. The interesting discussion on monetary policy, in the context of exchange rate appreciation and slower recovery, points towards the need to maintain easy monetary stance for some more time until there are clear signs of a much faster recovery. We are pleased that the new monetary policy framework is working well and welcome the actions taken to improve transparency of the framework.

We endorse the staff's recommendation on fiscal policy. We note that the "debt brake" fiscal rule has provided the authorities with a reasonably flexible mechanism for effective use of fiscal policy with a focus on balanced budget over economic cycle. It is encouraging that the budget law has safeguards against fiscal laxity when there are one-off revenue gains. We welcome the authorities plan to use such revenues for debt reduction. We appreciate the information given in Mr. Cippà's statement on authorities plans for tax policy, which partly addresses the staff concerns about the skewed nature of taxation. However, we note the divergence of views between staff and the authorities on the taxation on labor.

It is encouraging that despite the challenging environment, the financial sector remains strong and that it would only through a greater worsening of the economic climate that could exert additional pressure, which is an unlikely event in the foreseeable future. This is particularly so as the authorities are also taking action to address structural problems. We also share the view, to which the authorities too have agreed, that greater flexibility in the determination of minimum rates of return and payout ratios on pension accounts would be necessary to strengthen the insurance sector. We welcome the initiatives to enhance the supervision of financial markets, including the planned combined supervisory authority, in line with the recommendations of the FSSA report.

Enhancing the potential growth of the Swiss economy depends to a large extent on the speed of bringing in competition in the sheltered sectors. We welcome the proposed new Competition Law and agree with the staff that the Competition Commission should be given the support for its implementation. We also see the need for faster consensus building towards a more open and competitive product markets. In this regard, while welcoming the plans for the shift away from agricultural price support, we are also concerned about the continuation of high agricultural protection.

We endorse the staff suggestion to bring forward the 2010 target for official development assistance.

Mr. Wijnholds and Mr. Nijsse submitted the following statement:

I would like to start with compliments for the staff for the clear staff papers. The table with website addresses for statistical data on Switzerland was very helpful and I would suggest to make this a standard feature of all Article IV reports. I also read the Swiss FSSA report with great interest. Especially the supervisory challenges resulting from the international activities of the large Swiss financial institutions and the consequences of integration of banking and insurance activities in single institutions might provide interesting lessons for other countries. In this light, I will mainly focus my comments on the financial sector.

With regard to macroeconomic policy, my remarks would be very similar to the ones I made during last year's Article IV consultation. This of course highlights the main positive characteristics of the Swiss policy mix: macro-economic stability and policy predictability. The stable policy environment that has been created is a key factor for the continued competitiveness of the Swiss financial sector. The new medium term inflation targeting framework and the future fiscal policy rules have increased the transparency and predictability of the policy mix, thus contributing to economic stability.

It seems, however, that macroeconomic stability in Switzerland comes at the cost of a relatively meager growth performance. I agree with staff that there is still scope to increase economic flexibility and increase the growth dynamics by taking structural measures. Consumer prices, for instance, are high in Switzerland (even as much as 30 percent above price levels of comparable EU countries, according to the staff report). This is not only due to the higher utility prices, which are emphasized in the staff report. Apart from the relatively high wage costs in Switzerland, many rules and regulations on the canton and community level still seem to hamper reorganizations and increases in efficiency, for which consumers have to pay the price. Furthermore, the high protection level of the agricultural sector not only causes distortions by directing human and investment resources away from other, more competitive sectors, but it also places a burden on the spending capacity of the Swiss consumer. I therefore support the government in pursuing further market liberalization and deregulation.

The flagship of the Swiss economy in the rest of the world is its financial sector. Both in size and in reputation, Swiss financial firms are in the highest league of the global market. But both from a supervisory as well as from a competition policy point of view, the question is whether regulation and supervision have kept up with the development of Swiss financial firms. My conclusion would be that although in general, supervision seems to be adequate, there are still some elements in the system which has developed from a more small-scale cooperative financial system and which might need modernization to deal with the larger, more anonymous and less consensus oriented international business world.

First, there is the issue of the use of external auditors to do most of the practical on-site supervision work in the banking sector. Although those auditors can be closely scrutinized, the Enron saga suggests that also auditing firms can make major mistakes. In a less cooperative and consensus oriented internationalized business environment, it is questionable if one should rely heavily on auditors which are selected and remunerated by the firm being audited. I welcome the increased involvement of the SFBC in the on site audits of major banks, and I would stimulate the SFBC to increase its direct control over the audits.

Second, there is the role of the cantonal banks. Those institutions operate with government guarantees and with favorable capital requirements. Both from a competitive as well as from a budget-risk point of view, this seems acceptable as long as those institutions provide a social service by bringing banking services to regions or groups of people which would otherwise not have access to them. As soon as those cantonal banks start competing with regular financial institutions and even expanding into securities trading and foreign markets, as the staff report suggests, this not only distorts competition in the banking market but it also poses a considerable financial risk to the local authorities, as experience in some other countries shows. In that case, those banks should be privatized or at least be brought under the same regulatory, supervisory and taxation standards as private financial institutions.

Third, there is the question whether self-regulation is still an adequate supervisory system for the increasingly internationalized stock exchange. As soon as more and foreign parties enter the market, especially through off-site trading terminals, supervision based on trust and mutual control and discipline becomes more difficult. It might therefore be advisable to move to a more formal regulatory system to deal with the potentially larger and more complicated risks than which existed in the past.

Fourth, the cooperation between the SFBC and the FOPI seems to be based mostly on informal and voluntary information sharing between the two supervisors. Again, this seems like an adequate arrangement as long as the market remains small and easy to control. With two large banks, which are active in many countries and market segments and a collapse of which could have a major macroeconomic and budgetary impact, more formal arrangements for cooperation between supervisors would seem to be appropriate. This could also prevent the development of regulatory arbitrage between insurers offering products with a savings character or banks offering savings or investment products with an insurance character.

> Fifth, the FSSA report did not fully make clear to us whether supervisory standards have developed parallel to the expansion of activities of the large Swiss banks. I would be interested, for instance, if the system for risk provisioning for country risks is adequately prudent and requires, if necessary, additional provisioning for individual country risks. Furthermore, I wonder if a relatively small supervisor as the SFBC, with its extensive use of outside expertise, is adequately staffed to deal with the assessment of banks' own risk management systems, as is required under the Basle II Agreement.
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> Sixth, I wonder whether the distinction between pension funds and insurance firms from a supervisory point of view is adequate. Especially for larger pension funds, equal supervision as for insurance firms would be appropriate. It is questionable if a local level supervisor has the capacity to assess and react to the risk attached to the large, international investments of the large pension funds. Furthermore, regulatory arbitrage between pension funds and insurance firms might lead to a sub-optimal allocation of resources.
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> Finally, a few general remarks on the Swiss financial system. I strongly support the authorities with regard to the introduction of a comprehensive deposit guarantee scheme. Such a scheme is an important element from the viewpoint of consumer protection, which should be part of a developed financial market like in Switzerland. Furthermore, it can increase competition in the financial sector by lowering the entry barrier of having to build a reputation from scratch.

Mr. Cippà said that ten years ago, on March 29, 1992, Switzerland signed the Articles of Agreement, and became the 179th member of the Fund. Although the process leading up to the membership had been difficult, it had been a very rewarding experience. To celebrate the occasion, and to show appreciation to the institution, management, and the Board, Swiss chocolates would be served during the current meeting.

The Acting Chair (Mr. Aninat) congratulated Mr. Cippà on the anniversary, and said that it was an important milestone for Switzerland as well as for the Fund.

The staff representative from the European I Department (Mr. Corker), in response to questions from Directors, made the following statement:

> Let me start with issues raised on the staff's economic forecast. Mr. Shaalan asked whether, in the last few months, indicators have been pointing toward a pick-up in growth. There have been some positive signs, but they are still only tentative. The economy in the first quarter is believed to have continued to stagnate; consumption appears to be holding up relatively well, but exports were very sharply down by about 4 percent compared to the same quarter last year.

The leading indicators, however, have been inching up. We have one more observation to add to the figure in the staff report, because KOF, the research institution that puts out the most widely watched indicator, released its April observation today, which showed another further, but very small increase. Unfortunately, they also revised down the March data, so it is not a very strong signal as yet. Generally, indicators are suggesting that final demand in Switzerland is remaining weak. There are some indicators, though, of orders picking up. Inventory levels are being reported by industry as still too high, so we probably expect some further de-stocking in the immediate period.

Overall, recent indicators suggest that growth in the second quarter will be weak at best, but the leading indicators are consistent with stronger growth in the second half of the year. The staff's growth forecast of 0.8 percent is broadly in line with the Swiss authorities' estimate of about 1 percent. I note that the May 2002 consensus forecast, including other institutions, has inched up to 1.2 percent from 1.1 percent; but, in more recent press stories, some analysts announced that they are to adjust their forecast back down again, so this is very much a mixed picture, and cautious optimism is still the word of the day.

Mr. Kelkar asked why the staff would expect an output gap to persist for two or three years, particularly with the decline in investment and, presumably, therefore, some reduction in capacity. The decline in investment mainly reflects a correction of the investment peak in 2000. The level of investment still remains very high, so the rate of capital accumulation is still relatively fast. It would only decline marginally as a result of a lower investment rate. Moreover, we expect the investment rate to pick up again toward the end of this year and certainly during the course of 2003.

So, with only very little effect on capital growth, we would not expect to revise down our projection for potential growth. In fact, Chart 1-4 in the background issues paper allows one to calibrate how much a given fall in the investment rate would affect the potential growth rate. Given that the fall in the investment rate is only about 1 percentage point, it will have very little effect on capital growth and potential output. Indicators of capital utilization in industry suggest that utilization is now about 2 percent below average. It is not a very consistent series over time, but it is another indicator that capacity constraints are not an immediate concern in Switzerland.

On monetary policy, Mr. Wang asked the staff to effectively clarify its views on monetary conditions and whether the authorities need to be cautious with further monetary expansion in the period ahead, and Mr. Mozhin asked what the authorities' response should be to a further appreciation of the Swiss franc, given that interest rates are already quite low and fiscal rules are strict. The staff broadly agrees with Mr. Cippà in his statement that the staff's views on monetary conditions are very similar to those of the SNB. There is a suggestion in his statement that we rely more on monetary conditions indicators than the SNB; but I think that is a misconception. As you will see from the staff report, the staff consider a broad set of indicators, including real interest rates, yield curves, interest differentials with Europe, and money supply. We also look at the MCI, and we adjust it for trend increases in the exchange rate. Our view is similar to the SNB's in that all these indicators suggest that monetary conditions are supportive of growth.

Second, it is clear in the staff report that we support the framework the SNB is using in the sense that monetary policy decisions should be based on the medium-term inflation forecast. When the staff was in Switzerland in March 2002, it seemed that the inflation outlook was very benign. There was a widening output gap, and core inflation was about half a percent. We did not see a significant medium-term inflation risk. So, we thought that there was some scope, if the recovery were to falter or the exchange rate were to appreciate, to cut rates. Upon the mission's return to Washington, DC, apparently the authorities also agreed with us, because they cut rates following an appreciation of the exchange rate.

So, any misconception that there is a significant difference of opinion on monetary policy between the staff and the authorities is not accurate. On the specific question about where monetary policy should go in the period ahead, we would say wait and see. At this stage, monetary conditions are sufficiently supportive of recovery; real interest rates are very low at the moment; and there is no need to cut rates from that perspective. Indeed, as we say in the report, if the outlook proceeds as expected, then the SNB is likely going to have to start tightening policy—and possibly this year, if growth recovery is stronger than we anticipate.

To answer Mr. Mozhin's question on what should be done if the exchange rate appreciates again, we would note that there is still scope to cut rates, as they are 100–125 basis points away from the zero interest rate floor. Obviously, whether that is the right thing to do would depend on whether more information is available at that time on the inflation outlook or growth prospects. Low interest rates do raise the interesting question as to what kind of policies should be in place in order to avoid the interest rate trap. The staff stresses the need to have the automatic fiscal stabilizers working properly and fully under the new debt brake system that Switzerland will be introducing in January 2003. As several Directors have noted, one requirement is to have a well-capitalized unemployment insurance fund to avoid having to adjust contribution rates when weak demand pushes up unemployment.

There is a question that we raised in the staff report, and Mr. Mozhin also picks up, about how the fiscal accounts can reduce or cope with vulnerability to swings in erratic revenue items, in particular withholding taxes. These revenue swings are large, about 1.5 percent of GDP in 2001, and they are difficult to predict. However, it is also the case that they do not significantly affect the fiscal impulse, as a lot of the swings are related to payments by foreigners, which are then reimbursed the following year. So, this does not affect domestic demand conditions.

The question is how the new debt brake will cope with these swings, and Mr. Cippà has provided a large part of the answer in his statement, in the sense that forecast errors in these revenues will not apply be applied to the expenditure rule. They will be placed into a so-called virtual account, so shortfalls in erratic taxes do not lead to a tightening of the expenditure rule, nor do windfall gains lead to a loosening of the expenditure ceiling.

Moreover, there still could be an ex ante budgeting problem depending on how these erratic items are forecast; if a conservative budgeting approach is used, that is, it is assumed that the erratic items are going to come in low, then the expenditure ceilings may be set too tight. Likewise, if you tend to be optimistic about these erratic revenue items, then it the expenditure ceilings could be set too loose. One possible solution to get around this problem within the framework would be to set the revenue projections for these items at some average or trend level. Then, as Mr. Cippà explained in his statement, the second part of the debt brake takes over, and forecasting errors would then not cause any further problems in this respect.

The staff representative from the Monetary and Exchange Affairs Department (Mr. Hilbers) made the following statement:

I would like to make a brief, general point before answering specific questions. Of course, it is a special occasion today, with the ten-year anniversary of Switzerland's membership in the Fund. It is also special because this is the first time that the staff has conducted a financial sector assessment of a major international financial center of this size, complexity, and systemic importance. This FSAP has been a major effort on the part of the authorities, and the staff is very grateful for the cooperation from a wide variety of Swiss counterparts in conducting this exercise.

I would also like to emphasize that it was all a bit new to us, and the challenges of assessing the system of this complexity and size were considerable. The staff spent a great deal of time discussing financial sector issues with the Swiss financial sector supervisors and with the Federal Finance Administration, Swiss National Bank, as well as with many private sector participants. In particular, in the area of stress testing, the cooperation with the Swiss National Bank and the Federal Banking Commission, the supervisor of the financial system, the banks, and the securities markets was very inspiring.

As Mr. Yagi mentioned, this has been a learning experience both for the staff and for the authorities, and we can draw on this experience in assessments of other large financial systems. Also, the publication of the documents will enable others to learn from this exercise.

Turning now to the questions in Directors' statements, Mr. Wijnholds raised a very relevant point of how supervisors can keep up with the rapidly changing environment, both nationally and internationally, and that is a challenge that supervisors are faced with all over the world. He asks whether the current supervisory model, in which external auditors and self-regulatory institutions play an important role, is still appropriate. First, I think it is useful to observe that this model has served the system well so far, and that supervision has been effective and cost-effective in Switzerland.

The supervision of banks, securities markets, and insurance sector by the Banking Commission and the insurance supervisor has been strengthened in terms of quality and quantity, with a focus on large institutions, which are very important in the Swiss financial system, and with a focus on a more risk-based approach. In light of the size and number of financial institutions and the relatively modest size of the two supervisory agencies, external auditors and self-regulatory bodies play a key role in the supervisory process in Switzerland. The supervisors are aware of the risks of outsourcing on-site work, and have taken steps to check that the work is done according to the standards required. Staff notes that this so-called dualistic approach of supervision would benefit from a more formalized quality assurance program for supervising external auditors, and a further increase in joint, on-site inspections. Already, the Federal Banking Commission has taken steps in this direction.

With regard to Mr. Mozhin's observation about off-balance sheet exposures, it needs to be emphasized that this point was made in the context of our own assessment, reflecting the staff's recognition of limitations in what one can do during an FSAP exercise for such a complex financial system, including in the scope of the stress testing exercise. I would emphasize that it was not meant to indicate a particular weakness in the supervisory system in this area. Swiss banks do include off-balance sheet exposures in their models, and supervisors do include off-balance sheet exposures and positions in their assessments, in particular for the large and sophisticated institutions where they are most relevant. In effect, the increased emphasis on risk-based supervision was reflected in the creation of a new unit recently to validate bank risk models, including the treatment of off-balance sheet exposures within the banking supervisor.

Staff recommended some further expansion of resources dedicated to this activity in the future in light of Basle II requirements, and that process is already underway. The Banking Commission currently has a risk management team of 7 staff, and this group will be augmented to 12 members within the next one or two years.

It is intended to create three teams to work on credit risk, market risk, and operational risk, which will be headed by staff members who actively participated in the Basle II process as members of the relevant working groups. When considering the staffing issues in this area, it should be noted that it is also expected that besides the two large banks, only very few other banks will opt for the so-called internal ratings-based approach, which in a sense limits this potential problem in terms of its implications for supervision.

Mr. Wijnholds also asked about the prudential requirements for managing country risk. The two large banks, as well as other banks, are subject to the guidelines of the Bankers Association on the Management of Country Risks, which entered into force on December 31, 1997. These guidelines are declared mandatory by the Banking Commission; all banks must apply them and their implementation must be verified by external auditors. There is also a monthly reporting requirement for country risk, and there are no indications that provisioning may be inadequate.

On the point of pension fund supervision raised in Mr. Wijnholds's statement, the report notes that the first unfunded pillar is publicly managed, while oversight of the private pillars falls on cantonal supervision as well as supervision by the Federal Office of Social Insurance. Staff recommendation in this area is to consider combining private pension fund supervision with the planned integration of banking securities and insurance supervision, because of efficiency and coordination gains and also because, in practice, many insurance companies are heavily involved in the administration of private pillar pension funds. Further cooperation and integration of financial sector supervision in Switzerland would also help to bring these activities, which are currently under three different ministries, under the same ministerial responsibility.

Mr. Bischofberger made the following statement:

Like other countries, the Swiss economy has not been able to withstand the negative effects of the recent global slowdown and the September 11 events. Sound macroeconomic policies, however, place the economy in a good position to benefit from the expected upswing. More generally, owing to its strong fundamentals, Switzerland continues to find itself in a comfortable situation, as compared to many other advanced economies. Accordingly, Staff rightly point out that the main challenges facing the economy relate to its longer-term prospects. In my further comments, I shall mainly focus on these structural challenges as well as on fiscal and tax policies.

First, I welcome the interesting analyses undertaken in the main and the background documents on issues related to potential growth and structural rigidities—a topic which has featured prominently in recent Article IV consultations with Switzerland. Liberalizing sheltered sectors and fostering competition is key for boosting growth of total factor productivity and potential output. I welcome the planned measures to strengthen the Competition Commission, but I note staff's concerns as to whether they will be sufficient. Important headway has also been made in the telecommunications sector. However, much remains to be done elsewhere. As others have noted, the case for regulatory reform is clearly underscored by the OECD-studies undertaken on members' progress in this area.

Furthermore, it is worth noting that a positive impact on growth and productivity can also be expected from the implementation of the bilateral agreements with the EU. This process of economic cooperation should be further pursued.

Turning to fiscal policy, the introduction of the "debt brake" in 2003 will be an important step towards further transparency and credibility of the fiscal framework. The proposed rule contains several interesting elements, such as a mechanic rule to adjust the budget norm to the cyclical position of the economy. While this provides another safeguard against the undesired exercise of discretion, I do note that last year the staff found the formulation of the cyclical adjustor to be on the simplistic side. Generally, it will be interesting to see how the mechanics of the rule will play out, once it enters into force.

Given its overall sound fiscal track record, Switzerland appears to be generally well placed to comply with the requirements of the "debt brake". I agree, however, that this task may be complicated by the existing fiscal rigidities, such as the large incidence of erratic and earmarked revenue items. These reinforce the case for building up a reserve in the unemployment insurance fund. Also, it is worth noting that the cantons and communes, which make up about two thirds of the public sector, are not included in the new rule. Hence, closer vertical fiscal coordination may be warranted, in order to ensure overall discipline and avoid procyclical policies at the decentralized levels.

As regards the near-term outlook, further loosening of the fiscal stance should indeed be avoided this year, so as to facilitate a smooth transition to the new fiscal regime and to bolster its credibility. In this context, I welcome the information provided by Mr. Cippà in his most useful preliminary statement on the utilization of asset sale proceeds for debt reduction purposes. Looking forward, I welcome the authorities' intention to resist tax hikes as an instrument of fiscal consolidation. However, the uneven tax burden between capital and consumption suggests that there is some scope for rebalancing taxation toward consumption. It seems that a "natural" candidate for such a move would be the VAT, considering the relatively low VAT rate of 7.6 percent. While Mr. Cippà also touches on this issue in his statement, it is not entirely clear if future VAT increases will be at least partly offset by tax relief on capital and investment or if they will be used in full to finance additional social expenditure.

As regards monetary and financial policies, the Swiss National Bank's wait-and-see stance seems appropriate, especially after the interest rate cut earlier this month. The evolving picture will obviously also depend on exchange rate developments. But if the recovery proceeds as expected, it will be necessary to begin raising interest rates later this year. On the financial sector, I welcome Switzerland's participation in the FSAP as well as the ongoing efforts to further strengthen cooperation among financial regulators. I can broadly associate myself here with the comprehensive remarks made by Mr. Wijnholds in his statement as well as those by Mr. Shaalan and several other Directors.

Finally, I would echo Mr. Mozhin in encouraging stronger efforts to improve the availability and quality of economic statistics.

Mr. Alosaimi made the following statement:

The Swiss economy continued to expand last year, albeit at a markedly reduced pace. The macroeconomic conditions have remained favorable with virtually stable prices, low unemployment, and strong fiscal and external positions. With capacity and demand pressures still comfortable, the economy is also poised to grow in line with the projected global recovery.

The excellent Selected Issues paper refers to the Swiss growth record over the past quarter century as mediocre, and inquires whether this mediocrity is inescapable. Here, it is legitimate to ask whether higher domestic output growth is a first priority at the Swiss economy's development level. Indeed, given also the staff's reference to the inverse linkage between growth rates and an economy's base year income level, the relevant question for the Swiss context is not by how much growth could be raised, but rather what growth rate is adequate to at least maintain the current high living conditions in Switzerland.

That said, easing the labor constraint is clearly critical to sustaining growth in the face of an unfavorable skill mix and demographics of the aging Swiss population. The priority for labor market reforms is therefore welcome. A stronger effort for a more competitive product market is also important. Given the ongoing structural reforms and the authorities' focus on macroeconomic stability, I agree that the economy is well placed to benefit from the projected upturn in global growth.

On fiscal prospects, the likely rise in the deficit that Mr. Cippà notes in his helpful preliminary statement is not a concern, in view of the still tentative recovery. I commend the authorities' adoption of the improved policy framework, with renewed attention to fiscal consolidation and containment of public debt. The provision for financing of the demographically-induced increases in social spending by a higher VAT is appropriate. I would also underscore the staff's suggestion on tax reform and avoidance of spending rigidities, including especially the practice of earmarking revenues.

On monetary policy, the continued accommodative stance is appropriate, in view of the benign inflation outlook at this early stage of the recovery. The medium-term framework for monetary policy has worked well and should be continued. As the staff has noted, the policy framework is also well accepted by participants in the financial market. I therefore share the authorities' preference to stay the course rather than move on to a less flexible option, like adopting a point target for medium-term inflation.

On structural reform, I endorse the staff's emphasis on steps to make the relatively sheltered domestic industries competitive, like the financial services and export sectors. The active discussion of issues, including the work of the inter-ministerial working party and the initiatives under the agricultural policy project, bode well in that regard. The challenge is particularly demanding in view of the local complexities, including the competing claims of cantonal rights and the imperatives of internal market law. Increased perseverance with the ongoing initiatives, including product market reforms and improved corporate governance, is crucial.

Finally, the authorities' commitment to end all trade barriers to the least developed countries by 2006 is a step in the right direction. However, a more aggressive and broad-based policy is overdue. Specifically, a timetable is needed for dismantling the country's still very high levels of tariff protection and subsidies.

Mr. Lombardi made the following statement:

Let me start by thanking the staff for a very informative set of papers and Mr. Cippà for his insightful statement.

The Swiss authorities have to be commended for pursuing stability-oriented macroeconomic policies that have allowed this economy to absorb recent shocks in the face of the global slowdown as well as the tragic events of September 11.

In particular, we welcome the rule-based fiscal policy framework intended to credibly commit the authorities to sound public finance management. However, for this to be effective, such a commitment needs to be shared by the lower levels of government, especially in light of the relatively small size of the federal budget. In this regard, it is not clear whether local governments are willing to refrain from implementing pro-cyclical fiscal policies. Any clarification from the staff and Mr. Cippà would be appreciated. Furthermore, for this framework to operate smoothly, the issue of unpredictable and erratic sources of revenues would need to be addressed. Also in this respect, the staff's comments would be welcomed.

On monetary policy, the focus on medium-term inflation by the Swiss National Bank allows market participants to better assess monetary developments and, therefore, to react more smoothly to business cycle conditions.

There is, however, an aspect regarding the current policy framework that is not entirely clear. With central fiscal policy bounded to a balanced-rule and monetary policy focusing on medium-term inflation and constrained by an appreciating exchange rate, it is not clear how the policy mix would be attained. Staff's views would be very much welcomed.

So far the authorities have thus put substantial efforts in designing a stability-oriented framework. We believe that the next step is to reap all the possible benefits by enhancing the economy's potential growth. As the staff report points out, growth is lagging behind, though this evidence is difficult to reconcile with that portrayed by Figure 6 in the main paper, indicating that almost a third of firms has reported shortages of skilled labor this year.
In light of this, a medium-term goal of a 2-percent increase in GDP does not seem ambitious. Perhaps, much more could be achieved if skilled labor were encouraged.

In this regard, we see the low productivity more as a result of various kinds of barriers and regulations than as the outcome of a catch-up phenomenon of other countries. This is also indirectly accounted for by the lower productivity of agriculture and the other sectors sheltered from international competition as opposed to those sectors actively engaged in the international arena. In this regard, we strongly agree with the staff's recommendation to urge the authorities to increase competition, make the internal market work effectively and improve overall productivity.

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

Mr. Djojosubroto made the following statement:

We thank the staff for their informative reports on Switzerland, and Mr. Cippà for his very helpful statement. The Swiss economy lost its momentum in 2001, mainly due to a marked slowdown in the global economic climate and the pronounced crisis in the information technology sector.

We commend the Swiss authorities for their balanced macroeconomic policies and continued efforts in the implementation of structural reforms that have facilitated a more resilient overall economy today compared to the 1990s. Following slower economic growth last year, there are several signs pointing to an upswing in the economy, initially in the export sector, driven by the improved economic situation in the United States and Europe. We therefore believe that with a more favorable external environment and the adherence to expeditious macroeconomic policies, the Swiss economy will gain momentum over the coming years.

We are in general agreement with staff appraisal and shall limit our comments to the fiscal policy and structural reform.

On the fiscal front, we see that the Swiss fiscal policy optimally supports economic recovery. However, a notable decline in withholding tax revenue warns of renewed budget deficits at the federal level. We welcome the development in the fiscal area, in particular, the adoption of the new fiscal instrument "debt brake", a constitutional mechanism that aims at managing the federal budget and keeping the level of debt in check, and maintaining a balanced budget over the economic cycle. We agree with staff's view that the new expenditure and tax relief should be avoided for the time being, and that the one-off revenue should be used only for debt reduction purposes, so as to fulfill the requirements of the debt brake policy. Therefore, we welcome the authorities' plans to use the proceeds arising from the buy-back of Swisscom shares for repayment of government debt.

With regards to structural reforms, we agree with the staff that the reform agenda should be accelerated to improve the product market and to bring significant benefits to industrial and residential consumers. Insufficient competition remains a stumbling block in the telecom sector, and owing to the strong resistance from interest groups and the weak public support, other important reform projects concerning liberalization in energy, gas and postal services are progressing very slowly. We welcome the authorities' proposed Competition Law that would provide a significant framework to address some of the practices that creating inefficiencies and high prices in Switzerland.

We are very concerned with the high level of protection and subsidization of the agriculture sector, which remains one of Switzerland's most sheltered markets. This protection is not only creating inefficiency in the agriculture sector, but also distorting the trade with many developing countries, away from our commitment to adhere to freer trade for the benefit of all. We would, therefore, urge the authorities to push up the further opening of their sheltered sectors by rapidly dismantling the high tariffs to facilitate the market access of developing countries.

We are encouraged by the Swiss authorities' commitment to eliminating all barriers to imports from the least developed countries by 2006, and would urge the authorities to make further moves in this direction.

We also welcome the Swiss authorities' intention to raise its official development assistance to 0.4 percent of GNP in the medium term.

Mr. Boitreaud made the following statement:

Let me first thank the staff for this interesting paper. Let me also thank Mr. Cippá for his comprehensive statement. After a couple of quiet weeks in the Board schedule, the temptation to dig deeply into the Swiss economic issues is high, but I will try to resist, as the Swiss economy is genuinely sound and, even if we do not consider it as a model, we see no major vulnerability to stress.

Switzerland has weathered the global economic slowdown relatively well and is entering a new phase of the cycle with still sound fundamentals. Indeed, a 2.5 percent unemployment rate combined with a 0.9 percent inflation and fiscal surplus, while the balance of payments is stable, are enviable results which can be explained by years of sound and cautious policies.

Against this backdrop and despite its still relatively low level, we share the authorities' focus on the recent public debt growth. In order to maintain sufficient leeway to cope with unexpected shocks, like it was done in the case of Swissair, we encourage the authorities to stick to this new debt brake framework. In particular, we believe that attention should be maintained on expenditures evolution, while being flexible enough to adapt to the evolving needs. In this context, earmarking revenues which can promote transparency limit the flexibility of the public expense management and we share the staff's views that they should be progressively phased out.

Turning to monetary policy, we note that, despite the move to an inflation targeting framework, the exchange rate still plays a preeminent role in the Swiss monetary policy. Confronted by the regular appreciation of the Swiss franc, the SNB was finally forced to act and cut interest rates by 50 basis points in the beginning of May 2002. Such a move was not totally unexpected given the room for maneuver provided by a low rate of inflation and a still weak activity of the economy. However, it makes Switzerland the only major economy where rates are being cut at a time when some central banks have already raised their intervention rates. Given the uncertainties still surrounding the strength of the global economy and the safe haven role of the

Swiss franc, the low level of the interest rates leaves only limited leeway for further action in this context. Should the Swiss franc continue to appreciate vis-à-vis the euro, the impact on the exporters might then be difficult to absorb.

Finally, the staff uses the Swissair example to deal with the quality of the corporate governance in Switzerland. While we are not in disagreement with the staff's views on this topic, we would have appreciated a more extensive coverage of this issue, and in particular of the lessons of the Swissair failures, which remains one of the striking features of the last months and which is barely treated in the report.

To conclude, let me commend the authorities for the intensification of the efforts in the fight against money laundering and terrorist financing.

Mr. Prader made the following statement:

Unlike Mr. Boitreaud, I consider Switzerland as one of the model economies of the world, but its recent problems show that no country in the corporate world of global capital flows can be regarded as an island immune to external shocks, homemade troubles, instability, and governance problems.

The Swissair episode is a case in point. Even though it amounted to a national shock and gave rise to a lot of national soul-searching, it is gracefully mentioned only in passing in the staff report. Here I agree with Mr. Boitreaud that the governance issue is underreported in the staff paper. It is quite sobering for a country of such high standards as Switzerland and may serve as more than a warning of the dangers of inadequate corporate governance when private and public interests are not clearly separated by a firewall. The far-reaching consequences of the bailout, no matter how carefully it was designed, have significant effects on public funds and other elements of the society. Swissair has been accused of reacting slowly to the prospect of bankruptcy, and the two banks mainly involved have been widely criticized for their role. In Switzerland as in other advanced economies, similar problems may afflict other mainstays of corporate life. In any case, the economic fallout, immediate and secondary, will also be significant for the financial sector, for pension funds, for unemployment, and for consumer confidence as well.

Part of Swissair's problems was that the Swiss voted not to join the European Economic Area in 1992, making this year also an anniversary of mixed results, since for this reason Switzerland did not participate in the European deregulation of air transport. This decision may have repercussions not yet evident for other businesses, even though problems have not yet surfaced. We therefore agree with Mr. Zoccali and Mr. Costa's point that the critical relations between Switzerland and the EU would have deserved more elaborate treatment than they are given in the staff report. The issue of relations with the EU is one of Switzerland's most important structural issues and should therefore be analyzed during the next Article IV consultation.

But while a number of aspects of Swiss practice have been questioned as a result of recent events, public opinion is unlikely to demand fundamental change. There are several reasons to believe this.

One could of course argue that the rate of growth is low and the transparency of monetary policy could be greater, but for the Swiss people these may not be really important issues.

First, I agree with Mr. Cippà's candid statement concerning Switzerland's rate of growth. I also doubt that we measure it properly. In an economy as advanced as the Swiss economy, GDP may not adequately reflect all aspects of the life that growth is supposed to serve. The Selected Issues paper provides an interesting analysis of the causes of Switzerland's slow growth and rightly points to the slow pace of liberalization and product reform and the lack of competition. I think we can all agree with these findings. But in addition to thinking about policies for enhancing Swiss growth, some of our research should be directed toward refining our measurement capabilities. And I would not confine myself to the oft-mentioned issue of foreign revenues, although the performance of Swiss-owned assets may be very important for Switzerland even if it takes place far outside their jurisdiction. Replacing GDP with GNP will not really solve the measurement problem because I suspect that these indicators do not reflect some very important aspects of the quality of life for Swiss people in Switzerland or elsewhere.

Second, the gross public debt is above 50 percent of GDP—thus reaching average European dimensions—and the tax system could be improved. Realistically, the Swiss authorities have reacted to these weaknesses. The fiscal sphere is kept under control. So Swiss taxpayers, in their usual prudent spirit, agree with the staff that the fiscal rule called the debt brake should be applied on the expenditure side rather than the revenue side. In this connection having a small government sector is certainly helpful for keeping the budget balanced.

Third, Switzerland is a unique country, providing a safe haven from other peoples' wars, political instability, or financial turbulence. It would be worth a try, however, to exploit some of the secrets of Swiss success in ways that would work in other parts of the world.

All this provides a solid basis for optimism, but at the same time, the global lessons of the Swiss financial system, appropriately emphasized in the well-written paper on the FSSA, show that regulatory and monetary policy issues are very important to the world. The simple fact that the Swiss need not worry much about their future does not necessarily mean that the rest of the world has no need to pay attention to the far-reaching implications of Swiss developments. At any rate, it would be helpful if the Swiss authorities would start addressing some of the supervisory problems identified in the FSSA, such as the issue of the size of the staffs assisting the authorities and the problems of insurance supervision.

Mr. Nguema–Affane made the following statement:

First, I would like to thank the staff for their excellent set of papers, and Mr. Cippà for his comprehensive and helpful statement. The Swiss authorities should be commended for their sound macroeconomic policies, which led to satisfactory economic performance over the past few years despite the growth rate slowing down in 2001. I welcome the authorities' intention to pursue with policies in the medium term. As I concur with the thrust of the staff appraisal, my comments will focus on a few issues.

As regards the debt brake framework, its implementation will require more firmness in public finance management, especially at the lower levels of government. I agree that efforts should be focused on the expenditure side, but I share Mr. Shaalan and Mr. Bakhache's remarks about spending cuts in times of an economic slowdown.

On monetary policy, the current stance should be maintained, given the weaker than expected recovery and low inflation risk. The SNB is implementing inflation-targeting policies, which is working well. Like Mr. Kelkar, I welcome the action taken to improve its transparency.

Switzerland has implemented many structural reforms during the last decade that, unfortunately, did not lead to the expected rise in growth. However, this outcome should not prevent reform from being pursued, especially in the sheltered sectors. Structural measures being taken to improve competition, productivity, competitiveness, and corporate governance are encouraging.

I welcome the findings of the FSSA, which confirm the soundness of the Swiss financial sector. I encourage the authorities to consider the recommendations set in the report, especially about banking supervision. I welcome some of the recent measures to fight money laundering.

Finally, I welcome the commitment of the Swiss authorities to increase ODA to 0.4 percent of GNP, and to eliminate all barriers to imports from the least developed countries.

Mr. Whitehall made the following statement:

We commend the Swiss authorities on their record of strong macroeconomic policies, which have led to a significant period of moderate growth with low inflation, a structural fiscal surplus and near full employment.

The resilience of the Swiss economy was also recently seen as the global slowdown after September 11 had only a moderate impact. While growth was lower than average in 2001, there is no compelling evidence of a cyclical downturn, but of course caution needs to be exercised. The challenge for Switzerland is to build on past gains through structural reform. We agree with Mr. Prader's assessment that it would be wise to discover the secret of the successes of the Swiss authorities. We also wondered about the possibility of measurement problems leading to the understatement of GDP in Switzerland.

The completion of the FSAP is a positive development and the report is favorable, as expected. Like Mr. Mozhin and Ms. Vyturina we congratulate the authorities on having covered the main bases, which are effectiveness in risk management, supervision, and surveillance. In terms of supervision, we agree with the staff that the lack of budgetary independence is a potential weakness and that there is also a need to strengthen information sharing arrangements among domestic agencies.

However, like Mr. Djojosubroto we have some concerns in the area of international competition and creation of a level playing field. For example, we refer to the staff's statement on page 20 that, "In agriculture, subsidies amount to three quarters of value-added and tariff protection is high." We welcome the proposed reduction in price supports in the medium term, but echo the staff's concern that "it would take years before protection of agriculture dropped to even the high level of the EU."

We also note that there is a need for consistent treatment by the OECD of regimes with potentially harmful tax regimes. The Caribbean has of course been targeted in the past in this regard by the OECD and we have made the necessary commitments to transparency and exchange of information. But it is unclear what plans exist for similar treatment of large countries with significant international financial centers, and the extent to which this might affect taxation of international income in countries like Switzerland. Apart from the issue of a level playing field, the right to participation in international rule making is a key principle that the smaller members of our constituency also hold dear.

The staff representative from the European I Department (Mr. Corker), in response to questions from Directors, made the following statement:

> Mr. Lombardi asked about problems with the monetary and fiscal frameworks and whether they could, as constituted, cause problems for delivering the right mix of policies. I believe that he is speaking more in general, as opposed to the current situation. We alluded to problems in the policy mix in the staff report, but I am not sure that this necessarily is a framework problem. The framework works very flexibly on the downside on interest rates, as we have seen that demonstrated by the National Bank; they push rates down and respond to needed changes in monetary conditions quite flexibly. Obviously, Switzerland is a successful inflation-fighting country that has low inflation, so questions about interest rate traps and liquidity traps do arise more in the case of Switzerland because of their success in fighting inflation.
>
> On the other side of the coin, does the debt brake also constrain the situation? I agree that the stabilizers do not necessarily provide much flexibility on fiscal policy, and a great deal is devoted in the staff report to urge the authorities to make the stabilizers more flexible and provide some kind of comfort zone should a situation where overall looser policies are desired, as opposed to, say, a mix of a tighter fiscal stance and looser monetary policy, to counteract an exchange rate appreciation.
>
> There are, however, some safeguards within the fiscal framework that need to be pointed out. Basically, if a liquidity trap emerges and there is a need for looser fiscal policy because there is a prolonged recession in Switzerland, then parliament can vote for a fiscal expansion. Although the balanced budget amendment is constitutionally mandated, there is also a get-out clause. One would presume that this would be used if needed in a particular situation—of course, we are not expecting this need to evolve in the current situation, because there are still 100–125 basis points to move interest rates down.
>
> A couple of Directors mentioned the lack of reporting on the Swissair case in the staff report. I am not sure that this was an issue that the staff wanted to delve into at length. I thought we had rather elegantly linked it to the governance problem, which, of course, is a very topical problem not just in Switzerland, but also in other countries with recent cases such as Enron and other prominent examples. We probably could have said more about the specific Swissair case of poor management, ambitious expansion plans, and lack of shareholder control. However, as this matter is somewhat outside the core area of the Fund, we considered that our role was to highlight that these governance problems are not just confined to certain countries but that they affect all countries, even countries that appear to be very successful and very well run.

Mr. Prader said that he understood the staff's reluctance to get involved with such a sensitive issue, but that Swissair was a symbol like the Swiss mountains and so the effect was widespread. The staff had correctly pointed out that this was not a problem confined to developing countries, and more discussion of the matter in the staff report would have been useful.

Mr. Cippà agreed that the Swissair case had been an unexpected development, which had been based on a flawed strategy and corporate problems. However, it was not appropriate to generalize that case as an example of Switzerland isolating itself from the world. In fact, that notion was contradicted by the message from the FSAP, which underscored that Switzerland had many global players in banking and financial markets, as well as in manufacturing and other sectors. The Swissair case was unfortunate, but it was important to draw the necessary lessons from it, especially on corporate governance.

Mr. Fidjestøl made the following statement:

> I thank the staff for a well-written and interesting set of papers, which highlights the challenges facing the Swiss economy. I also appreciated Mr. Cippà's helpful statement. I noted his remark in the statement and at the start of the meeting that this Board discussion marks the tenth anniversary of Switzerland's membership in the Fund. At this occasion I would like to make a couple of remarks related to this matter. In the mid 1980s when I worked on Switzerland as a staff member and took part in an informal staff visit to Switzerland, the Swiss people had just defeated UN membership, and membership in the Fund seemed far away. Fortunately, Switzerland joined the Fund far sooner than anybody envisaged at the time, and the Swiss have since made a very valuable contribution to the work of the Fund. And now the Swiss people have approved UN membership. I would also add that coming from Norway, a country that like Switzerland has a large current account surplus, a considerable net foreign asset position, and recently an appreciating currency, I find the Swiss experiences particularly interesting, even though the background for these common characteristics of the two countries are in many ways quite different.
>
> The rather strong performance of the Swiss economy in the late 1990s was interrupted last year, illustrating Switzerland's dependence on developments in the world economy. Although growth performance weakened in 2001 with an associated increase in unemployment, both unemployment and inflation remain very low.
>
> I agree with the staff that the new monetary policy framework, which focuses on medium-term inflation is working well and has allowed the central bank to appropriately ease monetary policy. However, the overall effect of the reduction of interest rates and the appreciation of the Swiss franc is difficult to assess at this point. It seems appropriate to keep interest rates on hold, while remaining prepared to react to changes in the outlook in either direction.

The new fiscal framework with the debt brake seems broadly appropriate to deal with the medium and long-term fiscal challenges, and it provides some room for the working of the automatic stabilizers. However, I wonder whether actions by lower level governments could give rise to procyclical fiscal policy, given the limited share of the federal government in public revenue and expenditure.

Boosting growth performance would help alleviate the pressures on fiscal policy that Switzerland faces due to the aging of the population. While the weak relative long-term growth performance to a large extent is due to a catching up effect, the highly interesting selected issues paper provides convincing evidence that a rather slow pace of structural reform is an important part of the explanation of the slow growth. While the exposed sectors have enjoyed productivity growth that seems to have kept them fairly competitive despite the appreciation of the currency, productivity growth in the sheltered sectors seems to have been slower than in other industrial countries. Staff appropriately points to the need to strengthen competition policy in order to reduce inefficiencies. The rather weak competition policy may partly be due to the fact that Switzerland in 1992 chose not to join the European Economic Area that would have made it part of the European internal market. Furthermore, according to the staff report, it seems that Switzerland has not fully achieved an internal market within the country. I therefore welcome the agreement in this field between Switzerland and the EU that will take effect on July 1. I assume this agreement will have effect on the ability of the cantons to regulate competition. Comments from staff on the effects of the agreement with the EU would be welcome.

Switzerland has a well-developed financial sector that plays an important role in the international financial system. It is therefore reassuring that the FSAP exercise concludes that all three “lines of defense” against financial sector problems, risk management, supervision, and surveillance are well placed and functioning. Given the importance of Swiss financial institutions in the international financial system, it is particularly important that financial supervision in Switzerland is of the highest quality. While the outsourcing of on-site work seems to have worked satisfactory so far, I think the general development of supervision, in particular the new capital adequacy accord, will make it necessary for the Banking Commission to have a stronger direct involvement in on-site supervision. I also believe that further integration of banking, securities and insurance supervision through a single supervisory institution will contribute to more efficient supervision. In general I can associate myself with the views on supervision expressed by Mr. Wijnholds and Mr. Nijsse.

Like Mr. Mozhin and Ms. Vtyurina I would draw attention to the need for improvement in the availability and quality of economic statistics. Despite improvements in recent years this is an area where Switzerland continues to lag behind other industrial countries.

Finally like Mr. Zoccali and Mr. Costa and others I encourage Switzerland to increase official development assistance more rapidly than presently envisaged by the authorities.

Mr. Epstein made the following statement:

We agree with the thrust of the staff appraisal. Overall disciplined macroeconomic policies have helped Switzerland withstand the global economic slowdown relatively well and position the economy on a medium- and long-term path of sustainable growth and low inflation. We are perhaps less optimistic about the short term and the speed to which growth is expected to return to its potential rate (around 2 percent). The staff forecasts real GDP growth of 0.8 percent this year and 2.6 percent in 2003 on the back of a global economic recovery in the second half of 2002 and the domestic monetary easing of 2001–02. However, Europe-wide economic indicators point to still sluggish final domestic demand, while lower short-term interest rates domestically have not resulted in a corresponding decline in long-term interest rates. Indeed, as shown in Figure 9, the long-term government bond rate has been rising this year, while recovery-sensitive mortgage rates remained relatively unchanged. Of course, Switzerland's continued high current account surplus, at around 10 percent of GDP, means that broad leeway exists for final domestic demand to grow without unacceptable deterioration to external accounts.

Regarding monetary policy, we believe the authorities deserve praise for efficiently managing their monetary policy stance to support growth while maintaining medium-term price stability. We agree with the staff that the Swiss National Bank's (SNB) focus on medium-term price stability has allowed the SNB to respond flexibly to business cycle conditions and exchange rate developments. We join the staff in encouraging the SNB to continue expanding the information it provides about its inflation forecast and the rationale for policy decisions.

We welcome the authorities' participation in an FSAP. Switzerland's financial sector is highly developed, diversified, and well capitalized. Systems of regulation and supervision are largely compliant with international financial standards and codes, and the Swiss anti-money laundering regime in the financial supervisory area is broadly in line with international best practice. Moreover, we note that the Swiss authorities have been at the forefront of global efforts to combat terrorist financing.

Turning to fiscal policy, we agree with the emphasis on spending restraint over higher taxes to deal with future budget constraints. We welcome that fiscal policy will remain moderately expansionary this year, while still resulting in a slight budget surplus. We also welcome Switzerland's new fiscal framework—the debt brake rule—scheduled to take effect in 2003. Given that the new framework will likely require medium-term federal budget savings on the order of a 0.25-0.5 percent of GDP, the authorities are well advised to utilize a combination of spending restraint and a reduction in earmarking of revenues in order to avoid resorting to tax hikes.

Finally, as regard to structural reforms, we join other Directors and agree with the staff that in order to sustain faster productivity growth, more emphasis should be placed in the area of product competition. Globalization has intensified restructuring in Swiss enterprises exposed to international competition, but restructuring in sheltered domestic sectors (e.g., electricity market) remains rather slow in comparison with other industrial countries. We thus welcome the authorities' engagement in this important policy area, including the proposed new Competition Law, as efforts to lower entry barriers and increase competition in protected sectors would only benefit consumers and the efficient operation of the Swiss economy.

Ms. Stuart made the following statement:

I would like to thank the staff for a good paper, a good Selected Issues paper, and also a thorough FSAP. I think this FSAP is a very welcome contribution to the Fund's overall work on surveillance, and I welcome the facts that the authorities are publishing the FSSA. Overall, I agree with the thrust of the staff reports. The risks to the Swiss economy appear in balance, although there is fragility in the financial sector, which could be important going forward.

On monetary policy, we agree with the staff that there is no urgency to tighten the stance, given the weak growth forecast for this year and also the low level of inflation. On fiscal policy, I agree with the comments of many of the speakers before me, and agree with the staff that, resort to hypothecated taxes, if possible, should be reduced, as that would increase flexibility on the expenditure side.

As I noted earlier, the FSAP is very welcome, and we agree with the thrust of staff comments here. We would like the focus of the Swiss system on risk-based supervision that should help them find problems early and allow them to move staff around according to risks identified in different parts of the system. So, that might help them with the staffing problems.

In addition, looking forward, we can see that the coordination of insurance and banking supervision will be increasingly important. Here, we think that there are some common skills that the staff has and so increased coordination between the authorities, and perhaps in regards to staffing as well as information flows, could be helpful. In fact, like Mr. Fidjestøl, we see merits in having a single supervisory authority, which would then even help the staffing movements even further.

On corporate governance, I agree with Mr. Boitreaud and Mr. Prader that it is underdone in the main report. Finally, on the need to improve statistics, I would think that it is particularly important for Switzerland to move toward ESA-95 on the national accounts, given the importance of its financial sector and all the developments that ESA-95 incorporates in terms of capturing financial sector information.

Ms. Davidson made the following statement:

Not surprisingly, at this stage of the discussion, I don't have much to add to the comments made by other Directors. But, on their anniversary, I would like to commend the Swiss authorities for their record of economic management.

Just to highlight a couple of points that have already been made by other speakers:

- I would like to join many Directors in underscoring the need for further progress on the liberalization of product markets and, in particular, the agricultural sector.

- In last year's discussion, we expressed some concern as to fiscal flexibility under the "debt brake" rule, and against this background we join other Directors and staff in encouraging the phasing out of earmarking of revenues.

- We also encourage further improvement on the statistical front.

Finally, we wish the authorities continued success.

The staff representative from the European I Department (Mr. Corker) said that it was difficult to estimate the economic growth effects of the bilateral agreements with the EU. The staff was aware of a study conducted by KOF, a research institute in Switzerland, that suggested that the bilateral agreements could add 2 percent to the level of Switzerland's GDP over 10 years.

Ms. Vtyurina said that, although the staff felt that large off-balance sheet exposures made it difficult to assess vulnerability to shocks from international financial markets, the way this was reported in the staff paper suggested that there was a potential vulnerability from not being able to assess the shocks. Could the language in the report be clarified? Also, some further explanation on what the Swiss authorities were doing regarding this issue would be helpful.

The staff representative from the Monetary and Exchange Affairs Department (Mr. Hilbers) replied that the sentence in question referred mostly to the stress testing exercise, which had been conducted in collaboration with the authorities, the Swiss National Bank, and the Federal Banking Commission, and which had focused on the so-called banking book of the banking sector. Therefore, this particular exercise, based on which the vulnerability of the banking sector to external developments was assessed, did not include an assessment of off-balance sheet activities and off-balance sheet positions of the banking sector. That, in itself, did not mean that a specific part of the banking sector was not covered by supervision or was not covered by banks themselves in terms of their internal risk management activities. In discussions with the staff, the banks, including all of the major institutions, had indicated that they included that aspect in their exercises. But it was not possible for staff to come up with an assessment that also captured these off-balance sheet positions. It should be noted that this was not just an issue in Switzerland, but throughout the world. It was often difficult to come up with an accurate assessment of off-balance sheet positions—especially estimates of the sensitivity of off-balance sheet positions to changes in the external environment—such as changes in exchange rate, interest rate, and credit quality. This would require sophisticated methods of calculation, and the mission had not been able to undertake such an assessment.

The Acting Chair (Mr. Aninat) said that a clarification on the off-balance sheet exposures would be included in the staff report.

Mr. Cippà made the following concluding remarks:

> I would like to thank the authors of the statements and other colleagues for the very pertinent and constructive comments, which my authorities will certainly appreciate. I would also like to thank Mr. Corker and Mr. Hilbers for answering in great detail all the questions raised.
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> My understanding of Directors' statements and the discussion is that Directors have no major problems with the assessment of the situation given by the staff, which is by large also shared by my authorities. Switzerland suffered from the global recession, but the fundamentals of the economy remain strong, with low inflation, low unemployment, and an essentially sound policy mix on which cautious optimism for the future can be safely based.
>
> The conduct of monetary policy, especially in the aftermath of September 11, and the new monetary framework have been particularly praised. Some concern was raised about the remaining room for maneuver at the authorities' disposal in the event of further sharp appreciation of the Swiss franc. In this respect, I fully share Mr. Corker's remarks. Moreover, let me say that things are actually under control, and the situation seems to be improving with the recent appreciation of the euro, which we believe is still undervalued. Let me also say that on an historical perspective the current situation is not particularly worrying. Ever since the breakdown of the fixed exchange rate

regime in the early 1970s, the SNB has been struggling with the appreciation of the Swiss franc, and at times a very sharp appreciation. On the comments made by Mr. Epstein, who encouraged the SNB to release further information about inflation forecasting, let me answer that this is indeed happening. Three articles about forecasting models have been recently published on Quarterly Bulletins of the SNB, and I am told that more will follow soon. I will be happy to provide Mr. Epstein with copies of these articles.

Also on the fiscal side, Directors seem to appreciate the sizeable efforts made by the authorities to put the accounts on a sound medium-term footing, which should allow the country to be better prepared to tackle the inevitable, mostly demographic, future challenges. Temporary setbacks on the fiscal front, like the Swissair affair, should be seen precisely as temporary. Let me assure you that there is no intention on the side of my authorities to provide any additional financing to the newly established Swiss airline.

Your comments were less enthusiastic regarding structural reforms. This is understandable, and even my authorities would like to see a more rapid pace of implementation. This being said, let me add some qualifications. We always say that in the domain of structural reform, ownership is key. I fully agree with that. But what we have to understand is that in Switzerland, ownership is not only desirable, it is a sine qua non condition. Because of the particular institutional setting of direct democracy, without popular ownership there is no way that big decisions regarding the structure of the economy can be implemented. Reality in Switzerland is that people can overrule the government and not vice versa. And it is even more complicated than that, but I do not want to bother you with all the regional and cantonal checks and balances that characterize the Swiss political life. Given that ownership is a precondition, it must be built beforehand, and this most of the times is a rather lengthy process. In this context, every proposal must be fully transparent (from here the strong support of this chair for transparency issues in general) and the benefits and possible negative implications fully explained to the population. And in this respect, in order to change a status quo that has been functioning relatively well for so many years, you need to be more than convincing. It is well known that if you want to beat the boxing heavy weight champion, most of the time you have to knock him out. In this context, negative examples, even abroad, are very damaging. We all hope that by September, the California electricity privatization debacle will be forgotten. At the same time, as implied by Mr. Zoccali, positive experiences are relevant in enhancing this process. We are all very happy that the telecom privatization can be presented as a big success with big advantages for the consumer, and we are using it very extensively.

What are also important in this persuasion effort are independent assessments, especially if corroborated with valuable analytical contribution. In this context, my authorities rank the annual surveillance exercise with the

Fund very high. Discussions like the one we hare having today are very helpful for my authorities in their efforts to push forward the reform agenda. This year the staff did a particularly good job in analyzing the reason for the relatively low growth performance in Switzerland and linking it, at least partially, to the insufficient productivity of sheltered sectors. As I said in my preliminary statement, my authorities agree that competition has to be enhanced. A draft competition law has been prepared that will be submitted to Parliament soon, and an inter-ministerial working party was set up in spring 2002 to study specific recommendations on measures that should enhance growth in Switzerland.

As regards Europe, mentioned by Mr. Prader and Mr. Zoccali, I would not object a more comprehensive consideration for the coming discussions. Europe is obviously very important for us. I also agree that joining Europe we would probably represent the most important step forward in pursuing the structural reform agenda that we can imagine. My authorities know that and joining the EU remains an objective, at least over the medium term. Needless to remind, of course, that my remarks about ownership apply with special force in this context. We should not be too pessimistic either. Following on Mr. Fidjestøl's historical remarks, it took us 48 years to join the Bretton Woods Institutions, but after that only ten more years to join the UN. The speed is clearly catching up.

This year the discussion has greatly benefited from the FSAP report. Given the novelty of the exercise as well as the importance of the financial sector for the Swiss economy, it is no surprise that many comments and questions were specifically addressed to financial issues.

First, we welcome the general findings of the FSAP that Swiss banks resilience to shocks is high and that all three lines of defense against financial sector problems, i.e. the quality of risk management and corporate governance, supervision and overall systemic stability surveillance, are well placed and functioning. This being said, we appreciate the staff's recommendation aimed at developing further tools to help assess the vulnerability of the system. As I said in my preliminary statement, we agree with most of them. I would even say that some of these additional tools have already been implemented, like for instance the newly established Competence Center for Systemic Stability at the SNB in collaboration with the Swiss Federal Banking Commission. Some other recommendations are in the process of being implemented.

Many questions referred to the efficiency of supervision, to the dualistic approach, to the need for better cooperation or even integration of insurance and banking supervision, and last but not least to the need to dedicate special attention to the two large banks, which are global players and account for more that 50 percent of the system. All these questions are pertinent and I think that they have been extensively dealt with in the FSAP report. But even here the conclusions are reassuring. The system of supervision has been working well and more importantly the authorities are constantly adjusting it to the changing environment. Therefore, for instance, the two big banks are now under enhanced scrutiny, which has somewhat altered the traditional indirect way of exercising supervision in Switzerland. Another big improvement is the increased cooperation between the Swiss and the United States and United Kingdom's supervisory authorities.

The staff is right in saying that to have an efficient and solid financial system, it is crucial that all three lines of defense work properly. I would add that it is also important to find the correct balance among the three. Thus, for instance the need to identify and prevent vulnerabilities for the system must be assessed against the need for keeping financial markets working efficiently. The purpose of supervision is not to eliminate risks altogether. If we eliminate risks, we eliminate banks, whose activity is by definition managing risks. Supervision sets prudential and ethical rules. But within these limits, each bank must be free to assess and manage its own risks, and how successful it deals with that will ultimately forge its reputation and success in the market.

To conclude, I would like to thank again you, Mr. Corker and Mr. Hilbers together with all those who contributed to this discussion.

The Acting Chair made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for their sound macroeconomic policies, which have put the economy in a good position to benefit from the global recovery following last year's economic slowdown. Looking forward, the continued adherence to a stability-oriented and transparent macroeconomic policy framework, together with an acceleration of structural reforms, will underpin prospects for higher, sustained growth.

Noting that inflation risks remain low, output is below potential and signs of recovery are still tentative, Directors considered that monetary policy can afford to remain accommodative in the period immediately ahead. The latest interest rate cut was therefore welcome, and an appropriate response to the recent upward pressure on the exchange rate. Looking forward, Directors considered a wait-and-see approach to be appropriate, but noted that the Swiss National Bank (SNB) may need to begin tightening the monetary stance later in the year, depending on the strength of the economic recovery.

Directors considered that the monetary policy framework, with its focus on medium-term inflation, has allowed the SNB to respond flexibly to business cycle conditions and exchange rate developments. The framework has provided an effective vehicle for communicating policy intentions, and the

SNB should continue expanding information to the public about its inflation forecast and the rationale for policy decisions.

Directors agreed that the role of fiscal policy in supporting recovery will need to be constrained. While the current mildly stimulative stance of fiscal policy is not problematic from a cyclical perspective, slippages in budget implementation should be avoided, as this would add to adjustment strains next year when constitutionally mandated fiscal consolidation will be required. Directors also encouraged the authorities to use unbudgeted one-time revenues to reduce government debt.

Directors welcomed the adoption of the new fiscal framework requiring balanced budgets over the cycle, and saw the principle of a brake on public debt accumulation as prudent planning for longer-run demographic strains. They noted, however, that savings are likely to be needed at the federal level in coming years to ensure compliance. In this context, Directors emphasized that priority should be given to restraining expenditure growth over raising taxes. This will require scaling back demands for supplementary appropriations, as well as greater flexibility in redirecting expenditure items, which, Directors noted, would be facilitated by a reduction of the currently pervasive earmarking of revenues. Given the limited scope for the federal budget to play a counter-cyclical role under the new framework and the often procyclical behavior of lower levels of government, they also encouraged the authorities to pursue their objective of building up a reserve in the unemployment insurance fund to prevent procyclical changes in contribution rates. More generally, it will be important to implement the debt brake in a manner that prevents shortfalls in erratic revenue items from forcing expenditure cuts at times of weak economic activity.

Directors welcomed Switzerland's participation in the Financial Sector Assessment Program (FSAP), and endorsed the main findings and recommendations of the Financial System Stability Assessment (FSSA). While the financial sector is well capitalized and the lines of defense against potential problems appear to be functioning properly, continued vigilance will nevertheless be warranted in the current challenging economic environment. In this regard, Directors supported moves to further strengthen cooperation among financial supervisors, to introduce a more formalized quality assurance program for external auditors, and to increase onsite inspections by the Banking Commission. They also encouraged the authorities to review the preferential treatment of the cantonal banks, pursue further integration of banking and insurance supervision, move ahead with plans to introduce mandatory deposit protection, and address the problems related to the mandatory minimum return on pension accounts. Directors commended the authorities for their efforts to combat money laundering and their initiatives to track down terrorist financing.

Directors agreed that an acceleration of product market reforms will be key to improve Switzerland's productivity performance and growth record. The challenge is therefore to inject more competition into sheltered domestic sectors, which would enhance economic efficiency and benefit consumers. In this regard, Directors welcomed proposals to strengthen the powers of the Competition Commission, and they encouraged the authorities to complete the liberalization of the telecommunications sector, speed up the opening of the electricity sector, and phase out distortive subsidies and high tariffs in agriculture. They also looked forward to the implementation of bilateral agreements with the European Union, and highlighted the importance of addressing shortages of skilled labor. Directors underscored the need for high standards of corporate governance, and considered the proposed codes of conduct a useful first step in this area.

Directors commended the authorities' initiative to eliminate trade barriers for the poorest countries, while encouraging them to bring forward their plans to raise official development assistance.

Directors noted that available statistics are adequate for surveillance purposes, but saw scope for further strengthening statistical infrastructure in key areas such as the national accounts, wages, and fiscal data.

It is expected that the next Article IV consultation with Switzerland will be held on the standard 12-month cycle.

3. ZAMBIA—POVERTY REDUCTION AND GROWTH FACILITY—REVIEW, MODIFICATION, AND WAIVER OF PERFORMANCE CRITERIA, AND FOURTH ANNUAL PROGRAM; POVERTY REDUCTION STRATEGY PAPER AND JOINT STAFF ASSESSMENT; AND ENHANCED INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES—ADDITIONAL INTERIM ASSISTANCE

Documents: Fourth Review and Fourth Annual Program Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criteria; and Request for Additional Interim Assistance Under the Enhanced Initiative for Heavily Indebted Poor Countries (EBS/02/81, 5/10/02; Cor. 1, 5/28/02; and Cor. 2, 5/29/02); Poverty Reduction Strategy Paper (EBD/02/77, 5/13/02); and Poverty Reduction Strategy Paper—Joint Staff Assessment (EBD/02/78, 5/13/02)

Staff: Sharer, AFR; Masood Ahmed, PDR

Length: 3 hours

The staff representative from the African Department (Mr. Sharer) submitted the following statement:

> The following information has become available since the issuance of the staff report for Zambia (EBS/02/81). It does not alter the thrust of the staff appraisal.
>
> CPI data indicates that the 12-month inflation rate decelerated to 17.8 percent in April, which is just below the program target. Reflecting a downward trend in inflation, the yield on 91-day treasury bills declined from nearly 50 percent at end-December 2001 to around 35 percent in mid-May. The kwacha-U.S. dollar exchange rate has depreciated by about 9 percent since January 1, 2002, somewhat more than relative inflation, possibly reflecting continuing uncertainties in the copper sector; the spread between the Bank of Zambia auction rate and the bureau exchange rate has narrowed significantly.
>
> Provisional monetary data indicate that reserve money moved broadly in line with program projections during the first quarter. Gross official reserves at end-April 2002 are reported to be about US$96 million, which is also consistent with the program target. Available fiscal data suggest that revenue and expenditure developments appeared to be broadly on track during the first quarter.
>
> The authorities have informed the staff that the ZPA has readvertised the tender for the sale of 51 percent of government's shares in the Zambia National Commercial Bank, which is a performance criterion under the 2002 program. To improve transparency in government operations, and consistent with commitments made in the Letter of Intent, the Zambian authorities have begun publishing in the local newspapers the monthly cash releases to the line ministries by the Ministry of Finance.
>
> Regarding the copper sector, the staff has been informed by the authorities that an understanding in principle on most substantive issues has recently been reached between Anglo-American plc. (AA) and the Zambian government, which is designed to enable Konkola Copper Mines (KCM) to continue to operate as a going commercial concern and to remain in the private sector. The provisional agreement provides for an exit fee to be paid by AA to KCM and a financing package, which together cover virtually all of KCM's expected operating deficit for the period 2002–03, after which KCM is expected to become profitable. AA would have no further liabilities to KCM and its shares would be put in trust while the process of attracting a new strategic equity partner is under way. The staff understands that AA's management team would remain in place while an orderly transition is being arranged, and that AA would continue to provide KCM with procurement and marketing arrangements until at least end-March 2003. The authorities have

confirmed that the understandings are fully consistent with their commitments in the Letter of Intent. As noted in the staff report, the fifth review of the program, to be initiated in July 2002, will include an assessment of the developments in the copper sector.

The World Bank has been actively engaged in supporting the government strategy, including providing assistance to the government to access legal, financial, and technical advisors. The Bank will continue to assist the government to find new strategic equity partners and to help Zambia adjust further to a competitive world copper market. Moreover, the staff understands that some major donors are sympathetic to providing additional assistance to Zambia related to the financial difficulties in the mining sector.

Mr. Rustomjee submitted the following statement:

At the outset, my Zambian authorities would like to record their gratitude to the Fund management and staff for their continuous support and valuable advice, which have assisted Zambia in its pursuit of macroeconomic stabilization and economic liberalization efforts. They are also thankful for the cooperation extended by their bilateral development partners. This support, together with the interim assistance being provided under the enhanced HIPC Initiative, have greatly contributed to the authorities' efforts to maintain the program on track, while also addressing the basic social and infrastructure needs of the country.

The new government that took office in early 2002 has renewed Zambia's strong commitment to remain on the path of adjustment and reform. Cognizant of the fragility of the economic situation, particularly in the face of unfavorable developments in the copper sector, the authorities are determined to further strengthen their economic and social reforms with the aim of achieving stronger and sustainable economic growth and reduce the incidence of poverty, which remains substantial. They believe that a sound diversification of the economic base will be key in this process.

The authorities intend to maintain, or even improve, their track record of performance by further deepening of the reform effort. This is reflected in the several ambitious measures embedded in the program and the authorities are hopeful that their request for augmented access to help face the impact of lower commodity prices on the balance of payments will receive a favorable consideration by the Executive Board.

Policy Implementation During 2001

My authorities' steadfast commitment to the adjustment and reform process is reflected in the considerable progress that has continued to be made toward macroeconomic stability during 2001. Thanks to improved performance in mining, manufacturing, construction, and wholesale and retail trade, real GDP grew at a much robust pace than initially expected, translating into a positive per capita income growth for the second year in a row. The pursuit of tight monetary policy was crucial for the sharp decline in inflation to 18.7 percent from 30.1 percent in 2000, notwithstanding the significant rise in maize prices due to the drought.

Fiscal policy management aimed at further consolidation in 2001. This was achieved, although not to the extent envisaged in the program. Revenue performance exceeded expectations. However, expenditure grew faster than originally planned in the run-up to the presidential and legislative elections, during the last quarter. Cash releases to priority social sectors were 20 percent larger than budgeted, while the wage bill rose more than projected. As a result, the overall fiscal deficit was 0.7 percentage points of GDP higher than projected, which together with the shortfall in the disbursement of external assistance, led to a larger-than-programmed increase in government's domestic borrowing.

Progress was also made in the implementation of the structural reforms. Thus, the financial sector agenda has advanced broadly as envisaged. Measures have been taken to strengthen the overall banking system with the advertisement for sale of 51 percent of government shares in the Zambia National Commercial Bank (ZNCB), the increase in the capital base to strengthen bank solvency, and the liquidation of the insolvent banks. Preparations are underway to place the electricity company, ZESCO, for concessioning. There were, however, some delays in the implementation of the planned reforms in the oil sector in the run-up to the elections that led to shortfall in the disbursement of external assistance, to which the execution of these reforms are tied. Hence, while the state-owned oil company, ZNOC, was placed under receivership in late 2001, the authorities saw merit in delaying the concessioning of the refinery, the pipeline, and the storage facilities until after the due diligence study and valuation to be carried out by international consultants were completed.

Special attention continued to be devoted to improve governance and accountability. As part of the measures taken to improve transparency of public resources, the final government accounts for 2000 were submitted to the Auditor General in September 2001, and to the Parliament this year. The intended publication of the report on the cobalt sales was not made possible because of the threat of legal action by Metal Resource Group, the buyer of the cobalt.

The staff report shows that Zambia's performance under the program remained broadly satisfactory with most performance criteria and structural benchmarks being met. Unexpected overrun in public spending and, particularly, the shortfall in external assistance were the major contributing factors that led to the non-observance of a few performance criteria, especially for December-2001, for which the authorities have requested the relevant waiver.

Medium-Term Strategy for 2002–04

My authorities are fully aware of the important challenges that need to be faced to foster the growth potential of the economy and alleviate poverty. They intend, therefore, to continue implementing firmly the required policies to consolidate macroeconomic stability and accelerate structural reforms with the objective of reaching the HIPC completion point successfully. These policies are clearly set out in the medium-term strategy outlined in the full PRSP, which was prepared after a wide-ranging consultation process throughout the country, which culminated in the holding of a national stakeholder summit in October 2001.

The strategy aims essentially to sustain the recent gains in the growth of per capita income and to extend the benefits of such gains to all segments of the population in order to improve their economic welfare. The success of this strategy is, however, critically dependent on developments in the copper sector. Therefore, given the considerable uncertainties afflicting this sector in the aftermath of the unexpected withdrawal from the Konkola Copper Mining (KCM) announced by Anglo-American plc, the authorities intend to give top priority to diversifying the economy away from the mining sector. In this regard, agriculture, tourism, and textiles were identified as areas offering good prospects for diversification. It would, however, be unrealistic to assume that growth in these non-mining sectors could compensate, in the medium term, for the expected decline in the copper sector production. Against this background, a more conservative approach was adopted in setting the medium-term targets for the period 2002–04. The real GDP is projected to increase at a more moderate rate of 4 percent; inflation is estimated to decline to single digits by 2003; and gross international reserves are anticipated to increase to the equivalent of 3 months of imports by 2004. To sustain these objectives, the authorities intend to encourage greater private sector investment, while placing increased emphasis in improving spending efficiency.

The Program for 2002

The formulation of the program for 2002 was based on the basic premise that the KCM will remain open and that its production will be at the same level as that reached in 2001. My authorities have stated their commitment not to assume ownership of the mines. They undertook to set up a task force, which includes the private sector and mining, financial, and legal experts, that will be studying the available alternatives and will advise the government on a possible course of action. In the meantime, the authorities are also looking into the possibility of attracting a new strategic investor to operate the KCM. In light of this, there have been no provisions made in the fiscal program to support any expenditure related to the mining sector. However, as a last resort, should the need arise for the government to extend financial support, the authorities intend to implement additional fiscal measures, including new broad-based tax measures, to ensure that these outlays are fully covered.

Fiscal discipline remains at the core of the authorities' stabilization effort. Given the uncertainties about the external donor financial flows, the program will continue to focus on domestic policy measures that will assist to enhance the prospects of attaining fiscal sustainability in the medium term. This will be addressed both through the strengthening of revenues and expenditure control, while reorientating spending toward priority social sectors and basic infrastructure. The fiscal deficit is projected to decline to 3.1 percent of GDP in 2002, from 4.7 percent in the previous year. As a result of the expected improvement in the fiscal performance, government's financing requirement will be reduced to 1.2 percent of GDP, thus making room for an increase in credit to the economy, consistent with the growth objective.

My authorities attach high importance to strengthened public expenditure management, which they see as fundamental to enhance efficiency and that would greatly assist in dealing with the persistent problem of the accumulation of domestic arrears. With regard to the latter, the authorities have already started an exercise to capture the stock of domestic debt, including domestic arrears, which is expected to be completed by September 2002. Moreover, important steps are envisaged to prevent the emergence of new domestic arrears, which include clarifying financial regulations; setting up a commitment control system in the line ministries; establishing an expenditure monitoring unit in the Ministry of Finance and National Planning (MFNP); and imposing quarterly expenditure ceilings. A short-term consultant has been hired to help design the Integrated Financial Management Information System (IFMIS), which will become the government's main accounting instrument in the longer run.

The central bank will continue to pursue prudent monetary policy. The monetary program will be consistent with the inflation and foreign reserves objectives of the program and will be based on an increase in broad money that is broadly in line with the growth of nominal GDP. The prevalence of high real interest rates remains a major concern to my authorities, particularly given its adverse impact on economic activity. In this respect, they will pay particular importance to reducing the government's domestic borrowing requirement, in addition to focusing on measures to lowering inflation. Moreover, they will be focusing their attention on a number of measures intended to reduce costs for the commercial banks. The privatization of the ZNCB is expected to be finalized in the coming months. As a result, a number of rural branches are likely to be closed. In this respect, the authorities are studying possible alternatives that would allow the maintenance of the financial services in the rural areas.

My authorities are committed to maintain a liberal trade and exchange regime. The exchange rate will continue to be determined by market forces, and the central bank intervention in the foreign exchange market will be limited to meeting the program's international reserves target and to smoothing short-term fluctuations of the exchange rate. As a further step to strengthen the countries' stance as an open economy, the authorities have recently accepted the obligations under the Article VIII, Sections 2,3, and 4.

The PRSP

My Zambian authorities have finalized the PRSP after an extensive consultation process carried out throughout the country, and involving various segments of the civil society. It sets the government's main objectives and strategies for poverty reduction. The strategy focuses on measures to achieve strong and sustainable economic growth that generates employment creation opportunities. The PRSP provides a good overview of poverty and its causes. The proportion of the population living below the poverty line is reported to be around 73 percent with poverty being more prevalent in rural areas (83 percent) compared to the 56 percent in urban areas. Recent trends show that poverty has been rising faster in the urban areas as a result of failing industries and rising unemployment. The economy has been disproportionately dominated by the mining activity, which has been in decline for a long time. Hence, one of the key aspects of the poverty reduction strategy will be to enhance the prospects for diversifying the economy away from the mining sector. In this regard, the authorities are working in conjunction with the World Bank and have scheduled a High-Level Diversification Workshop on the Copperbelt for the first week of June 2002, which is expected to give a significant impetus to the process of diversification. The agricultural sector, with its large unexploited resources, is viewed as offering a good chance for successful diversification. The authorities have, therefore, chosen to accord the highest priority to enhance agricultural productivity. Other areas seen as having a great potential to equally succeed include the tourism and textiles industries. The PRSP also emphasizes the importance for a landlocked country to have a functional rail and road transportation system. Under the strategy, great emphasis is also placed on enhancing effectiveness in the delivery of social services. Special attention will, likewise, be accorded to the issue of governance.

Conclusion

Notwithstanding many adverse circumstances under which Zambia has been operating, the authorities have persistently reiterated their strong commitment to the implementation of policies and reforms agreed in the program, which is evidenced by the fact that the programs have been maintained broadly on track. However, timely international support plays a critical role in maintaining the momentum of these reform efforts and to meeting the challenges that lie ahead. Therefore, we request the Board to complete the current review under the PRGF arrangement, and consider favorably the request for additional interim assistance under the enhanced HIPC Initiative.

Mr. Brooke and Mr. Kelmanson submitted the following statement:

Overall, we agree with the staff's analysis and can support the proposed program waivers, the extension of interim HIPC debt relief, and the augmentation of access. We will comment first on the PRGF-supported program and then on the PRSP.

PRGF

It seems fair to say that recent progress has been remarkable in light of Zambia's economic record over the preceding 20 years. The main objective now should be to ensure that this good performance is maintained, in what is a particularly difficult environment. Since taking office at the turn of the year, the authorities have already overcome some significant economic challenges against a backdrop of uncertainty. This has mitigated Zambia's economic vulnerability; but the key uncertainty (the copper sector) remains. This uncertainty originates from exogenous shocks: the fall in world copper prices and Anglo-American plc's global restructuring exercise.

At the last informal Board meeting on Zambia, the staff were concerned about three specific issues, which created particular uncertainty for the 2002 program. Since then, the authorities have made significant progress in these areas and a number of challenges have been overcome:

The dispute concerning the misappropriation of funds disbursed under SAF IV in the late 1990s (which arose under the previous government and which caused the suspension of tranche releases from the EU's SAF V program) has been resolved, following an EU audit mission and agreement on corrective measures. Most measures, which primarily relate to better enforcement of existing regulations, are scheduled for implementation in the second half of 2002.

Second, the dispute regarding debt owed to Russia has been resolved following bilateral negotiations and this has paved the way for a Paris Club agreement on Cologne terms.

In addition, a tight budget was passed, notwithstanding the fact that the government lacked a parliamentary majority, and had little time to prepare it.

The other issue discussed at our previous informal meeting, the copper sector, remains the subject of ongoing discussions between the government, the World Bank, and possible private sector partners. We agree with the staff that, given the importance of the sector, the government is right to make every effort to keep the mines in operation by finding a new strategic partner. We also welcome the authorities' commitment not to take over ownership of the mines and to find a financially viable solution that is consistent with government finances.

Clearly, a collapse of the copper market or a failure of the maize harvest could seriously hamper plans this year. Managing these risks will be critical to the program's success. In the more medium term, employment issues and the problems of HIV/AIDs must be faced. In addition, the authorities should do all they can to minimize the risks of interruptions in official aid flows. Similar risks exist in all program and Zambia's case is no different. But, given the progress made on economic issues, within a difficult external environment, we feel strongly that Zambia deserves, and needs, Fund support.

PRSP

We believe that the PRSP is a sound document and that it represents an improvement over the version presented to the National PRSP Summit in October of last year. The document now contains a medium-term financial framework, performance measurement data, and clearer proposals for implementation. These are all welcome developments. We commend the authorities on what has been, by all accounts, a very participatory process. Given that we support the PRSP overall, and agree with much of the analysis set out in the JSA, our comments focus on a few areas for continued attention and development.

First, the government needs to improve the integration of the PRSP with its core political, planning, and financial processes. It is unclear from the document how integrated PRSP expenditure plans are with this year's budget. Although the PRSP was endorsed by the cabinet, it has not yet been debated by Parliament, nor has it been subject to further consultation with civil society or donors. Linked to this, there is also a clear need for all government processes and commitments to be fully implemented, e.g. in respect of PEM, diversification, performance measurement, and public service reform. In addition, given the importance of governance to poverty reduction, we welcome efforts to prioritize governance programs and anti-corruption initiatives. Improved access to justice and effective decentralization will also be important.

Second, a deeper analysis of the interrelationship between growth, poverty, and policy actions is needed, as noted in the JSA. The PRSP contains a disaggregated description of poverty incidence, but has yet to identify targeted policies for vulnerable groups. Further work will be needed to define specific anti-poverty policies for the productive sectors (i.e., tourism, agriculture, industry, and mining). The United Kingdom stands ready to assist the government in building capacity in this area.

Third, targets, indicators, and monitoring mechanisms need to be refined. More work is needed to clarify annual and three yearly plans and targets. This will require enhanced coordination and leadership from the Ministries of Finance and National Planning. More explicit indicators should be developed in the context of longer-term development targets, e.g. the Millennium Development Goals. Capacity building will be important here, especially at the provincial and rural levels. The Civil Society for Poverty Reduction emerged as a key player during the PRSP process; there may be a role for this and other such groups in monitoring progress going forward.

Fourth, participation should be maintained and deepened. A deeper dialogue with the private sector could be sought, and work with the donor community must be maintained. While the GRZ has a role to play here, the donors do too. The JSA perhaps gives insufficient attention to GRZ's appeal that donors realign their portfolios with PRSP priorities. This has yet to happen and the modalities for coordinated support and reducing heavy transactions costs must be addressed. To facilitate this, the government should work to allow donors the space to support (technically, financially, and politically) the PRSP process. A frank and open dialogue should be developed with donors about how their contributions can be aligned with the PRSP.

To conclude, the authorities have done much to build a base for macroeconomic stability and economic growth. Along with a participatory PRSP, the conditions for sustainable growth and poverty reduction are being developed. With continued commitment, and the support of the international community, real progress can be made.

Mr. Shaalan and Ms. Farhan submitted the following statement:

Zambia's macroeconomic situation has recorded a degree of improvement in the past two years, with favorable performance in 2001, as demonstrated by the rise in GDP growth rates and the significant reduction in inflation. Substantial progress was also made in implementing structural reforms. In spite of these gains and the debt relief, Zambia still faces serious difficulties on the path towards debt sustainability and higher economic growth. We take special note of the successful record of performance in a number of macroeconomic areas, as well as in structural areas. We look forward to the continued efforts at addressing weaknesses in the fiscal area, in particular expenditure management. To be successful, these efforts need to be supported by appropriate and timely donor assistance. The limited success in reducing poverty, along with volatility in donor support and the recent decision by Anglo-American plc. (AA) to pull out of the copper mining industry in Zambia, have added significant uncertainty to the prospects for continued progress in maintaining macroeconomic stability.

In view of the commitment and actions taken by the authorities, we are in broad agreement with the staff recommendations and can support the proposed decisions, including the waivers and request for additional interim assistance. We have a few comments for emphasis.

First, on the fiscal front, putting public finances on a sustainable footing remains a key challenge to the adjustment effort. The projected reduction in the deficit in 2002 appropriately reflects the pressing need to put the deficit on a downward path. Although the 2002 budget is quite ambitious, it should be firmly implemented, particularly in light of the high reliance on donor support, which continues to fall below expectations, and the need to limit recourse to domestic sources of finance. Moreover, and notwithstanding the current efforts to resolve the difficulties in the mining sector with minimal impact on both the budget and society, the possibility of added fiscal pressures stemming from the copper sector are a concern.

While we agree with the staff that, at this time, the burden of the fiscal adjustment should fall on domestic expenditure, we note that the projected reduction in spending of approximately 2.7 percentage points is very ambitious. This is particularly so in light of the uncertainty surrounding the government's involvement in resolving the problems of the mining sector. We hope that any spending that might be incurred, even if temporary, will not jeopardize fiscal viability. As such, and as indicated by Mr. Rustomjee in his comprehensive statement, it is essential that improving public expenditure management, as part of a medium-term expenditure framework, is pursued as planned, not only to prevent the accumulation of arrears, but also to ensure that resources are effectively spent to help meet the over-arching goal of reducing poverty.

Second, on the mining sector, it is unfortunate that AA has decided to withdraw from Zambia’s copper mining industry. As a main source of foreign exchange and a significant source of employment and income generation, the future of the mining industry has serious repercussions on the economy. So far, the government’s approach to the problem is commendable and promising. We would appreciate it if the staff could update us on recent developments regarding the negotiations with AA and any indications of renewed private sector interest in the industry.

Uncertainties in the mining sector clearly demonstrate the importance of diversifying the economy and continuing to promote a wider export base. As indicated in Box 2 in the staff report, prospects for diversification are promising, particularly in the areas of manufacturing and textiles. Continuing with the trade liberalization efforts to promote exports will go a long way in achieving rapid and sustainable economic growth. Moreover, improving infrastructure through privatization in the transport, telecom, and electricity sectors will also need to be pursued, in order to facilitate increased private sector activities and support the diversification efforts. This should be accompanied by measures to improve the business environment.

Third, we note the completion of the full PRSP. The paper is comprehensive and includes coverage of poverty diagnosis, a poverty reduction strategy with clear prioritization, and a framework for monitoring implementation. That said, however, the move from the planning stage to the implementation stage will not be without difficulties, particularly given the substantial capacity and resource constraints. We are particularly pleased that the paper is based on appropriate macroeconomic objectives, and clearly identifies the need for diversification, private sector development, and governance issues. We concur with the staff that the uncertainty over the future of copper mining adds to the risks to the poverty reduction process. The authorities should continue to monitor the implications of such developments on the economy and, more importantly, on the availability of resources for combating poverty.

Before we conclude, given that Zambia has completed a full PRSP, we would appreciate it if the staff could provide us with information regarding the expected time frame for reaching the enhanced HIPC Initiative completion point, with updates on the prospects for meeting the conditions to qualify for debt relief.

To conclude, continued commitment of the authorities to the reform process is all the more important, given the current economic difficulties. We encourage them to strictly adhere to their program, and call on the international community to be forthcoming in their financial and technical support.

Mr. Mozhin and Mr. Lissovolik submitted the following statement:

Introduction

Zambia's economic performance is improving appreciably, with real growth rising by 5 percent in 2001 and inflation subsiding; important progress is also being attained in moving forward with privatization and public-expenditure management. However, the intrinsic vulnerabilities of the economy associated with over-reliance on copper exports have come to the fore as Anglo-American plc is set to discontinue funding its mining operations in Zambia. The latter is likely to exact significant costs for the country's economic development. At the same time, the implementation of the PRGF-supported program thus far by Zambia has been on the whole commendable, though we do regret the underperformance in the macroeconomic sphere associated with the electoral cycle. Accordingly, we support the proposed decisions, including the granting of the relevant waivers. We proceed with our comments on some of the key issues pertaining to the program.

Economic Growth

The economic vulnerabilities that have sprung up after the KCM debacle are indicative of the risks of insufficient diversification and excessive reliance on copper exports. Indeed, in terms of sectoral development, the need to diversify the export base is already very pressing and, in this respect, it is encouraging to note the rise in Zambia's non-mining exports, a trend that will hopefully be sustained in the years ahead. We found Box 2 very helpful in outlining the possible gateways for economic sustainability in the medium to longer term, and consider such tables to be of use in PRGF reviews of other countries, where such analysis is pertinent. The two key pillars of economic diversification in the longer term are rooted in the revitalization of the agricultural and textile sectors—precisely the sectors where developing countries are setting high hopes with respect to trade liberalization. Accordingly, while donor support will be critical in the short term in adjusting to the implications of the abrupt decline in Zambia's copper exports, in the medium term, it is trade liberalization in the world economy (including in the context of the Doha development round of the WTO) and, in particular in the most advanced countries, that will be critical in assisting Zambia and other African countries in surmounting the difficulties of economic development.

Fiscal Policy

With the overall fiscal deficit exceeding 8 percent of GDP in 2001, fiscal retrenchment is key to macroeconomic stability in Zambia. On the expenditure side, fiscal adjustment needs to pursue the objectives of attaining a superior composition of budget outlays (with pro-poor expenditures being accorded greater weight), while at the same time avoiding any significant spending hikes that may undermine overall fiscal stability. Any policy activism in the expenditure sphere is inherently constrained by the limitations of the still fledgling expenditure-tracking PEM framework. There is also the problem of domestic arrears that may be exacerbated as a result of sweeping expenditure cuts. Furthermore, in view of the need to attenuate the negative implications of expenditure cuts for the social sector, some of the fiscal adjustment may also need to be borne on the revenue side. In the revenue sphere, we generally favor the approach proposed by the staff, namely that of increasing some of the tax rates (in particular the VAT and PAYE rates), partly in view of the fact that this approach is less likely to compound the problems associated with income inequality in the country. At the same time, revenue adjustment based on the extension of exemptions is likely to undermine the revenue base (mostly at the expense of the poorest layers of the society) and with time should be superceded by targeted social transfers. The relative mix in fiscal adjustment between expenditures and revenues, as well as between exemption-based and tax rate-based revenue adjustment will hinge in part on the further evolution of PEM in Zambia. Finally, we note that fiscal policy should play a leading role in rationalizing the policy mix between fiscal and monetary policy directed at lowering real interest rates, which pose significant risks relating to debt sustainability.

Monetary and Exchange Rate Policy

In the monetary sphere, we are concerned that the "unpleasant arithmetic" in the deteriorating mix between monetary and fiscal policies is leading the authorities to sub-optimal short-term solutions, such as the scheme that exempts lending to agriculture from commercial banks reserve requirements. We agree with the staff that this scheme could lead to distortions and abuse in the monetary sphere. On the exchange rate, we note that given the low level of foreign exchange reserves in Zambia, it is crucial that the market be allowed to determine the appropriate level of the exchange rate. And while market expectations with regard to the country's copper exports may indeed engender pressures on the exchange rate towards depreciation, the latter would in part serve to absorb external shocks and improve the prospects for superior performance of Zambia's non-mining exports. Finally, we welcome the acceptance by Zambia of its obligations under Article VIII, sections 2,3, and 4.

Structural Policy and Social Development

In the structural sphere, privatization is to play a key role in raising the performance of the industrial sector, while at the same time securing additional budget deficit financing. The overriding objective should clearly be raising the efficiency of the state enterprises, and in this respect, recent progress in preparing the controlling stake of ZNCB for privatization is encouraging. At the same time, privatization in the oil sector could be expedited, which also concerns other structural areas, such as the railways sector. In the social sphere we welcome the preparation of the PRSP document by Zambia, which, in our view, provides a basis for continued support of the Zambian economy. Within the PRSP document, like the staff, we are encouraged by the strong emphasis placed on fighting corruption.

External Debt

As regards Zambia's external debt to Russia, we are pleased to confirm that the issues concerning the modalities of the bilateral agreement signed in August 2001 have been resolved, and we look forward to Zambia's steadfast implementation of the agreement with the Russian Federation.

Conclusion

Clearly, in spite of the significant progress attained in Zambia over the past several years in the economic domain, external factors render the economic outlook less favorable in the coming years. On top of the risks unleashed by external shocks and adversities, there is the looming danger that these difficulties could reverse the achievements of economic policy in the country in recent periods. Fortunately, thus far, this risk has not fully materialized—in particular, trade liberalization in recent periods has been an important advance in the country's economic policy-making, and we are gratified that, in spite of the possible short-term fiscal benefits, the elevation of import duties at a time when protectionist impulses are more frequent and fashionable, has not been chosen as a solution to the imminent economic difficulties. To safeguard the hard-won achievements in the economic sphere, Zambian authorities will need to persevere in their efforts to foster economic expansion across a wider set of sectors, and to adhere to prudent fiscal and monetary policies in the macroeconomic sphere. Their achievements thus far in economic policy making merit continued international support.

With these remarks we wish the authorities of Zambia every success in their efforts.

Mr. Kelkar submitted the following statement:

We commend the authorities for bringing about a turnaround in the economic performance of Zambia. After decades of economic decline and falling incomes, real GDP has recorded robust growth in the last couple of years, and inflation, though still high, has been brought down considerably. The Poverty Reduction Strategy Paper presented by the authorities is remarkable for the underlying broad consultative process, for its analysis of the causes of poverty and candid acknowledgement of past mistakes, and for a comprehensive strategy for the future. We endorse the assessment in the analytical and cogent staff papers that this PRSP constitutes a basis for continued financial support on concessional terms.

Successful implementation of the PRGF-supported program and the poverty reduction strategy are, however, predicated upon maintaining macroeconomic stability and reorientation of public expenditure. As candidly admitted in Mr. Rustomjee's comprehensive statement, this would depend critically on the continued operation of copper mines, a prospect that appears difficult at the moment. While we welcome the authorities' resolve to keep the mines open, we are not sure how they propose to reconcile this with the commitment not to take over the mines under any circumstances. What is the course of action proposed, if no private sector initiative to operate the mines materializes, despite the best efforts of the authorities?

It is unfortunate that when Zambia looked poised to consolidate its recent gains, and the authorities needed to be encouraged, the country faces an uncertain outlook, thanks primarily to exogenous factors. We note that the copper prices today are lower than they were twenty years ago. The failure of Anglo-American plc to obtain funding for the proposed deep mining project and its consequent decision to withdraw from the KCM underscores the gravity of the situation. Given this background, we feel that the international community needs to be more understanding and supportive at this juncture. While the decline in the copper prices is part of the larger and more intractable issue of declining terms of trade for the poor countries, the donor support is a factor that could lend itself to a more flexible approach. Conduct of elections, for example, should be the domain of national governments and the donors ought to be more concerned with effective and proper utilization of aid for its intended purposes. Having said that, we welcome the Zambian authorities' commitment to take all possible steps to sustain and enhance cooperation with donors.

On our part, we support the release of the additional interim HIPC assistance, completion of the fourth review, and the proposed decision on waiver of some of the quantitative performance criteria. However, we would have welcomed more details in the staff paper on the relative impacts of shortfalls in donor support and fiscal slippages due to elections. Given the developing fiscal situation, to which they would not have been oblivious, the authorities could have exercised more prudence with regard to overshooting the programmed expenditure targets. In particular, we wonder if the large wage increases granted on the eve of elections could not have been avoided, or if they were warranted by rational considerations and were in any case overdue. We would welcome comments. Apart from the aforesaid short-term consequences, this has compounded the difficulties in attaining medium-term fiscal sustainability. As the staff paper has clearly brought out, the scope for additional revenue mobilization being limited, the thrust of the efforts would have to be on expenditure compression. We look forward to the formulation by the authorities of a more detailed and clearer exposition, than is manifest from the given documents, of their plan of action in this regard. It will need to be followed up by rigorous implementation. Given the projections of the domestic debt situation and the deleterious impact of the already very high interest rates, the urgency of concerted action on this front can hardly be overemphasized.

We are also concerned over the shortfall in HIPC-financed spending. This has been attributed to the initial difficulties in establishing an accounting framework and the lack of implementation capacity at the line ministries. While the first factor might have been addressed, the second requires a more long- term treatment. We would welcome an elaboration of the measures to address this deficiency, so that the projected increase in the social sector expenditures in line with the additional HIPC assistance and the PRSP-framework do not turn out to be overly ambitious.

We welcome the authorities' commitment to maintain a liberal trade and exchange rate system, to allow the exchange rate to continue to be market determined, and their acceptance of the Article VIII obligations.

The present uncertainties underscore the critical importance of reducing dependence on copper and diversifying the economy. We are pleased that the authorities have made significant progress in implementing structural reforms and would urge them to push ahead with the proposed measures, focusing on privatization and liberalization of petroleum sector. We have noted that progress on the latter has been slow, delaying the release of World Bank assistance. The PRSP has brought out the potential for diversification in the areas of agriculture, textiles and tourism. A World Bank study has confirmed the competitiveness of ready-made garments for exports. The authorities should now formulate appropriate schemes to foster development of these sectors. We are happy to note that the 2002 budget includes a number of initiatives for promoting growth in the agriculture and tourism. We would encourage the authorities to undertake similar steps for promoting manufacture of export oriented textiles.

We wish the authorities success in their challenging endeavor.

Mr. Guinigundo and Mr. Cho submitted the following statement:

We regret that Zambia failed to reach the completion point under the enhanced HIPC Initiative. The staff is now proposing an extension by one year of the PRGF-cum-HIPC, recommending: (i) the granting of waivers of performance criteria; (ii) to augment access under the PRGF-supported program by 5 percent of quota; and (iii) to provide interim assistance under the enhanced HIPC Initiative in order to meet external debts falling due during the period of the extended program.

Staff's proposal to defer the completion of the arrangement appears to be based on the following:

- Program slippages were mostly due to factors beyond the control of the authorities;

- There have been substantial efforts on the part of the authorities to make up for program slippages, especially in the areas of structural reforms and the steady progress made in the context of the PRSP;

- More time is needed to review the impact of the country's copper sector on both the macroeconomy and its debt sustainability.

Although we agree with the broad thrust of the staff's proposal, we also have some reservations arising from potential risks to the program. While we see the main cause for the program slippages as delays in donors' support, we also have to say that Zambia's performance is yet to convince donors, as noted in staff's paper (footnote 3). The program slippages could have been narrower if the authorities had taken a stronger grip on fiscal expenditure. With the recent decision of a foreign company to withdraw from the country's copper mining sector, the program's success now becomes more reliant on donors' support, which could be adversely affected. The challenges for the authorities in the forthcoming years are indeed formidable.

Under these circumstances, we can support the staff's proposal in the hope that the extended program will provide the authorities with an opportunity to more strongly demonstrate their ownership of the program and win back donors' trust and support. Mr. Rustomjee's statement to this effect is reassuring. At the same time, this will certainly require the authorities to do much more in the critical areas of policy implementation and structural reforms. We would like to urge the authorities to be better prepared to meet these challenges, by highlighting what we see as potential risks to the program.

Fiscal Policy

It is clear that fiscal consolidation is absolutely necessary in view of the urgent need to reduce the financing gap to a minimum. The revised program based on the baseline scenario calls for the domestic fiscal deficit to be reduced by 1.6 percentage points this year.

The need for fiscal consolidation would be even greater given the more difficult prospects under various alternative scenarios. It would require significant belt-tightening efforts on the expenditure side and equally tough efforts on the revenue side. There is certainly a need to stress urgency on both sides.

Nevertheless, we find the proposed measures on the expenditure side somewhat weak given the sense of urgency of the Zambian situation. For instance, based on Table 7, a great portion of the savings in the recurrent departmental charges (RDC) will come from once-off expenditures like election-related expenditure and the OAU Summit preparation spending, both of which account for 1.3 percent of GDP. But these are not recurring items. Other proposed cuts in the RDCs are either fuel costs or security-related spending. However, savings from fuel costs will only have a neutral impact on the fiscal balance because they are almost equivalent to the tax cut on diesel. Security-related spending cuts are the result of an easing in tension in the border areas and are not the result of fiscal prudence.

Although we are sympathetic to the authorities' argument that the roll back of the wages bill would be an impractical option, we are not fully convinced why savings in wages and salaries could not be achieved. Even if wages cannot be reduced retroactively, civil service reform can still be pursued. This is a difficult job and it may take time before the authorities could see its benefits, however, it would give a strong signal to donors that the authorities are committed to serious reform. We presume that civil service reform is still on the reform agenda, given the existence of public service retrenchments in the budget. But we also note that the retrenchment cost has dwindled and is not envisaged from 2003. Staff's advice on the progress of public sector reform is welcome.

Moving to the revenue side, the authorities' choices in increasing tax revenue seem to be substantially narrowed, assuming the authorities retain the various concessions introduced in the 2002 budget. We understand staff's concern that increases in import surcharges would undermine trade prospects, which Zambia needs to nurture to ensure sustainable growth. We also understand that increasing the VAT might be the last option that can be considered in a contingency plan. Given these limited policy choices, we wonder if some of the items presented in the earlier tax rebate package can be reviewed for possible revocation, especially the excise taxes on diesel and electricity. Staff may wish to comment on this issue.

Pilot Scheme of Exempting Lending to Agriculture from Reserve Requirement

On monetary policy, we would like to raise an issue on the pilot scheme of exempting a certain type of lending from complying with the reserve requirement. We fully understand the authorities' concern about the rising cost of interest payments. Despite the remarkable achievement in promoting price stability, interest rates remain high, causing a serious burden on fiscal management and dampening private investment.

Nonetheless, this is an issue that should be dealt with at the macroeconomic level. Addressing the issue of interest rates from a sectoral perspective is bound to cause distortion in resource allocation, which will lead to inefficiency in the banking sector. The reserve requirement policy is one of the main tools for liquidity management, especially in an economy where open market operations are yet to be fully developed. Upholding the pilot scheme could well undermine the very credibility of the monetary authorities in their primary objective of reducing inflation.

A Few Clarifications

Finally, we would like to seek clarification from the staff on a number of issues.

- Staff has made it clear that the quantitative performance criterion on domestic arrears was not met as at end-September, but it is not clear whether this was met as at end-December. Apparently, given that arrears clearance is budgeted over the program period, domestic arrears is still over the program ceiling. We are not sure whether this is indeed the case. If this is the case, why was another waiver on the domestic arrears as at end-December not requested? Is this because new arrears were not accumulated during the period between September-December last year? Even so, we understand that there is a need to set another performance criterion on the same variable as a waiver granted at a certain test period is not automatically valid for the next test period.

- In paragraph 29, the staff seems to endorse the authorities' intention that any external assistance in excess of that included in the program will be used to reduce government debt. If, indeed, there are donors who are eager to provide assistance exceeding the program level, there is no doubt that reducing public debt should be given the highest priority. However, we wonder whether this benign prospect may very well go along with the sense of urgency for fiscal consolidation that the staff encourages of the authorities. Is there any possibility that the authorities' strong commitment could be weakened due to an expectation of extra support from donors that may or may not materialize?

- In an attempt to accelerate the privatization of the ZNCB, the authorities have decided to take over certain SOEs' liabilities to ZNCB and to set up a new institution for rural banking. Given that these imply an additional fiscal burden, we wonder whether the costs associated with financial restructuring are properly taken into account in the medium-term budget. Related to this issue, the authorities in their LOI (paragraph 22) refer to recapitalization of BoZ. Staff may wish to clarify what these recapitalization costs mean and what they imply for the national budget.

- We are pleased that the Paris Club has managed to agree on the terms of debt relief to Zambia. Nonetheless, as the staff notes, there is the overpayment problem arising from the delay in forging the agreement. We would welcome the staff's advice on the status of efforts to address this issue.

Mr. Daïri submitted the following statement:

We thank the staff for the comprehensive and well-written papers, and Mr. Rustomjee for his insightful statement.

Zambia's economic performance showed a marked improvement in 2001, reflecting the authorities' strong policies. Real growth rebounded and inflation declined. The larger-than-programmed current account deficit resulted from higher imports for the mining sector, which were financed through private capital inflows. However, as a result of shortfalls in balance of payments support, performance criteria relating to international reserves, net claims on government, and net domestic assets of the BoZ were missed. Given the strength of the PRGF-supported program and the authorities' commitment to continue with adjustment and reforms, we support completion of the fourth review and granting of waivers for nonobservance of performance criteria.

After a somewhat expansionary fiscal stance in 2001, the strong adjustment envisaged for 2002 is welcome. Reducing the domestic deficit is necessary to place the domestic debt firmly on a downward path, as well as to support monetary policy in achieving the macroeconomic stabilization targets. While the various tax concessions may be socially beneficial, a considerable burden is being placed on expenditure cuts, including domestically-financed capital expenditure, which raises the need to consider new taxes, including possibly a VAT increase. However, the increase advocated by the staff, although temporary, may seem excessive and could erode the tax base. Staff may wish to comment on this issue. We welcome the reduction in recurrent departmental charges (RDCs) and the increased appropriation for the social sectors.

The excessive burden on monetary policy in achieving macroeconomic stability and the high government borrowing have led to high real interest rates and constrained private sector credit. A steady decline in interest rates is warranted to stimulate economic activity. Government intentions to reduce the PSBR and to apply excess external financing to domestic debt reduction are well placed. Also appropriate is the intention to streamline and simplify government access to BoZ financing. Furthermore, there is a need to address banking system inefficiencies, promote competition, and reduce the incidence of non-performing loans through strengthened regulation and supervision. We welcome the authorities' commitment to a flexible exchange rate policy to be monitored closely in light of potential pressures from reduced copper prices. A competitive exchange rate should help promote new lines of exports to reduce Zambia's vulnerability to terms of trade shocks.

Maintaining the momentum on structural reforms is critical for accelerating growth and poverty alleviation. The authorities' intention to continue reforms in the oil, electricity, and railway sectors should bolster economic efficiency, as well as donor and investor confidence. The privatization plan for the ZNCB is appropriate; however, while dealing separately with the rural branches issues may be the only approach to attract foreign investors, we understand the authorities' concern that it may cut access to banking to a large cross section of the rural population. Staff may wish to comment on the issue, including the need to promptly design an appropriate infrastructure for rural lending.

We commend progress in strengthening public expenditure management. Plans to control commitments, including quarterly expenditure ceilings, should help reduce expenditure overruns and accumulation of arrears. Furthermore, the authorities intend to audit arrears and monitor closely their clearance. Due consideration is being given to improving governance, including strengthening audit institutions and the Anti-Corruption Commission. Submitting the annual public accounts for parliamentary review is also an important step toward financial transparency and accountability. The authorities are encouraged to address EU concerns about the use of its funds and related governance issues, in order to pave the way for freeing up withheld assistance.

Zambia's medium-term economic outlook is overshadowed by vulnerability to external shocks. Potential decline in copper exports has prompted the scaling down of medium-term growth rates in the baseline scenario. Furthermore, a substantial external financing gap has emerged for 2003 and 2004, necessitating additional aid and debt relief. While the authorities "intend to give top priority to diversifying the economy," this objective often gets submerged in an unwieldy policy agenda. In particular, it is important to focus more aggressively on a private sector-led development strategy, infrastructure development, and selective and time-bound industrial policy interventions. As elaborated in Box 3, focusing on agriculture, tourism, and textiles initially is appropriate to exploit Zambia's comparative advantage and potential in these areas.

The authorities are to be commended for successfully completing their full PRSP. The wide consultations that characterized its preparation have enhanced consensus building and ownership. The strong focus on investment in human capital and in social and economic infrastructure should bolster the growth potential and robustness of the economy. The PRSP clearly provides a sound basis for continued concessional support from the international community. As stated by Mr. Rustomjee, timely international support would be critical for Zambia to maintain the reform momentum and meet the challenges ahead.

The gloomy outlook for copper exports has dampened Zambia's prospects for achieving external debt sustainability at the completion point as originally envisaged. We, therefore, strongly support a topping up of assistance, in light of the exogenously generated decline in export earnings and since it is recognized that the authorities' policy response is appropriate. Particularly significant is the commitment to achieve domestic fiscal sustainability and to promote a more efficient and resilient economy. Strengthening the monitoring of HIPC-financed spending should also help to ensure effective utilization of the resources committed under the enhance HIPC Initiative.

Extending his remarks, Mr. Rustomjee made the following statement:

I have issued my statement and look forward to today's discussion. I do have a few issues to add to my statement.

First, I would like to record my authorities' profound appreciation to the staff. This has been a truly difficult time for the authorities, particularly with the announcement of the withdrawal of Anglo-American Corporation from the copper section earlier this year. The staff have done a wonderful job to help the authorities, enabling the current program to be brought to the Board.

Second, I would like to bring to colleagues' attention an issue which has been developing in the southern African region, and, which in my view, touches directly on our discussion today. It is not a matter on which we can reach a decision today, but something to which, as an institution, we need to develop a quick, urgent, and solid response. This is the issue of drought in southern Africa. I would like to read out the opening section of a statement issued today by the World Food Program and the United Nations Food and Agricultural Organization:

"The United Nations Food and Agricultural Organization (FAO) and the World Food Program (WFP) warned today that at least 10 million people in four southern African countries are threatened by potential famine—and that figure is expected to rise when reports from two other countries are completed.

Reports published today, covering the results of recent joint missions to Malawi, Zimbabwe, Lesotho, and Swaziland said that millions of people are on the brink of starvation, and that they will face grave food shortages as early as June, which would continue up to the next main harvest, in April 2003.

The overall picture will become even bleaker when the report on Zambia—the country we are discussing today—and one on Mozambique are added to the assessment of an already critical humanitarian situation. Two successive years of poor harvests caused by natural calamities, coupled with economic crises and disruption of farming activities in parts, have slashed food production and availability across the region, resulting in one of Southern Africa's worst agricultural disasters in a decade.

Over the next year, nearly 4 million tons of food will need to be imported to meet the minimum food needs of the sub-region's population. Almost 10 million people in the famine-threatened countries need immediate emergency food assistance of some 1.2 million tonnes."

Earlier this month, the FAO stated that "in southern Zambia, severe drought has caused total crop failure, even devastating the usually drought-resistant sorghum. Despairing farmers have set their livestock loose to eat up the dried up stalks. The drought has also affected the eastern part of Zambia. Many Zambians are experiencing their second year of crop failure and have little or no food stocks to fall back on. Families are having to use their savings to buy food. Some are selling their livestock at throw-away prices before water sources dry up. Others are surviving off the fruit of baobab trees, or eating so-called famine foods, such as wild cucumbers and a boiled root mix."

I am raising this issue for three reasons.

First, to point out to Board colleagues and management that a massive problem is under way in the region, which will need an early, concerted, sensitive, and adequate generous response from our institution. Ten million people are facing starvation and the credibility and hard work of the institution will be called into question if we do not act quickly.

Second, I am raising this issue, to make a strong appeal to my colleagues in the advanced industrial countries to step in to avert a very significant catastrophe. I am aware, in the case of Zambia, of important grain contributions by the United States, Japan, and the EU. But the magnitude needed—and the speed of reaction needed—are not enough. I appeal to all those members that can help to convey this appeal to their authorities to provide immediate substantial food grain assistance to the affected southern African countries. The WFP report on Zambia will be published in the next few days. Please react positively, quickly, and strongly when the precise magnitudes are known.

Third, I am raising this issue because of a concern I have as to the level of financial resources, which will be released following today's discussion. I note—and thank the staff for this—that there is provision today for an augmentation of 5 percent of the PRGF.

> This is useful. But the Zambian authorities have indicated that the terms of trade decline following the September 11 terrorist attacks stands at close to $100 million—about four or five times the level of augmentation. It is also a fact that since those horrible attacks, 70 percent of the country's export base has been put at risk through the announced withdrawal of a single company from copper production. On top of this, Zambia is, as some colleagues may know, a haven for refugees from several neighboring countries, including Angola and the Democratic Republic of the Congo (DRC). There is, therefore, the added need to feed some 117,000 refugees. To give a sense of the critical nature of this problem, the WFP reports that due to lack of food pledges, since January 2002, the refugees have been receiving a reduced ration (50 percent), and because of ongoing shortages, this will need to continue. And now, we have the advent of drought. Here, I should mention that the WFP has already advised that the April harvest seems unlikely to alleviate food shortages for many months. So, the problem seems here to stay, at least until the 2003 season, suggesting that some forward-looking financing considerations, aside from the immediate food relief challenge, would be appropriate.
>
> I do seriously wonder whether the proposed 5 percent augmentation proposed by the staff is adequate. I am aware that the staff have made an extraordinary effort to help the authorities to put together the current program. But now a critical emergency has arisen, which is here to stay, and we—as well as all Zambia's development partners—need to consider how we can go the extra mile to assist. I would like to ask the staff if there is a case for a higher level of augmentation; and I would also like to ask the World Bank representative to provide us with details as to how the World Bank is addressing this challenge. For my part, I would suggest an augmentation of 15 percent. Zambia has an unusually high level of quota, so I would not at this stage suggest anything more, at least until the results of the WFP study has been published. We have a problem, and we need to fund an immediate solution.
>
> Let me contrast their appeal with the package announced yesterday for another country—which our chair will fully support as the reasons are sound—of $1.5 billion. I could note that this is more than the total amount provided by both Bretton Woods Institutions to Zambia in the last 30 years.

Mr. Daïri said that Mr. Rustomjee's remarks on the food security situation in Zambia were disturbing, and that he was somewhat puzzled that the staff paper had failed to make a reference to that issue. The Fund would not appear credible if it did not mention in the Board discussion the food situation, and if it did not signal a readiness to extend assistance within its mandate to help alleviate the problem.

Mr. Rustomjee emphasized that the food security problem in Zambia had developed suddenly, and that the staff should not be held solely responsible for not reporting it in the staff paper. The quantification of harvests in Southern Africa had traditionally been difficult, and the staff had been working closely with the authorities to address the problem. Unfortunately, much of the monitoring of harvests rests with the international aid agencies, which possessed the capacity to quantify harvest outcomes. The authorities were currently waiting for reports by these agencies on the impact of the drought on food production. Going forward, once more data on the drought became available, the Fund should consider extending some assistance to Zambia, although the larger share of the responsibility to help alleviate the food shortage probably rested with the World Bank.

Mr. von Kleist made the following statement:

We appreciate the staff paper for today's discussion, as well as Mr. Rustomjee's statement, which both provide good insights into the Zambian authorities' achievements so far and the considerable challenges and program risks that lie ahead.

Before turning to the program as such, let me start with a few remarks on the staff paper. The paper has a number of shortcomings, which negatively affect its transparency, which in turn affects our ability to properly monitor the program's conditionality. While Table 2 on Page 69 of the paper in an exemplary manner provides a clear-cut overview of the program's structural performance criteria and benchmarks, as well as of their respective observation, a comparable clarity is lacking regarding the quantitative performance criteria set out in Table 1 on Page 68. Neither in the text nor in the Table is it made completely clear that the ceiling on the outstanding stock of domestic arrears of the government was simply dropped as a performance criterion for end-December 2001. The text only mentions that this performance criterion would not be met for end-September. Instead, Table 4 of the Appendix contains the development of a database of individual domestic payment arrears as a structural benchmark. In the revised Table 3, which we only received today, it becomes clear that the original quantitative performance criterion is now resurfacing—in a watered-down version—as a structural benchmark and a quantitative benchmark.

In addition, the use of dashes for the last three ceilings in Table 1 could easily mislead the reader to think that those performance criteria had either not been monitored or not been observed. I have especially a question regarding the ceiling on new external payment arrears. For end-September and end-December 2001, it is stated that waivers of non-applicability were granted. I am not sure when and by whom, since we are only discussing the review today. Unfortunately, the paper also does not cover the observation of performance criteria for end-March 2002, nor for that matter, are economic developments in the first four months of this year discussed in any depth. The paper concentrates on developments in 2001 and then proceeds as if 2002 has just started, while in reality, 40 percent of this year have already passed. The additional statement issued by the staff yesterday contains some shreds of information concerning developments in 2002, but also no explanation why the end-March review and conditionality were abandoned.

As a last point on the formalities issues, it is regrettable that the proposed augmentation of access under the PRGF-supported program is not mentioned as a subject on the cover page of the main staff paper, as it should be.

Turning now to developments in Zambia, as the staff clearly points out, besides further developments in the copper sector, the domestic debt dynamics are the main threat to the program's success. Expenditure decisions are clearly within the discretion of the authorities, but within an IMF-supported program, their financing should be sound and stability- and growth-oriented. The authorities' increasing reliance on financing through domestic debt and domestic arrears is clearly not sustainable and results in double crowding out: first, increasing interest payments reduce the budgetary room for maneuver, not least with regard to poverty-reducing expenditures, and, second, via higher real interest rates, it crowds out private entrepreneurs from the much needed access to capital, thereby undermining growth and diversification prospects. Considering what we want to achieve with the enhanced HIPC Initiative, these forms of domestic financing are highly counterproductive.

In this context, it is regrettable, to say the least, that one gets the impression from the staff paper that shortfalls in the provision of donor budgetary support have contributed to the need for an increased reliance on domestic debt and arrears financing. It needs to be emphasized that the factors behind these shortfalls are slippages in the implementation of conditions attached to that support. Donor governments have to insist on the full implementation of these conditions in the interest of the people, who are supposed to benefit from such support, but also, and not least, because it is taxpayers' money, for the use of which donor governments are held accountable by their parliaments. Also, serious fiscal slippages, such as the wage increases, contributed in a major way to the problem

With regard to further developments in the copper sector, we acknowledge the authorities' intention not to include in their financial program for 2002 direct financial support for the mining sector. However, the existing budgetary contingency planning in the form of broad-based tax measures provokes the question why such revenue measures are deemed feasible in 2002, whereas in 2001, the government preferred to choose the obviously politically less painful option of sharply increasing its domestic debt and arrears financing. In addition, the authorities' reluctance to bring the top pay-as-you-earn tax rate in line with the corporate income tax rate sheds a doubtful light on its commitment to fiscal consolidation. Against this background, we are somewhat surprised that the PRSP explicitly foresees new investments by the government in the mining sector.

I share the staff's view that—given the copper sector's potentially decreasing contribution in the medium term—diversification of the economy is of utmost importance. In this respect, agriculture is certainly one of the promising sectors which could become a significant source of growth. However, certain large Fund members' recent trade and agricultural policy changes make such efforts even more challenging. The envisaged subsidies by the Zambia authorities for the agricultural sector do not seem well targeted.

While monetary policy should continue to aim at bringing down the still high inflation rate, we urge the authorities to coordinate monetary and fiscal policies more closely to avoid a further increase in the real interest rate. We share other speakers' concerns regarding the implications on monetary policy of the exclusion of agricultural lending from reserve requirements.

Further, on the budget, like Mr. Brooke and Mr. Kelmanson, we see the need to improve the integration of the PRSP, especially with financial planning. It is regrettable that the medium-term expenditure framework has not been completed. In this context, we would like to ask the staff to explain the discrepancies between budgeted and "outturn" figures for HIPC-financed programs in 2001, as laid out in Box 4 of the staff paper. In this context, I am wondering what impact the four-year service from 1997–2001 of a resident advisor on budget management by the Fund had on the budget management of the Zambian authorities.

Further on the PRSP, I could not find an explicit commitment by the authorities to adhere to market principles in general. It is, therefore, unclear which role the private sector may play regarding increasing economic growth, the central precondition to reduce poverty.

To conclude, notwithstanding major concerns about the authorities' ability to stabilize the fiscal situation under an unclear economic outlook, I support the proposed decisions, acknowledging that part of Zambia's complicated economic situation is a result of unfavorable external developments.

Mr. Liu made the following statement:

At the outset, we would like to thank the staff for the set of well-written reports on Zambia, and Mr. Rustomjee for his insightful statement and his oral statement on the serious situation that Zambia faces with food shortages and the drought, which this institution should take into account.

Like other speakers, we commend the Zambian authorities for their efforts in implementing sound macroeconomic policies and speeding up structural reforms. The provisional data suggest that Zambia's overall economic performance has continued to improve during 2001, with the real GDP growth rate over 5 percent, and the end-year inflation rate declining in line with the program. Moreover, all the program's structural performance criteria and benchmarks for end-September and end-December 2001 were met, although some quantitative performance criteria were missed, due mainly to circumstances beyond the authorities' control. Progress was also made in the banking and petroleum sectors, as well as in public expenditure management. We welcome the completion of the PRSP and believe that the PRSP, designed to focus on reducing poverty through the pursuit of growth and the more effective targeting and implementation of public sector policies, provides a sound basis for continued international financial support on concessional terms. Looking ahead, Zambia still faces daunting challenges. We are pleased to note that the new government is fully aware of the fragility of the economic situation and we commend the authorities for their resolve to maintain macroeconomic stability, strengthen and accelerate structural reforms, and alleviate poverty. The authorities' broadly satisfactory performance and strong commitment to the adjustment and reform process should deserve timely international financial support. Therefore, we fully support the proposed decisions. Since we are in broad agreement with the staff in their analysis and recommendations, we shall limit our comments to a few important issues for emphasis.

We share the view that the government's medium-term strategy for growth and poverty reduction hinges critically on developments in the copper sector. However, it is unfortunate that AA has decided to withdraw from Zambia's copper mining industry, and the considerable uncertainties in the mining sector highlight the importance of diversifying the economy and continuing to promote a wider export base. Therefore, we support the authorities' intention to give priority to diversifying the economy away from the mining sector. Like Mr. Daïri, focusing on the agricultural, tourism, and textile sectors seems appropriate in exploiting Zambia's comparative advantage and potential in these areas. We welcome the recent increase in non-traditional exports and the general improvement in the private sector's economic performance and investment as evidenced over the past two years.

On the fiscal side, like other speakers, we stress the importance of putting public finances on a sustainable footing. Given the uncertainties about external donor financial flows, we are of the view that the program should continue to focus on domestic policy measures that will assist in enhancing prospects of attaining fiscal sustainability in the medium term. We welcome the authorities' plans to strengthen public expenditure management, including improvement of the monthly fiscal report, as this is critical to enhance efficiency, prevent the emergence of domestic payments arrears, and strengthen the capacity for tracking poverty-reducing expenditures.

On monetary, exchange rate, and external sector policies, we are encouraged that monetary policy will be geared primarily toward achieving the program's inflation and international reserves targets, and welcome the authorities' commitment to maintain a liberal trade and exchange rate system, to allow the exchange rate to continue to be market determined, and their acceptance of the Article VIII obligations.

Finally, on PRSP, we are glad to note that the authorities have finalized the PRSP after an extensive consultation process throughout the country, involving various segments of the civil society. The paper clearly sets out the government's main objectives and strategies for poverty reduction. We believe that this paper provides a credible poverty reduction strategy and a sound basis for continued international financial support on concessional issues.

With these remarks, we wish the authorities every success in the future.

The staff representative from the African Department (Mr. Sharer), on the food security situation in Zambia, said that there had been a notable shortfall in the production of maize, a basic staple. The authorities had become aware of the shortfall in a timely manner through the regular survey activities of the Ministry of Agriculture. In addition, there had been clear price signals, as food prices had begun to rise more rapidly toward the end of 2001 than the normal seasonal pattern. The greater-than-expected increase in food prices had been the major reason that the authorities had missed the program's inflation target by about 1 percent of GDP. The authorities had subsequently acted expeditiously to import maize directly and sell it through the private sector. Therefore, the food situation at the end of 2001 had been appropriately handled by the authorities.

In light of the food shortage at the end of 2001, the authorities had been acutely aware at the beginning of 2002 of reports of irregular rainfalls and had been monitoring the situation, the staff representative continued. The authorities had informed the staff that it was still premature to conclude that there would be a major shortfall in food production in 2002; the Ministry of Agriculture had not yet completed its regular surveys. However, the problem of potential famine in some neighboring countries that Mr. Rustomjee had mentioned should not be ruled out. There had been a modest provision in the budget to cope with the extra food imports that had been needed for the eastern region of Zambia, which bordered Malawi. The food security situation in Zambia would be closely monitored by the staff, but based on the current information, it did not yet present a major problem.

On Mr. von Kleist's comments on the presentation of program conditionality in the staff paper, the staff had tried to be transparent in terms of reporting on the policy discussions with the authorities—including the policies that had not been adopted, such as the modest income tax increase—and in presenting information on performance criteria in the tables of the staff paper, the staff representative responded. All the tables on conditionality in the staff paper should be read in conjunction with the Technical Memorandum of Understanding; for example, footnote 1 of Table 1 and Table 3 referred to definitions of performance criteria contained in the Technical Memorandum of Understanding.

On the issue of domestic payment arrears, the letter of intent of October 15 (included in the previous staff report) had specifically indicated that the performance criterion on domestic arrears would be replaced, the staff representative clarified. That performance criterion, which had been in place since the Fund-supported program came into being in March 1999, had been based on quarterly reviews and audits that were conducted by the audit department of the Ministry of Finance. However, the staff had realized that it would be more appropriate to monitor domestic arrears through the monthly expenditure commitments reports of the line ministries, via a commitments reporting system. The staff was currently working with the authorities and donors to improve that reporting system, which was also the major focus of the work of the Fund's resident advisor on public expenditure management in Zambia. Once the commitments reporting system was working more effectively, the quarterly audits by the Ministry of Finance would be able to function as quality checks to monitor domestic payment arrears.

The external payment arrears of $31 million, as mentioned by Mr. von Kleist, was related to the dispute over the external debt owed to Russia, the staff representative explained. The request for a waiver on external payment arrears had been mentioned in the authorities' current letter of intent, as well as in the staff paper on page 6 and in the proposed decisions.

On the question of why there had been no performance criteria for end-March 2002, negotiations on the program review had not been concluded until after the end of March, the staff representative answered. In addition, the letter of intent had not been issued until May 9.

Regarding the macroeconomic developments for the first four months of 2002, the recently issued staff statement updated available information, the staff representative said. The latest data confirmed the staff's view that the PRGF-supported program was on track through the first third of 2002. However, owing to Zambia's weak data system, the staff did not have more than a month's data for 2002 at the time of the issuance of the staff papers.

Mr. von Kleist reiterated that the treatment of the waivers of performance criteria in the staff paper lacked transparency. For example, the request for a waiver on the new external arrears performance criterion had not been mentioned on page 6, paragraph 5 of the staff paper, where all the other missed performance criteria had been listed. In addition, there seemed to be a discrepancy between the figures of the performance criteria that were contained in Table 1 and Table 3. The staff should, therefore, find a means of communicating clearly to Directors on the performance criteria that had been missed and by what extent.

The staff representative from the African Department (Mr. Sharer) replied that the staff would review the tables in the staff paper and refine them to make the information on performance criteria clearer and more transparent.

On the substantial increases in domestic financing and domestic debt, they were related to the delay in disbursement of donor support, the staff representative explained. The authorities had originally formulated their budget based on a set of conditions laid out by the donors. However, additional issues had been raised much later in the year, particularly related to the audit by the European Union. The subsequent delay in donor assistance by the European Union had contributed to the shortfall in external financing. The staff had been informed by the European Commission that those additional issues had been substantially resolved, and that EU donor assistance would resume soon. The authorities did not adopt the proposed increase in tax rates, for political reasons, but the amount of revenue involved was too small to have made any difference to the level of domestic financing and domestic debt.

On the copper sector, while there were considerable uncertainties and risks posed by the withdrawal of Anglo-American plc, the authorities' commitment not to provide any direct subsidy from the budget to keep the mines open and to retain them under private sector ownership was appropriate, the staff representative stressed. The draft agreement that had been reached between Anglo-American plc and the authorities was fully consistent with the commitments of the letter of intent. In particular, it covered the financing of the anticipated cash flow deficit of KCM for the next two years, based on a cautious view of copper prices at an average of 73 cents a pound. Furthermore, some of Zambia's major donors had indicated that they were sympathetic to the idea of providing some form of financial support for the copper industry, although the conditionality would still need to be agreed. The World Bank would also continue to be closely involved in the process of implementing the authorities' strategy in the copper sector. Moreover, the authorities were committed to take further tax measures, particularly increasing the VAT rate, if public support for the mines became unavoidable. A major element of the next review of the Fund-supported program would be to assess the situation in the copper industry.

On the issue of improving the effectiveness of technical assistance and the implementation capacity of the authorities, there had been past problems with utilizing technical assistance efficiently due to a lack of commitment, the staff representative acknowledged. The new government had strongly emphasized the importance of reform and transparency, and had hired a number of new people in the Ministry of Finance and elsewhere to that effect. Such changes provided some optimism that the authorities' efficiency in implementing technical assistance would increase. However, improving implementation capacity in areas such as public expenditure management remained difficult. All the major donors to Zambia were making strong efforts to improve their coordination and cooperation in that area, so as to reduce conflicting administrative demands on the authorities, which could also weaken implementation capacity.

On the issue of tax measures, the tax adjustment proposed by the staff was not excessive, particularly in light of the projected fiscal gaps in 2003 and 2004, the staff representative commented. A potential increase in the VAT rate, if fiscal problems were to emerge, was not a particularly desirable solution, as the VAT rate was already comparatively high at 17.5 percent. However, there was no other alternative measure available—increasing expenditure cuts beyond what was envisaged in the Fund-supported program was not realistic, as the authorities had already reduced RDCs to a minimum, while the staff did not wish to see cuts in social expenditure.

Mr. Daïri felt that the staff proposal to increase the VAT rate to 20 percent was somewhat excessive and asked for a comparison with the VAT rates in neighboring countries. On the proposed privatization of ZNCB, it seemed that a broad section of the rural population would be cut off from access to credit as a result. Perhaps the staff could comment on what measures could be immediately implemented to avoid such a regressive policy outcome? Perhaps it would be better to postpone the privatization until an appropriate infrastructure was put in place to ensure not only the continuation, but the expansion, of rural credit. Regarding the diversification of the Zambian economy, perhaps a more active targeted industrial policy would be appropriate to start up the process of diversification, instead of relying solely on the market mechanism and macroeconomic policies?

Mr. Rustomjee said that the FAO recently issued a statement warning that up to 1.3 million people, out of 10.2 million people in Zambia faced the prospect of famine. Moreover, there would not be further food assistance by the World Food Program after July because of insufficient money and food supplies. The regional director of the World Food Program in Southern Africa had warned that unless massive food resources were urgently mobilized, the famine would affect more people. In addition, meteorologists warned that the El Niño climatic phenomenon could adversely affect next year's harvest. In addition, opportunistic infections arising from famine, such as HIV/AIDS, could increase. Could the staff representative from the World Bank provide some information on what was being done to help alleviate the food shortages in Southern Africa?

The staff representative from the World Bank (Mr. Dinh) replied that the World Bank was concerned about the food situation in southern Africa, in particular the food shortages in Malawi, Mozambique, Zambia, and Zimbabwe. However, the food problem in each country varied, and the situation in Zambia was probably less severe than the other countries. An agricultural mission from the World Bank was currently in Zambia to assist the authorities in assessing the impact of the drought on food production. The World Bank's preliminary estimate was that the shortage of maize for 2001/02 would be about 200,000 metric tons, which would cost around $40 million. Moving forward, the World Bank would be coordinating closely with donors and the authorities on resolving the food crisis.

Mr. Daïri asked the staff representative from the World Bank to provide some information on the policies to foster economic diversification in Zambia.

The staff representative from the World Bank (Mr. Dinh) said that the issue of economic diversification in Zambia had been around the past 25–30 years. The World Bank, in various economic sector work, as well as in various lending instruments, had emphasized the need for diversification. Diversification depended not only on macroeconomic stabilization, but also on structural reforms at the sectoral level. The World Bank was currently helping the authorities to renew their diversification efforts, beginning with a workshop to raise the awareness of diversification, which would involve participants from other countries, particularly Southeast Asian countries, such as Malaysia, where diversification from tin production had succeeded. This workshop is to be followed by specific projects and activities for diversification. It was hoped that the copper mining crisis would serve as a wake-up call for the renewal effort to diversify the economy, which was crucial for Zambia going forward.

Ms. Phang asked whether the World Bank had already designed a plan with the authorities on how to diversify the economy.

The staff representative from the World Bank (Mr. Dinh) responded that the causes for the lack of diversification in Zambia were complex. A major factor had been the failure of successive governments from the 1960s to the 1980s to withdraw from extensive intervention in the economy. In part, diversification had also been hurt in the past by the lack of macroeconomic stabilization. Throughout the 1980s and 1990s, and until two years ago, the Zambian economy had never been stabilized. Even the current inflation rate of 17.5 percent was still relatively high, as were real interest rates. In that unstable macroeconomic environment, it was difficult for the private sector to invest in the country. However, the fact that diversification had not succeeded in the past 25 years should not prevent the Government from renewing its efforts to address the diversification issue.

The staff representative from the African Department (Mr. Sharer) stated that there had been some progress in achieving economic diversification in Zambia. Copper exports, which used to constitute about 95 percent of exports, had declined, while the industrial sector had improved significantly in the past two years. The key factors that improved diversification efforts were a realistic, market-determined exchange rate, macroeconomic stability, the improved functioning of financial markets, better targeted public expenditures, further privatization, and, particularly, the pursuit of structural reforms. However, regional instability remained detrimental to diversification. On Mr. Daïri’s question on whether the authorities should have a more activist role, the authorities should focus on fostering a stable macroeconomic environment and making public expenditures efficient.

On Mr. Daïri’s question on the proposed VAT increase, the VAT rate in Zambia previously had been 20 percent, the staff representative continued. Compared to other African countries, a 20 percent VAT rate was somewhat high, and the staff would not favor the proposed increase, except in an emergency where the authorities had no other means of raising the needed revenues. The proposed increase in VAT rate would raise $30–$40 million, but that was only a contingency plan at the present moment.

Regarding the question on rural credit, there was no intention in the privatization of ZNCB to disregard lending to the rural population, the staff representative emphasized. The ZNCB had been forced by the authorities to operate some 10 to 15 loss-making and poorly run local branches in the rural areas, which was not the best way to promote rural credit. Rural credit institutions should aim to provide cash points and links to the local economy. The rural branches of ZNCB would not be immediately closed, but the authorities should be given a deadline to do so in the future. There were actually other rural financial institutions in Zambia, such as the post office savings bank, although they were not functioning properly. The intention of the Fund-supported program was not to ignore rural credit, but to help it work efficiently in the future.

On Mr. Cho's question on the government taking over the state-owned enterprises' liabilities to ZNCB, as the government already owned ZNCB and had to clean up the bank's balance sheets, there would be no additional economic cost in terms of taking on those liabilities, the staff representative replied. If the balance sheets of ZNCB were strengthened before privatization, its sale price would be adjusted upward accordingly. Similarly, with the recapitalization of the Bank of Zambia, there was a need to restructure its balance sheets, rather than just provide additional resources. The key to ensuring the proper finances of the Bank of Zambia was the formation of a committee to regularize the provisions under which the bank provided credit to the government.

On the question on boosting agricultural activities through exempting new agricultural loans from the reserve requirements of the monetary system, the promotion of agriculture, particularly catering to the needs of small-scale farmers, was a significant element of the election campaign, the staff representative mentioned. President Mwanawasa had emphasized that his new government would focus on promoting agriculture. There were provisions in the budget for social spending to target rural agriculture. However, the staff had expressed its concerns and the Bank of Zambia was fully aware of the potential distortionary impact of the scheme of agricultural lending that was exempt from reserve requirements. That scheme had been introduced on a purely pilot basis and would be reviewed in the near future.

Mr. Yeritsyan made the following statement:

> I welcome the authorities' firm resolve to keep the program on track and to prevent delaying the completion of the fourth review, despite the difficult political situation due to presidential elections at the end of last year and further complications in the mining sector. I also note that this review underscores a clear progress in implementing structural reforms and in improving discussions with donors and creditors. Meanwhile, the program remains strong, well streamlined, and well focused, which deserves a complete implementation. Therefore, I support the proposed decisions along with the staff's appraisal.
>
> The rest of my intervention will concentrate on a couple of issues, which, in my view, are critical in order not to get stuck in permanent difficulties and continued delays in the future, when more sophisticated institutional capacity and knowledge would be needed to better link the implemented policies to a clear and understandable outcome, and thus, maintain public support for the reforms. My comments are as follows:

First, bold measures toward fiscal transparency, better consolidation of government transactions, and creation of a mechanism to prevent the occurrence of old arrears should be consistently included in the program. There are such measures in the current program, but all this should be combined under a comprehensive strategy, such as the Medium Term Expenditure Framework (MTEF). I would expect this kind of strategy integrated in the full PRSP before us, which would have already set clear targets and a reasonably short timetable for implementation. It is also obvious that the authorities should undertake some kind of a due diligence study of fiscal rules and treasury functions. A well functioning treasury itself could resolve a significant part of these problems. I think that Mr. von Kleist made a good point about the resident advisor's role regarding this issue.

I strongly support the staff's strategy in designing the performance criteria of the program, which concentrates more on structural measures in the fiscal sector than on numbers at this stage. In the future, I would like to see all fiscal measures driven by the proposed outcomes under the MTEF and the authorities medium term program should concentrate on improving the tax administration. This, perhaps, would also allow setting some quantitative fiscal targets.

Second, governance issues are critical to improve the country's outside image among donors and investors. The authorities' commitments under the PRSP are quite strong, which rightly anticipate broader public participation through transparency, better management of public resources and improvements in the rule of law. However, the authorities' strategy under the PRSP still seeks to be turned into a comprehensive and concrete working plan. I would like to highlight only one of the policy action plans under the first pillar of the governance strategy—developing decentralization policy. It has too wide a definition and, if this also implies fiscal decentralization, substantial progress in the above-mentioned fiscal measures is a precondition. Moreover, sustainable tax revenue sources and capacity constraint issues should be addressed first. We have already seen some other non-success fiscal decentralization cases, which were a result of rushing policies. At this stage, unfortunately, there are such questions with regard to almost every policy action plan presented in the PRSP, and very little information is provided to understand them. The appropriate sequencing and timing of measures is also a matter of concern.

Third, there is a need for greater independence of the Bank of Zambia (BoZ) and improving its capacity to tackle the inflation problem. In this respect, I would like to ask the staff to explain what the nature of claims on non-government in the BoZ's balance sheet is, which increased from kwacha 187 billion in 2000 to 315 billion at the end of 2001. Will there be a contingent effect on the BoZ's capital, and is the loan loss provisioning mechanism appropriate to reflect the capitalization needs of the BoZ? On the issue of ZNCB, I would like to recall our previous statement that moving the branches to another state-owned bank or state-owned company merely postpones the problem and will probably not avoid the need to close these branches in the future. It seems that the authorities still stick to this idea, and, thus, I would stress the need for a comprehensive cost benefit analysis of this measure. We have not yet seen what the size and quality of the overall transactions of these branches are and whether it is possible to find better service providers if the government announces an open tender for its transactions into provinces and rural areas. Why are the new investors not interested in these branches?

Fourth, it is worrisome to read the staff's conclusion that Zambia's record in implementing the recommendations of the technical assistance missions is mixed. After all, that technical assistance is provided to also improve institutional capacity. Therefore, I do not quite understand the staff's statement that the technical assistance efforts have lagged mainly because of capacity and resource constraints. Should not the technical assistance missions' recommendations take into account these constraints and try somehow to diminish them? A couple of minutes ago, the staff explained that the mixed implementation has been the result of lack of the authorities' commitment. Which one is the truth? I really think that some sort of a technical assistance assessment section or box should be a permanent component of the staff report or the LOI, which would describe some detailed status of implementation of technical assistance recommendations related to the Fund's program. Better linking of the technical assistance recommendations to the programs implementation will increase the authorities seriousness in making a new technical assistance requests.

Finally, I concur with the Joint Staff Assessment of the PRSP. It should be developed further into detailed working plans, which will allow to assess the progress of implementation not only post fact, but also ex ante.

In conclusion, I stress that the program needs to be fully implemented for the next reporting period. A more strategic approach should be taken in terms of the fiscal stance to ensure that public resources are used appropriately and that the measures proposed in the PRSP are fully financed. Greater transparency and accountability is needed to increase public participation and build up domestic pressure for consistent implementation of reforms. This will be facilitated by further operationalization of the PRS by developing a detailed working plans based on its outcomes. Institutional capacity building and better use of technical assistance is a key to success.

Mr. Pinto Moreira made the following statement:

Let me first indicate my appreciation to Mr. Rustomjee for his informative and helpful statement. In 2001, Zambia made considerable progress toward macroeconomic stability. Inflation was reduced sharply, and the exchange rate was stabilized. Performance under the Fund-supported program was broadly satisfactory, although some performance criteria were missed at end-December 2001. Growth performance was also robust. However, this situation remains fragile. I, therefore, welcome the authorities' commitment to push ahead with their reform program for 2002. As I concur with the staff appraisal, I support the proposed decisions. I will focus my comments on three points: arrears, structural reforms, and the PRSP.

In the fiscal area, performance for 2001 was mixed. The overall fiscal deficit exceeded the program target, reflecting an overrun in aggregate expenditure, although revenue increased substantially and exceeded the program targets. The key challenge for the authorities is to establish fiscal sustainability. In this regard, I welcome the measures envisaged under the 2002 budget. On the revenue side, I share the authorities' view to temporarily raise the VAT as a contingent measure. On the expenditure side, it is encouraging to note that the authorities tend to reduce domestic expenditure. In addition, discipline in expenditure management improved. It is also encouraging to note from Mr. Rustomjee's statement the measures that the authorities intend to take in order to prevent the emergence of new domestic arrears. The tax exemptions introduced in the 2002 budget may put further pressure on the fiscal position. However, they are intended to favor social sectors for poverty reduction purposes and are, therefore, difficult to oppose. The issue of tax exemptions is one of policy trade-off.

On the structural front, significant progress was made in the implementation of structural reforms, including steps to privatize a major commercial bank, the strengthening of the overall financial sector, and the beginning of the withdrawal of the state from the electricity sector. While reform was slower than envisaged in the oil sector, it is encouraging to note that the Zambian authorities intend to proceed with the remaining reforms.

As regards the mining sector, the decision by Anglo-American plc to discontinue funding for its mining operations create major problems for the country, and I encourage the authorities to continue their efforts to find a new strategic investor. In the meantime, and given the adverse social impact that closing the mining will have, I support the authorities' decision to keep the mines in operation.

With regard to the PRSP, I commend the authorities for successfully completing their full PRSP designed in a participatory approach. I also welcome the strategy consisting of using the pursuit of growth, the diversification of the economy, and the more effective targeting and implementation of public sector policies as a pillar of poverty reduction. Indeed, strong and sustainable growth over a long period of time will be crucial to reduce widespread poverty in Zambia. The diversification of the economy away from the mining sector is key to reduce vulnerability to exogenous shocks and diversify sources of sustainable growth.

Finally, the implementation of appropriate public sector policies along with the acceleration of structural reforms will enhance the economic environment and ease the development of the private sector in favor of a private sector-led growth. With these remarks, I wish the authorities every success in their endeavors.

Mr. Vermaeten made the following statement:

Let me begin by assuring Mr. Rustomjee that we will transmit his urgent message on the drought to our authorities and we will certainly do our best to mobilize support.

Zambia should be commended for the progress it has made in the last few years—particularly compared to the record of the previous 20 years. Like Mr. Brooke and Mr. Kelmanson, we feel strongly that Zambia deserves, and needs Fund support and, therefore, endorse the staff's recommendations to grant the necessary waivers, augment the PRGF, and continue to provide interim HIPC relief.

I would also like to congratulate the authorities for their efforts in creating a locally-owned and participatory PRSP. We believe that it is far-reaching in scope and very ambitious, and constitutes a solid basis for further policy dialogue and a significant step towards improving aid coordination. I will submit, for the record, the comments that were made by our constituency at last week's Board meeting at the World Bank on Zambia's PRSP. The only thing I wish to add to those comments is that, like a number of other Directors, we were very pleased to see the strong emphasis placed on fighting corruption and to remind Zambia to not become complacent—the Transparency International Corruption Perception Index still ranks Zambia as a country with very serious problems. I would hope that the authorities take actions designed to improve their status each and every year.

On the PRGF-supported program, given that we share the concerns expressed by a number of the statements—particularly the concerns over fiscal slippages—and given that we broadly agree with the staff's recommendation, I will focus my comments on three areas in which I think future staff papers could be improved upon. Specifically, (1) the need for more analyses on sources of growth, (2) the fragility of the growth assumptions, and (3) the need to develop a more cohesive plan with clear, measurable benchmarks to strengthen public expenditure management and technical capacity.

First, as we said at the time of the PRGF review, we think PRGF reports need more information, analysis, and strategies on enhancing growth—and this is particularly true for a country like Zambia where the country's prospects and external position is at a critical juncture, as it relies so heavily on a single industry. The paper essentially treats the current difficulties in the copper industry entirely as an exogenous shock—and does not adequately explore how the copper industry can be made more competitive.

From our understanding, most copper production in Zambia takes place in older, underground mines. Privatization and new capital investment has brought down the cost of production somewhat, but technical limitations—such as the grade of the ore and the fact that the mines are underground—combined with overstaffing means that the cost of production of existing mines is unlikely to fall below 70 to 80 cents a pound. Given that copper prices are now just over 70 cents, it is no surprise that Anglo-American plc decided to pull out of Zambia.

We note that at the same time this decision was made, Anglo-American plc committed $1.3 billion to buy a Chilean copper mine with similar output capacity as KCM, as well as announcing its intention to increase its base metals division. Anglo-American plc's operational costs are twice as high in Zambia as they are in Chile (47 cents/pound in Chile versus around 85 cents/pound in Zambia).

While this paints a very pessimistic picture of the current situation, it was heartening to speak to a representative of a Canadian mining company with significant interests in Zambia. This person was adamant that Zambia had tremendous potential to grow in that there is significant evidence of very rich grade, open pit copper deposits. These open pits are now beginning to be exploited and have cost structures closer to 40 cents a pound.

Now, I am not sure whether I have characterized the copper industry properly, but my point is simply this. We need more analyses and information on the sources of growth—and mining is definitely a major industry in Zambia with growth potential that is crucial for earning foreign currency. If the cost structure of the large existing mines cannot be reduced due to technical reasons, and if there are copper deposit with much lower cost structures that can be exploited, then a strategy is needed to encourage investors to exploit the more cost-effective mineral deposits. Or more generally, we need to determine what are the underlying structural inefficiencies in the labor market, and the transportation and financial systems and what needs to be corrected to bring down Zambia's production costs, so that it can target a specific global market copper share within the next 5 years.

That being said, we recognize the importance of economic diversification and appreciate the information provide in Box 2 of the report. We also fully agree with Mr. Mozhin and Mr. Lissovolik that a key to success in the agricultural and textile industry will be the opening of markets by the most advanced countries.

Our second suggestion for improving PRGF reports is closely related to the issue of needing more analyses on the sources of growth. That is, we are concerned over the extremely fragile assumptions underlying the program and feel growth projections should be more conservative for the base case in future reports.

At last fall's Board meeting, we noted our concern with growth estimates of 5-5.5 percent. Likewise, we worry that the revised projection of 4 percent growth over the medium term is still overly optimistic, given current circumstances, particularly with the withdrawal of Anglo-American plc and the current copper production cost structure.

Of course, there are other risk beyond non-favorable copper prices. For example, as previous staff papers emphasized, sixty-eight percent of men in the copper belt are HIV positive and these risks are also compounded by the continuing existence of weak capacity and ongoing governance problems. And Mr. Rustomjee has informed us that, unfortunately, Zambia faces even greater challenges due to the drought.

Combined, these factors suggest that a 4 percent growth is optimistic for a base case on which an economic plan and donor support is built. Using overly optimistic projections builds unrealistic expectations, the Fund's credibility suffers, and the HIPC relief granted is insufficient to make debt levels sustainable.

Third, and lastly, we are concerned over Zambia's lack of ability to absorb technical assistance, particularly related to public expenditure management, and we are not entirely convinced that there is a clear, cohesive plan with measurable benchmarks in the PRGF-supported program and PRSP to address these weakness and to hold Zambia accountable.

Zambia has received a large amount of technical assistance in a variety of areas, as Mr. von Kleist has said, yet it is difficult to point to results. As noted by the staff, the capacity of Zambia to implement the policies highlighted in the PRSP is of fundamental concern. One factor that makes capacity building so difficult in Zambia is HIV/AIDs. For example, we learned from last week's World Bank Board discussion on Zambia that 1,600 teachers died of HIV/AIDS in 1999, compared to about 2000 new teachers that were trained in that year.

As well as general capacity building, improvements in expenditure management are needed to enact the PRSP, to strengthen the overall pro-poor bias, and to enhance transparency of the budget process. As the staff indicates, there are ongoing problems in budget execution that have disproportionately affected the social sectors, while on the other hand, defense spending has risen versus budgeted amounts and as a percentage of GDP.

Unfortunately, Zambia currently ranks last amongst 24 HIPCs in the recent Fund/Bank review of expenditure management systems (scoring 3 out of 15).

Zambia is attempting to address these problems in a variety of ways, and on a number of fronts. Like Mr. Yeritsyan, what we think is missing is a coordinated plan to tie these initiatives together, with clear, measurable benchmarks to hold Zambia accountable. Zambia already relies critically on donor support, and should the situation in the copper sector deteriorate, donor support will be even more important. Zambia needs clear benchmarks to strive for, and as these benchmarks are met, the donor community can become more confident that financial assistance will be well spent.

Let me conclude by, once again, congratulating Zambia on its recent accomplishment, and let me emphasize that the suggestions I have made today are in the spirit of making well written and well thought out staff papers even better.

Mr. Ralyea made the following statement:

We share Mr. Rustomjee's and other Directors' concerns about the food security situation in southern Africa. In that regard, we believe grant assistance is perhaps the best way for donors to help affected countries.

The list of requests before the Board today is long. The authorities request waivers of four of seven quantitative performance criteria for end-December, augmentation, additional interim HIPC assistance, and approval of the PRSP. We are inclined to grant those requests, despite some of last year's highly questionable election-related spending, particularly the increase in wages. The new administration deserves a chance to implement its economic program with Fund support, given the strength of its program commitments. In particular, the planned improvement in the domestic primary balance and the authorities' strategy for addressing challenges in the copper sector are welcome. We expect the government to fulfill the letter and spirit of its program, notwithstanding shocks or capacity constraints.

That expectation also extends to the authorities' efforts to improve the government's expenditure management system. The line item in the budget called "change in balances and statistical discrepancy" suggests severe problems exist in monitoring expenditure commitments and disbursements. Obviously, such a poor expenditure management system undermines formulation and implementation of economic policies, including poverty reduction programs, and invites the misuse of government funds.

We will look for substantial progress in strengthening expenditure management under the remainder of this program, in particular the tracking of poverty-reducing expenditures and the use of HIPC resources, and the development of a Medium-Term Expenditure Framework. The government should also adhere to its own laws regarding the auditing of the budget accounts. Looking further down the road, we expect the Integrated Financial Management Information System to be operating effectively in more than a few departments before a HIPC completion point is considered. Improvements in this area would complement nicely the emphasis in the PRSP on improved governance, including a zero tolerance of corruption.

We agree with the thrust of the government's strategy for handling KCM. We encourage the government to limit strictly financial assistance for KCM to emergency situations only. Past governments poured enormous amounts of money into the copper sector, undermining numerous IMF-supported programs on precisely such grounds. Also, the government's experience with the privatization of ZCCM suggests strongly that the authorities should pick up the pace on the privatization of ZNCB, as is contemplated.

Zambia continues to be highly dependent on donor support. Balance of payments financing from official creditors, IMF disbursements, and interim HIPC relief, is projected to be about 17 percent of 2002 GDP, covering almost 60 percent of Zambia's gross financing requirement. As demonstrated in the past, this level of reliance on variable donor funding can create problems for budget execution and monetary policy.

Nonetheless, the staff suggests that additional debt relief beyond that provided under the enhanced HIPC Initiative could be used to cover projected medium-term fiscal and external financing gaps. We would urge the authorities to look to additional fiscal measures first and foremost. The authorities can exercise greater control over their own budget decisions relative to their control over donor decisions to provide aid. More broadly, one could argue that the fall in copper prices, if sustained, might impair Zambia's long-term debt servicing capacity. If this proves to be the case, we encourage the Fund to push for increased concessionality in the total donor assistance mix.

On a related note, we do not deny Zambia's need for technical assistance in several areas. But the list of fields in which the Fund already has provided technical assistance, and the length of time this relationship has existed without notable effect, raises serious questions about the effectiveness of this technical assistance. Going forward, we would want to see implementation of past technical assistance recommendations before significant amounts of new technical assistance are provided. Similar to Mr. Yeritsyan, we encourage the staff to report on the implementation of past and any future technical assistance recommendations in future Board documents.

On program design, we wonder if the quantitative performance criteria adequately safeguard Fund resources, given the government's recourse to non-bank domestic financing last year? Had the staff considered a ceiling on primary expenditure?

In conclusion, Zambia's new authorities have a chance to chart a different course for Zambia. We urge them to seize the opportunity and implement assiduously their economic program. We also encourage the authorities and the Fund to address the issues raised in this statement.

Mr. Sazanov made the following statement:

Let me start by thanking the staff for their report and Mr. Rustomjee for his informative statement. We largely agree with the staff's appraisal. Since Zambia's overall economic performance has been improving markedly for the last two years, especially by comparison with its long history of economic weakness, we support the completion of the review and the proposed waivers. We also support the requested augmentation of 5 percent of quota and the extension of interim HIPC Initiative assistance to cover 2002. And while we urge the authorities to avoid any further slippages in their fiscal management, we understand the difficulties caused for Zambia by the considerable shortfalls in external assistance.

We commend the authorities' completion of all the program's structural performance criteria and benchmarks during the second half of 2001, which conclusively proves the Zambian authorities' determination to accept full ownership of envisaged programs. While we broadly agree with the staff's appraisal, we have a few comments on some important points.

Unless promised donor support is provided on time, it will be hard to the authorities to maintain the necessary financial discipline, especially in light of the mandated increase in spending on poverty reduction. We join the staff in urging the Zambian authorities to seek assurances of the timely disbursement of pledged resources. We also call on the international community to meet their obligations by providing the timely support that is vital for the continuation of Zambia's overall economic development.

We also urge the authorities to vigorously follow up the recent improvements in the performance of their private sector, which have somewhat increased Zambia's export potential. These achievements must be pursued and extended by means of better coordinated policy measures. Economic diversification is urgently needed to advance Zambia's economic development and reduce poverty. We welcome the Poverty Reduction Strategy Paper produced by the Zambian authorities.

We join the staff in welcoming the authorities' recent efforts at structural reformation, but warn them against putting speed ahead of quality as privatization proceeds. They must find a high quality investor and agree on terms that will be beneficial the government.

We also urge the authorities to look for other measures that can help ensure the program's success even in the absence of timely and adequate external support, an outcome that seems likely in light of the fate of assistance pledged to support Zambia's fiscal stability. Technical support from the international community and the international financial institutions is also needed to outline the necessary measures for ensuring further economic development, and must be complemented by a commitment by the Zambian authorities to make the best use of this technical support.

With this, we wish the authorities every success.

Mr. Skurzewski made the following statement:

Let me say at the outset that this chair supports the proposed decisions on completing the review and endorsing the new annual program under the PRGF, although with some reluctance. We also share most of the concerns already raised by Mr. von Kleist, Messrs. Guinigundo and Cho, Messrs. Mozhin and Lissovolik, and other Directors.

We assess Zambia's macroeconomic performance in 2001 with less optimism than the staff does. While the real GDP rose considerably and inflation declined, the fiscal performance and current account worsened significantly, mainly due to election-related expenditures and shortfalls in donor assistance. As a result, the kwacha appreciated and real interest rates rose sharply. Also, the outlook for 2002 is mixed, even in the optimistic baseline scenario regarding the copper sector. That is why we think the program is not strong enough in the two important areas—fiscal adjustment and structural reforms.

Looking at the envisaged fiscal policy, I note that the domestic fiscal deficit is programmed to decline in 2002, but it will be still higher than two years earlier. Box 3 clearly demonstrates the dangerous consequences of the domestic debt dynamics, possibly leading to an unsustainable fiscal stance.

The financing gap of some 3 percent of GDP projected for 2002 and 2003 shows that the reliance on the external assistance will be very difficult to reduce, and may be even increasing. Considering this, much stronger actions seem advisable on the revenue side. It is right that the tax-to-GDP ratio is relatively high. However, the 2002 program envisages a decline of almost one percentage point of GDP compared to the previous year, when there had been a decline too. The few adjustments in the excise tax and the taxation of the government bonds seem not enough. The VAT rate increase proposed by the staff seems a reasonable choice and perhaps will have to be revisited. Last year's increases pushed the wage bill to an unsustainably high level of 7 percent of GDP, and while the authorities argue about impracticality of reversing it, the burden of fiscal adjustment will have to further fall on domestic expenditures. Here, I share the observation that the projected expenditure decline is related to the exclusion of one-off-expenses in 2001. Moreover, I also note without much sympathy the rising military expenditures. Apart from the medium-term sustainability, if the fiscal problem is not addressed decisively, interest rates will remain high, thus hampering overall growth and poverty reduction efforts.

Turning to the structural reforms, the problems in the copper sector prove even stronger now the need to further diversify Zambia's economy, with tourism, textile, and agriculture sectors offering the most promising alternatives. Last year's impressive growth in the value added and employment generated by tourism shows its potential, even if some of this growth was attributable to the OAU summit. As far as the agriculture is concerned, I am quite convinced, however, that this sector should not be promoted by a new subsidy scheme for fertilizer and reduced taxes on fuel and electricity, in addition to the already existing incentives. I would rather see a need for improved rural roads and infrastructure, which would also be beneficial for the poor.

On the KCM project, while I note the importance of this facility for the export revenue and the direct and indirect employment, I welcome the government commitment not to take over the mines, in light of its already fragile finances. The staff quotes the falling copper prices having the major influence on the investor's withdrawal decision, but I wonder about the possible lack of the cost-efficiency measures, which are said in paragraph 22 to have shown only some success. I also welcome the staff's comment in the PRSP assessment suggesting more focus on the mining sector efficiency, rather than on doubtful future investments. I hope the staff can report more on these aspects at the KCM, including on the progress with retrenchment efforts mentioned in the initial IFC project description, at the time of the next review.

Regarding the HIPC, I take note of the worsening of the external position, which could require significant debt relief beyond that provided under the enhanced HIPC Initiative. I gladly note that the export projections are now more realistic than at the decision point. At the completion point, however, we will assess carefully whether the country fulfills the requirement of topping up. As to the poverty-reducing expenditures, I welcome that measures were or will be taken to improve the budget execution and monitoring of expenditures. This will not only increase the likelihood that budgeted expenditures actually reach the poor, but will also ensure that there is no shortfall in poverty-related spending. Administrative capacities are, however, still weak and I encourage the authorities to implement the recommendations of the technical assistance studies. Finally, at the time of the next review, I would appreciate some information on Zambia's progress regarding the completion point triggers.

With these remarks, I hope that the improved performance will allow us to complete the future reviews without any doubts and I wish the authorities well.

Mr. de los Santos made the following statement:

We want to join previous speakers in congratulating the Zambian authorities for their encouraging economic performance during 2001. The country experienced a robust real GDP growth and inflation was reduced to expected levels. Furthermore, the overall implementation of the PRGF-supported program was in line with expectations.

Though progress has been made, further improvements in revenue generation and public expenditure management are needed. Public sector spending should be contained during 2002, limiting non-priority fiscal outlays to a minimum, as a way to reduce the notably high level of overall fiscal deficit, which reached 8.1 percent in 2001. In this connection, we agree with the staff consideration that a reduction in the stock of domestic debt is needed to both lessen the high financial burden arising from accruing interest on that debt and to counter inflationary pressures. It is encouraging to hear about the authorities' intentions to take actions in this direction, and their purpose to reorient the 2002 budget expenditures to support priority sectors, such as agriculture, education, and health. This would be consistent with the improved attention to these sectors during 2001, when about an extra 20 percent over the budgeted funds were channeled to it. We commend the authorities for their commitment to implement the poverty-reducing strategy and, in this regard, we salute the transparent and orderly way that the enhanced HIPC Initiative resources are being used, tracked, recorded, and reported for public domain.

The tight monetary policy adopted along 2001 has been suitable, but authorities should monitor developments of interest rates to induce an adequate level that encourages further investments. Reducing the stock of the government's domestic debt and limiting further financing to the public sector would work positively toward a reduction of the interest rates level. We also consider as appropriate the BoZ's intentions to assume a cautious monetary expansion during 2002, and to conduct this policy exclusively through the use of indirect monetary instruments.

On the external side, Zambia shows significant vulnerabilities, arising mainly from the persistence of depressed international prices of copper—its main export product. We note with high concern the prospects for copper prices for the short to medium term, and the potential major impact on the Zambian economy if either Scenario 2, or the baseline scenario with 10 percent lower copper prices, as presented in Annex 1, Table 1, materialize. In particular, the external current account deficit would grow even further, reaching unsustainable levels, and foreign gross reserves would be under heavier pressures. Under these circumstances, the Zambian authorities have no options but to make all possible efforts to support a further expansion of nonmetal exports, which experienced an outstanding growth in 2001, and, as suggested by the staff, take immediate actions toward the diversification of the country's economic base. The tourism sector, which last year generated greater than expected receipts and, which according to staff estimates, has the potential to grow by as much as 10 percent a year over the medium term, could be a case in point in the diversification strategy.

We commend the authorities for their recent decision to accept Article VIII, Sections 2, 3, and 4 of the Articles of Agreement and the Board's approval of it and, in this connection, we welcome their resolution to not interfere with the market forces that determine exchange rate levels. Their promise to limit their intervention in that market only to those occasions when it is needed to meet the program's target of reserves, or to smooth short-term sharp fluctuations, is appreciated.

The advances in the implementation of the structural reforms program, mainly those actions to improve public expenditure management and to eliminate the discretionary tax exemptions, deserve our recognition. We expect that the authorities will continue implementing key measures to improve the business environment and foster a greater participation of the private sector in the Zambian economy.

We also entrust the authorities for the culmination of the PRSP preparation, and recognize the efforts they made to grant the participation of all sectors of the Zambian society in the discussion of policies and programs that were finally encompassed in the strategy to attain economic growth and social development in Zambia.

Finally, we support the authorities' requests for the waiver of the missed performance criteria and for additional assistance under the enhanced HIPC Initiative and the staff proposal that the fourth review under the PRGF arrangement be deemed completed.

Mr. Santos made the following statement:

We are being asked today to complete the review of a program that, in our view, was fundamentally off-track. No doubt, it is fair to recognize, the real economy is holding its own, reflecting to a great extent the generally good performance in implementing structural reforms, particularly in the areas of trade and exchange liberalization, and opening up the copper sector to private initiative. However, this contrasts with a much weaker performance in implementing financial policies, especially fiscal policy, which, if not corrected promptly, could put in jeopardy the improved growth performance over the recent past.

Already, the increased financing needs of the public sector that had to be satisfied by recourse to domestic financing and the upward pressure placed over real interest rates are crowding out credit to the private sector. Moreover, fiscal slippages were also at the core of the drawdown of reserves to very low levels, reducing considerably policymakers' room for maneuver in the near future. And while, no doubt, the tightening financial situation was also the consequence of shortfalls in donor support, those shortfalls should not be seen as completely outside the authorities' control, as they reflect to some extent policy slippages.

Whatever the reason, we have some mixed feelings about the decision to draw down reserves to accommodate the lower level of foreign aid and the higher fiscal deficit. Instead, we would have preferred that the original reserve target had been met and that the exchange rate had been allowed to depreciate to reflect the change in circumstances, including a loss in terms of trade. We fear that a more appreciated level of the exchange rate may allow an unsustainable level of imports and in time may place a damper on non-traditional exports. Therefore, competitiveness considerations should be at the forefront of policy decisions.

Of course, it can be argued that fiscal and monetary goals are just intermediate ones, and that, in the end, what matters is that inflation declined very much in line with the program. While this is true, it is equally true that such an outcome was greatly helped by the appreciation of the exchange rate in effective terms. In our view, that is not a sustainable way to reduce inflation, as it entails costs to the achievement of other key program goals like external viability and economic growth, both of which may be penalized by the weaker competitiveness brought about by the stronger currency.

All these developments led to a breach of all main quantitative performance criteria for end-December by substantial margins, despite the softening of all those performance criteria on the occasion of the last program review, late last year. Moreover, had a waiver of non-applicability of the performance criterion on nonaccumulation of external arrears not been granted, another performance criterion would have been breached as, on substance, there were external arrears outstanding at end-2001. The report claims that the breach of the performance criteria reflected to a great extent the shortfall in donor support. We would note that there is an adjustor to take care of these factors, and so that is not a reasonable excuse. True, the adjustor has a cap ($45 million) and the shortfall in December ($75 million) was higher than the cap. However, the idea of the cap is that the excess of the shortfall over and above the cap should be addressed through stronger adjustment and clearly that did not happen. Moreover, while none of the end-December performance criteria covers progress in settling domestic arrears, the fact is that they have not been fully settled, as was envisaged under the original program for 2001. We note that in the program for this year, this was brought back as a quantitative benchmark. However, we would have preferred that progress in this area had been covered by a performance criterion, as was the case in the original program for 2001.

For all this, we have mixed feelings about the completion of this review and even more about the proposed augmentation of the PRGF arrangement by 5 percent of the quota. The report justifies such an augmentation on the basis of the weak external environment, which led to a larger balance of payments need. But, more importantly, had the program been implemented as programmed, the need for such increased financing would be much less evident. So, in our mind, by increasing financing, we are just bailing out Zambia for the poor fiscal performance that led to a depletion of reserves and eliminated any room for maneuver.

Looking a little closer at the reason behind the request for increased financing, the fall in the international market price of copper, it seems to us that this is fundamentally a permanent shock since copper prices, although expected to recover, are not projected to go all the way back to where we were projecting them before. A difference of 11 cents per pound is expected to remain even in the outer years of the decade. Hence, the best way to address this would be through exchange rate action, i.e. allowing the currency to depreciate to reflect the terms-of-trade loss. In addition, if the authorities are concerned about the value of the currency, they could strengthen adjustment to keep the devaluation more limited. However, the option for increased financing is not the best in our view as the shock is not of a temporary nature and because the debt ratio is already way above the 150 percent threshold throughout the projection period and more financing will only deteriorate the debt picture.

Moreover, with a Fund credit outstanding at 160 percent of the quota, Zambia is well above the access limit under the PRGF-supported program and also well above the average outstanding Fund credit of PRGF-eligible members (100 percent of the quota). Hence, we have little sympathy for the augmentation of the arrangement.

But, more generally, because there is no room for substantial additional financing over and above what is in the program without further endangering debt sustainability, we would encourage the authorities to deal with any unexpected factors that deteriorate the situation and financing gaps in future years, without incurring additional loans, even of a concessional nature. In these circumstances, we are concerned by frequent references in the report to the need to grant debt relief above and beyond the enhanced HIPC Initiative as a way to ensure debt sustainability. Such references to additional debt relief are dangerous as the authorities will then have an incentive to close future financing gaps by incurring additional external debt rather than by strengthening adjustment, as the expectation is that those additional loans will eventually be matched by additional debt forgiveness in order to ensure debt sustainability. That is, they will perceive additional loans as just grants, and that is a dangerous signal provided in the report.

Mr. Komatsuzaki made the following statement:

After a few years' recovery from a long-time economic decline, Zambia is once again facing a challenging situation. Policy performance continues to be broadly satisfactory, but Anglo-American plc's decision to withdraw from Zambia presented a large negative shock to an economy relying heavily on copper.

I agree with the staff's proposal to continue with support of Zambia, but there is a sizable risk ahead. With the withdrawal of Anglo-American plc, the medium-term growth strategy of Zambia has to be modified. Two areas of focus are (i) stabilization of the copper sector, and (ii) faster promotion of diversification. However, there is some risk concerning the future of the copper sector, including whether the KCM can remain open, and it is uncertain as to how fast diversification can proceed. Given this risk and uncertainty, the probability for success of the program must be estimated cautiously. The proposed augmentation and downward adjustment in economic projections by the staff are in line with this. As for the authorities, they should redouble their efforts toward good policy performance.

The authorities envisage fiscal consolidation this year, a necessity in light of increasing debt stock. Fiscal policy is under pressure, however, with increased demand on the expenditure side for social and poverty-related spending, while revenues are not expected to increase. There is also the risk that expenditures related to the copper sector may prove to be greater than envisaged. A contingency measure has been agreed, which is welcome, but it is unclear whether raising the VAT can completely offset a possible expenditure increase. To ensure fiscal consolidation in this strained situation, it is all the more important to prevent spending overrun in other expenditure categories. To ensure that budget execution is in line with the planned budget and to achieve the objective of expenditure containment, the capacity to manage and track expenditures has to be enhanced.

Inflationary conditions continued to improve in line with the program. The key in 2002 is to continue this favorable trend in inflation and at the same time provide necessary liquidity to the private sector. Available information in 2002 is encouraging so far. Reducing the interest rate on treasury bills is a welcome new development, indicating lowered inflation expectations and improving the public debt situation.

Given that the diversification of the economy has to be promoted rapidly, structural reform has taken on increased importance. I welcome that the authorities are making serious efforts to privatize ZNCB. Given its dominant position, the privatization and improvement of its management is a priority in realizing efficient functioning of the whole financial system. It is also important to proceed with structural reform in other areas.

A strong poverty reduction strategy is another necessary element in diversifying the economy, and I welcome that the full-PRSP was completed. It is encouraging that this PRSP puts sufficient emphasis on growth strategy.

With these remarks, I wish the authorities every success.

Mr. Rustomjee, while agreeing with Mr. Santos's comments on the need for the authorities to further strengthen structural reforms, pointed out that it would be difficult to expect Zambia to counter the exogenous shock to its copper sector—which constituted 70 percent of its exports, a major percentage of its formal employment, and a major source of income and GDP—without any additional PRGF resources. It would be unfair to challenge Zambia's request for an augmentation of 5 percent of quota in a situation of dire need, especially when the Fund had recently decided to release to another member country an amount of resources that was greater than what Zambia had received over 30 years of its relationship with the Fund.

On the issue of additional interim HIPC Initiative assistance, Mr. Rustomjee agreed that a legitimate challenge was whether Zambia would be able to utilize those additional resources effectively. The authorities' claim that they would be able to use those additional resources had been vindicated by the staff report, which stated that the quality of public expenditure management and the tracking of HIPC-financed spending had improved. On the other hand, the suggestion by Directors to further strengthen general public expenditure management was valid.

Mrs. Boucher made the following statement:

At this stage of the discussion, I will restrict my comments to a few points.

PRGF Review

Like other directors, I find regrettable the authorities' under-performance on the fiscal front, in areas where concerns were specifically expressed during the previous review. These developments certainly cast a shadow on the country's overall macroeconomic performance. It should be clear that the Fund's support, particularly in the context of the HIPC process, goes hand in hand with stringent fiscal discipline, which is imperative to macroeconomic stability, along with efforts to reallocate resources to priority outlays. Having said that, we acknowledge the progress made in a number of critical areas on the structural front, including the liquidation of ZNOC, which accounted for a large part of ZNCB's difficulties and should help expedite the bank's privatization.

Looking ahead, I share the views expressed by other directors on the very uncertain outlook, particularly considering that it is difficult to predict whether a new strategic partner for KCM can be found by end-March 2003, at the time that procurement and marketing arrangements with Anglo-American plc will lapse. In this context, at a minimum, the authorities need to strictly adhere to the program's objective. Particular focus on governance and accountability will be necessary, including further strengthening of overall budget monitoring and control which will be critical, not only in the context of the HIPC assistance, but also to secure continued access to donor support. On technical assistance, I concur with the comments made by Mr. Yeritsyan; I also appreciated the staff's candid comments on the difficulty to improve implementation capacity and on the need for greater coordination of donor support in this area.

I can support the proposed decisions on the granting of waivers, increased access, and extension of interim relief that we hope will assist the new authorities' policy implementation efforts at this critical juncture, which is given singular acuteness with the issue of the drought situation and prospects of food crisis commented by Mr. Rustomjee, which will obviously need to be closely monitored by the Fund and the World Bank in coordination with the donor community.

PRSP

We commend the Zambian authorities for having produced a comprehensive document, with a particular effort made on assessing the cost of implementing the PRSP.

On growth prospects, more in-depth analysis on ways to enhance competitiveness will be helpful to identify the sectors which need rapid restructuring, such as the mining sector, as rightly emphasized by Mr. Vermaeten, as well as areas where diversification would have the best chance of being successful and sustainable. Progress in the fight against corruption and enforcement of the rule of laws will also be critical to create a favorable environment for the development of the private sector.

The agriculture sector has been given adequate emphasis, but is rather weak on the issue of land tenure. The PRSP notes that the initial impact of liberalization on Zambia's smallholder farmers has been negative and that the reform envisaged by the authorities aims at addressing the issue of access to both agricultural inputs and credits. The budget for 2002 takes into account the authorities' plan in this area as noted in Box 2, although I understand that the details of the reform agenda are still being discussed with the World Bank. Some aspects might need to be revisited after full assessment of the depth of the current drought crisis. Some fine-tuning to adjust the budget to the final agreed framework might also be needed. We would recommend strong coordination among the World Bank, the Fund, and all relevant partners, including local operators and donors involved in the sector, in designing adequate support policies, learning from similar experiences in other countries in the sub-Saharan region and ensuring full ownership of the reform agenda.

Finally, we agree that the PRSP provides a sound basis for the Fund's support, while noting that this document will need further elaboration, including specific targets and indicators on sector programs, particularly in the fight against HIV/AIDS and gender, as well as greater attention to social safety net programs.

Mr. Al-Azzaz made the following statement:

Zambia's adjustment and reform effort continues to make progress under the PRGF-supported program. Despite some fiscal slippages related to the end-year elections, performance on balance has been satisfactory. Developments during 2001 attest to the progress made with robust growth and further decline in inflation.

That said, it is clear from the staff report that substantial policy challenges remain. This has been compounded by the uncertainties in the copper sector. Early and forceful action is needed to consolidate the progress already made and achieve the medium-term objectives.

As I am in broad agreement with the staff appraisal, I will limit my remarks to a few issues for emphasis.

Regarding the copper sector, I welcome the recent developments in the staff's update that will allow the Konkola Copper Mines to continue to operate as a commercial concern and to remain in the private sector. Indeed, given the importance of the copper sector to the economy, the government is right to pursue viable options for the mines to operate pending identification of a new strategic investor. The authorities' intention to diversify the economy a way from the mining sector bodes well for the future. In this regard, I am encouraged by the authorities' awareness of the need to pursue further reforms vigorously. In particular, focus on increasing private sector participation and improving the investment climate is crucial. Further progress in strengthening banking supervision and prudential regulations is also important.

Achieving the program's fiscal target is clearly a priority. Given the expected decline in revenues, the focus on expenditure side is appropriate. The proposed cutbacks in spending, reduction of domestic payments arrears, and further strengthening of expenditure management are all steps in the right direction. Transparent and efficient use of resources is also critical in view of the envisaged HIPC-financed expenditures and the reorientation of non-HIPC resources toward the social sector. Here, I am encouraged by the improved tracking of poverty-reducing expenditures and the progress made in developing an Integrated Financial Management Information System (IFMIS).

The Central Bank's prudent monetary policy has contributed to further reduction in inflation last year. The Bank's continued commitment to price stability is reassuring. I also welcome its commitment not to intervene in the foreign exchange market, except to smooth short-term fluctuations. Moreover, I share the authorities' concern about the still high level of interest rate and welcome the measures envisaged to address the issue. This reinforces the importance of achieving the fiscal target.

To conclude, the Zambian authorities have demonstrated strong commitment to economic adjustment and reform under the current program. The progress made deserves the international community's support. I, therefore, support the proposed decisions.

With these remarks, I wish the authorities further success.

Ms. Phang made the following statement:

I support the proposed decisions, albeit with some concerns. I also support Mr. Rustomjee's call for an augmentation of access under the PRGF-supported program by 15 percent of quota.

I retrieved some information on Zambia's economic performance in the 1970s and 1980s, and returning to my earlier question to the staff representative from the World Bank, why are we now organizing a workshop to discuss economic diversification in Zambia, instead of using the resources to help the authorities implement the appropriate policies? In the 1970s and 1980s, when agriculture was only supplementing the mining sector, it was more productive than it is now, which means that the Zambian authorities' plan is a workable one and, therefore, resources should go into assisting its successful implementation. If we are going to spend the money on holding the workshop, and the authorities already have a good plan, why not put the money into implementing the plan?

Japan has rescheduled $84 million of Zambian debt over 33 years; this is a good example for other creditor countries to follow, if they can. I also welcome the Acting Chair's earlier statement that Zambia should be given a grant to combat its food security problem.

I would like to know from the staff, or the World Bank staff representative, how much money is needed to help Zambia increase the diversification of its economy, because that will answer Mr. Rustomjee's call for an increase in the proposed augmentation under the PRGF-supported program. Comparing the current situation to the past, when Zambia had well-built maize and other agricultural storage depots in almost every village, it seems that a large amount of money is needed.

The Acting Chair (Mr. Sugisaki), on the food security problem, commented that loans made under PRGF-supported programs were on a concessional basis, and a grant would better address the problem. If any further balance of payments need arose, then the Fund should consider further augmentation of the existing PRGF Trust. However, at present, as it was still unclear how much foreign exchange would be required to cope with the food security problem, the Board should only consider the current staff proposal to augment access under the PRGF by 5 percent of quota. Meanwhile, management and staff would monitor the food situation, and consider further assistance that the Fund could extend to Zambia.

The staff representative from the African Department (Mr. Sharer), on the question on the amount of money that was needed to promote diversification, said that Zambia had a poor record of economic performance, with growth averaging around or slightly below zero percent for the last 20 years. The problems of a lack of diversification could not be addressed instantaneously through the provision of an amount of money. While the authorities were currently implementing the appropriate policies, it would take some time for those policies to bear results.

On the questions on the financing gaps of the budget, and whether the authorities should rely on additional debt relief to fill those gaps, the budget had been based on cautious assumptions with respect to the level of foreign assistance and the evolution of domestic variables, the staff representative remarked. The authorities did not intend to rely on external resources to fill in the financing gaps of the budget. If the balance of payments support turned out to be higher than anticipated, that would help reduce the budgetary gaps. A number of Paris Club creditors had indicated that, if and when the HIPC completion point were reached, they would provide additional debt relief. In addition, there was no indication that the authorities would avoid the domestic adjustment that would be needed to finance the gaps in the budget.

Regarding the overall budget deficit, which was slightly higher compared to two years ago, it was due to the inclusion of foreign-financed HIPC expenditures, as well as rising social expenditures vis-à-vis other expenditures, the staff representative explained. The appropriate definition of the budget deficit to be applied in Zambia's case was the domestic primary balance, which was the domestic balance, excluding interest. A performance criterion on the domestic budget balance had previously been included in the Fund-supported program until it was removed about 18 months ago, at the urging of the Board to streamline the number of performance criteria. The adjustment in 2002 would continue to focus on the domestic budget balance.

On the rise in military expenditures, a large portion of the general and supplemental wage increases had consisted of a significant wage increase to the army, the staff representative said.

On the question on the credit to non-government entities in the Bank of Zambia's balance sheets, it was related to the guarantees that had been given to the oil sector a few years earlier, the staff representative elaborated. As a result, a quantitative performance criterion had been introduced to prohibit the granting of further guarantees by the central government or the Bank of Zambia to those non-government entities, which had since been observed by the authorities.

On the question on whether the growth estimates were optimistic, although the data was provisional, the 4 percent projections were not overly optimistic, the staff representative noted. Those projections were based on Zambia's experience: growth performance of the past two years had improved sharply, compared to the historical average of zero percent, while per capita growth rates had been positive. Such growth was not the result of fortuitous external circumstances; in fact, there had been adverse external circumstances during that period. Rather, it had been the result of the reversal of inappropriate policies that had been pursued for so long. The growth projections had also been scaled back due to the developments in the mining sector, and had taken into account the negative impact of HIV/AIDS on the economy.

On the question on the cost structure of the copper sector, Zambia had higher costs compared to Chile, as much of Zambia's copper supplies were found underground, the staff remarked. The higher cost structure also reflected the fact that the copper industry had been poorly mismanaged for a long period of time. However, Zambia's copper ore was of a much higher grade than Chile's. Zambia, therefore, needed well-managed copper companies that would conserve their resources when prices were high and that would build in a margin when prices were low. The chart on page 32 of the staff paper showed clearly that the copper mines could have been successful if the cost structure had been lower. According to many Zambian officials, including Anglo-American plc managers in Zambia, Anglo-American plc was pulling out of Zambia because the unexpected dip in copper prices had changed the rate of return on the Konkola Deep Mining Project. Anglo-American plc was not interested in the more modest returns of existing copper mines, which would be exhausted in nine years without the Konkola Deep Mining Project. Thus, there was a basis for saying that Zambia could sustain a profitable copper mining sector if it were properly run as a private sector entity.

Mr. Rustomjee said that a grant would be more appropriate to help Zambia address its food security problem. Donor countries should consider increasing their level of assistance to the six drought-affected countries in southern Africa, particularly as reports from the UN agencies were beginning to confirm the seriousness of the situation.

On the issue of augmentation of access under the PRGF-supported program, Mr. Rustomjee recalled that, after the September 11 attacks, the Fund had committed itself to adopting a flexible approach, on a case-by-case basis, when considering member countries' requests to augment their access to PRGF resources. The Governor of the central bank of Zambia had recently reported that the impact of the September 11 attacks on Zambia's terms of trade was estimated at US$100 million. The authorities' request for an augmentation of 5 percent of quota, which amounted to approximately SDR 25 million, would only constitute about one-third of that estimated terms-of-trade loss.

In concluding, Mr. Rustomjee thanked the staff for their ongoing work with the authorities, and Directors for their valuable comments and for supporting the proposed decisions. All the comments by Directors on fiscal, monetary, exchange rate, and structural policies would be reported to the authorities for consideration.

The Acting Chair made the following summing up:

> Directors observed that Zambia had made considerable progress towards achieving macroeconomic stability and reviving economic growth in 2001, as shown by a relatively high real GDP growth, a significant reduction in inflation, and a more stable exchange rate. They noted that all the structural performance criteria and most of the program's quantitative performance criteria and benchmarks were observed. However, they were disappointed by fiscal slippages in the fourth quarter of 2001, notably the overrun in wages and domestic capital spending in the run-up to elections in December 2001. They, therefore, urged the authorities to implement strictly the fiscal policies agreed under the program. Directors also noted the considerable shortfall in donor budget support. Under these circumstances, timely disbursement by donors of pledged assistance will be important, and Zambia, for its part, must help make this possible, including by meeting all conditionality. This would help to avoid destabilizing the macroeconomic situation and compressing social sector spending. Directors took serious note of the potential and imminent threat of the regional drought on Zambia's economic prospects in the period ahead, which will require assistance from the international community and needs to be kept under close review.

Looking ahead, Directors expressed concern about Zambia's economic and financial prospects following the announcement by Anglo-American plc that it would discontinue funding its mining operations in Zambia. In view of this development, Zambia needs to redouble its efforts to sustain recent gains in macroeconomic stability and growth. They endorsed the authorities' firm commitment not to take over ownership of the mines and to find a financially viable solution consistent with sound government finances. The importance of finding a new strategic investor for the mines was underscored. They also noted that these developments underline the need to diversify the economy. In addition to maintaining macroeconomic stability, this will require accelerating structural reform, investing in productive infrastructure and human capital, and improving governance. In this context, they welcomed the recent re-advertisement inviting bids for an increase in the sale of the Zambia National Commercial Bank shares to 51 percent (a performance criterion under the 2002 program) and urged the authorities to conclude the sale as rapidly as possible, in order to improve financial sector efficiency and protect the public finances. They also emphasized the need to take decisive steps to improve transparency and governance in order to enhance business confidence and create an enabling environment for investment and growth.

Directors stressed the critical importance of strictly adhering to the 2002 budget targets and maintaining an appropriately tight monetary policy to achieve the inflation target. Several Directors noted the increase in the stock of domestic debt and accompanying rise in interest payments, and stressed the importance of ambitious fiscal adjustment in the medium term to avoid a debt trap and to reduce real interest rates. Directors observed with satisfaction the increased allocation of public expenditure towards the social and economic sectors, consistent with Poverty Reduction Strategy Paper (PRSP) priorities. They also stressed the importance of implementing the plans to strengthen expenditure management.

Directors endorsed the program for 2002 and approved augmentation of access under the Poverty Reduction and Growth Facility (PRGF) program by 5 percent of quota. In view of the corrective steps taken by the authorities to date, including adoption of the 2002 budget consistent with program framework, they granted waivers for the nonobservance of the end-September 2001 performance criterion on domestic arrears and the end-December 2001 performance criteria on net domestic assets of the Bank of Zambia, net bank claims on government, gross international reserves, and nonaccumulation of external payments arrears. Consequently, Directors completed the fourth review of the PRGF program. They underscored the need for strong program ownership and improved program monitoring and implementation.

In approving the extension of interim assistance under the enhanced HIPC Initiative, Directors urged the authorities to further strengthen implementation and tracking of expenditure in order to ensure that HIPC debt relief will be used effectively. They welcomed the completion of a full participatory PRSP, including a poverty reduction strategy, which lays the foundation for future concessional assistance from the Fund. They urged the authorities to implement the key PRSP recommendations as well as other conditions for reaching the completion point under the enhanced HIPC Initiative, especially those relating to increasing the amount and improving the quality of social sector expenditure.

The Executive Board took the following decisions:

Poverty Reduction and Growth Facility—Review, Modification, and Waiver of Performance Criteria

1. Zambia has consulted with the Fund in accordance with paragraph 2(f) of the three-year arrangement for Zambia under the Poverty Reduction and Growth Facility (PRGF) (EBS/99/35, Sup. 1, 3/26/99) and paragraph 32 of the letter dated October 15, 2001 from the Minister of Finance and Economic Development of Zambia, in order to review program implementation and reach understandings regarding the conditions for disbursements under the arrangement for the period through October 2002.

2. The letter dated May 9, 2002 from the Minister of Finance and National Planning of Zambia (the "Letter"), together with its Technical Memorandum of Understandings ("the Technical Memorandum") shall be attached to the PRGF arrangement for Zambia, and the letters dated March 10, 1999, June 30, 2000, March 29, 2001 and October 15, 2001 from the Minister of Finance and Economic Development of Zambia, together with their attachments, shall be read as supplemented and modified by the letter dated May 9, 2002 and its attached Technical Memorandum.

3. Accordingly, the PRGF arrangement for Zambia shall be amended as follows:

a. In paragraph 1(a) "SDR 254.45 million" shall be replaced by "SDR 278.90 million";

b. the following shall be added as new paragraphs 1(ccc)(v), (vi) and (vii):

"During the third year of this arrangement:

(v) the ninth disbursement, in an amount equivalent to SDR 41.41 million, will be available on August 15, 2002, at the request of Zambia and subject to paragraph 2 below;

(vi) the tenth disbursement, in an amount equivalent to SDR 41.41 million, will be available on November 15, 2002, at the request of Zambia and subject to paragraph 2 below; and

(vii) the eleventh disbursement, in an amount equivalent to SDR 41.41 million, will be available on February 15, 2003, at the request of Zambia and subject to paragraph 2 below."

c. paragraphs 2(a)(i)-(vii) shall be deleted and replaced with the following:

"(i) the ceiling on the cumulative increase in net domestic assets of the Bank of Zambia, or

(ii) the ceiling on the cumulative increase in net bank claims on government, or

(iii) the floor on gross international reserves of the Bank of Zambia, or

(iv) the ceiling on the stock of short-term debt and new medium- and long-term nonconcessional debt,"

d. the following shall be added as new paragraphs 2(aaaaa), 2(bbbbb), 2(ccccc) and 2(g):

"(aaaaa) Zambia will not request the ninth and tenth disbursements referred to in paragraphs 1(ccc)(v) and (vi) above if the Managing Director of the Trustee finds that the data as of June 30 and September 30, 2002, respectively, indicate that any of the ceilings and floors referred to in paragraphs 2(a)(i) to 2(a)(iv) of this arrangement, as specified in Table 3 of the Letter and in the Technical Memorandum, were not observed. The conditions for the eleventh disbursement referred to in paragraph 1(ccc)(vii) above shall be established during the fifth review of Zambia's program contemplated in paragraph 2(g) below."

"(bbbbb) Zambia will not request the ninth and tenth disbursements referred to in paragraphs 1(ccc)(v) and (vi) above if the Managing Director of the Trustee finds that Zambia has not carried out its intentions with respect to the structural performance criteria specified in Table 4 of the Letter and in the Technical Memorandum."

"(ccccc) Zambia will not request the ninth and tenth disbursements referred to in paragraph 1(ccc)(v) and (vi) above if it has taken any of the actions specified in paragraph 2(c) and (d) above, or if:

(i) the central government of the Bank of Zambia collateralizes or guarantees at any time any loans from ZESCO or ZNOC, as defined in Table 3 of the Letter."

"(g) Zambia will not request the ninth disbursement specified in paragraph 1(ccc)(v) above until the Trustee has determined that the fifth review referred to in paragraph 39 of the Letter has been completed."

4. The Fund decides that:

a. the fourth review contemplated in 2(f) of the arrangement for Zambia under the Poverty Reduction and Growth Facility (PRGF) (EBS/99/35, Sup. 1, 3/26/99) is completed, and

b. Zambia may request the seventh and eighth disbursements referred to in paragraphs 1(ccc)(iii) and (iv) of the arrangement notwithstanding the nonobservance of:

(i) the end-September 2001 quantitative performance criterion on the outstanding stock of domestic arrears of the government, specified in paragraph 2(a)(iv) of the arrangement;

(ii) the end- December 2001 quantitative performance criteria on (a) the increase in the net domestic assets of the Central Bank of Zambia; (b) the increase on net bank claims on the government; and (c) gross international reserves of the Bank of Zambia, specified in paragraphs 2(a)(i), (ii) and (v) of the arrangement; and

(iii) the continuous performance criterion on non-accumulation of external payments arrears, as specified in paragraph 2(c)(i) of the arrangement, on the condition that the information provided by Zambia on the observance of these performance criteria is accurate. (EBS/02/81, 5/10/02)

Decision No. 12752-(02/53), adopted
May 29, 2002

Enhanced Initiative for Heavily Indebted Poor Countries—Additional Interim Assistance

The Fund as Trustee (the "Trustee) of the Trust for Special PRGF Operations for the Heavily Indebted Poor Countries and Interim PRGF Subsidy Operations (the "Trust") decides:

(a) that satisfactory assurances regarding the exceptional assistance to be provided under the enhanced HIPC Initiative by Zambia's other creditors continue to be in place, and

(b) that the Trustee shall disburse to Zambia as additional interim assistance the equivalent of SDR 117.2 million, which shall be made available by the Trustee to Zambia in the form of a grant that shall be paid no later than three business days after the adoption of this decision to the account for the benefit of Zambia established and administered by the Trustee in accordance with Section III, paragraph 5 of the Trust Instrument; the proceeds of the grant shall be used by the Trustee to meet Zambia's debt service payments on its existing debt to the Fund as they fall due, in accordance with the following schedule: 69.8 percent of each repayment obligation falling between June and December 2002. (EBS/02/81, 5/10/02)

Decision No. 12753-(02/53), adopted
May 29, 2002

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/02/52 (5/24/02) and EBM/02/53 (5/29/02).

4. KINGDOM OF BAHRAIN, ISLAMIC REPUBLIC OF MAURITANIA, MAURITIUS, ST. KITTS AND NEVIS, AND REPUBLIC OF YEMEN—ARTICLE IV CONSULTATIONS—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 St. Kitts and Nevis, Kingdom of Bahrain, Yemen, Islamic Republic of Mauritania, and Mauritius, shall be until the dates indicated in EBD/02/79 for such countries." (EBD/02/79, 5/20/02)

Decision No. 12754-(02/53), adopted
May 28, 2002

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAM/02/73 (5/23/02) and EBAM/02/74 (5/28/02) is approved.

APPROVAL: August 27, 2002

SHAILENDRA J. ANJARIA
Secretary