October 29, 2003
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 03/80

10:00 a.m., August 22, 2003

Contents

Executive Board Attendance

H. Köhler, Chairman
A. Carstens, Acting Chair

Executive Directors	Alternate Executive Directors
S. Al-Turki	A. Alazzaz
	A. Al Nassar, Temporary
I. Bennett	C. O'Loghlin
	D. Lewis-Bynoe, Temporary
	F. Vermaeten, Temporary
K. Bischofberger	C. Harzer, Temporary
	B. Reichenstein, Temporary
	S. Wolff-Hamacher, Temporary
M. Callaghan	M. Reddell
	W. Cho, Temporary
	C. Amador, Temporary
	S. Boitreaud
	P. Gitton, Temporary
	M. Robert, Temporary
	O. Basdevant, Temporary
S. Indrawati	I. Alowi
	A. Rogers, Temporary
V. Egilsson	B. Andersen
	J. Zubkova, Temporary
N. Jacklin	N. Epstein, Temporary
W. Kiekens	J. Jonas, Temporary
	M. Marques, Temporary
	J. Sipko, Temporary
G. Le Fort	A. Zoccali
	D. Vogel, Temporary
	D. Ayala, Temporary
A. Mirakhor	M. Daïri
	A. Monajemi, Temporary
	M. Barootchi, Temporary
A. Mozhin	Y. Lissovolik, Temporary
	I. Zakharchenkov, Temporary
	L. Rutayisire
	E. Menye, Temporary
	T. Nguema-Affane, Temporary
	M. SidiBouna, Temporary
L. Martí	M. Beauregard
	R. Villavicencio, Temporary
	R. Calderón-Colín, Temporary
	H. Vittas
	J. Santos, Temporary
	A. Lanza, Temporary
	D. Lombardi, Temporary
M. Portugal	C. Cobos, Temporary
	V. de los Santos, Temporary
Y. Reddy	V. Bhaskar, Temporary
	D. Prasad, Temporary
	M. Brooke
	N. Joicey, Temporary
	A. Stuart, Temporary

	J. Droop, Temporary
A.S. Shaalan	O. Kanaan
	S. Bakhache, Temporary
	G. Shbikat, Temporary
	K. Nauphal, Temporary
I. Usman	P. Ngumbullu
	A. Atoloye, Temporary
	A. Muganda, Temporary
X. Wang	H. Ge
	P. Sun, Temporary
	J. Yu, Temporary
	Y. Yakusha
	H. Litman, Temporary
	M. Abbing, Temporary
	N. Gigineishvili, Temporary
K. Yagi	M. Kitahara
	T. Miyoshi, Temporary
	S. Naka, Temporary
	T. Sekine, Temporary
	W. Szczuka
	T. Skurzewski, Temporary
	S. Vafaev, Temporary

B. Esdar, Acting Secretary; S. Leite, Acting Secretary; A. Linde, Acting Secretary
Z.R. Ahmed, Assistant; S. Maxwell, Assistant; H. Mooney, Assistant; M. Pedroni, Assistant;
W. Rahman-Garrett, Assistant

Also Present

IBRD: A. Ahsan, Senior Country; D. Aykut, Economist; D. Bateman, Country Program Coordinator; J. Verbeek, Senior Country Economist; H. Zaman, Senior Economist. ECB: J. Wijnholds, R. Ritter. African Department: M. Nowak. Asia and Pacific Department: D. Burton, Director; S. Dunaway, S. Kalra, C. Kramer, S. Mitra, H. Shishido, S. Yelten. European I Department: M. Deppler, Director; A. Leipold, Deputy Director; Y. Bal Gunduz, V. Cerra, J. Escolano, K. Krajnyak, M. Lutz, M. Moreno-Badia, M. Sommer, R. van Elkan. External Relations Department: T. Dawson, Director; J. Hayden, C. Lotze, L. Mboto Fouda. Finance Dpartment: Z. Zhan. International Capital Markets Department: G. Haeusler, Director; H. Tran, Deputy Director; W. Alexander, P. Dattels, M. Edmonds, T. Groome, M. Krygier, J. Odenius, K. Ohashi, L. Pedersen, J. Roldos, C. Schnure, R. Thorne. Legal Department: Y. Liu, M. Milford, R. Mundkur. Monetary and Financial Systems Department: G. Casselle, K. Chenard, G. De Nicolo, P. Kupiec, T. Olafsson, K. Tintchev, S. Wajid. Middle Eastern Department: V. Kramarenko, M. Zavadjil. Policy Development and Review Department: M. Fetherston, M. Fisher, J.J. Hallaert, K. Hviding, R. Kincaid, K. Nakamura, M. Schulze-Ghattas, S. Seshadri. Research Department: T. Callen, L. Kodres, J. Ostry. Secretary's Department: P. Cirillo, M. Da Costa, M. Miller. Western Hemisphere Department: P. de Masi, A.M. Jul, A. Kose. Advisors to Executive Directors: I. Ábel, A. Baukol, G. Campos, D. Farelius, A. Ismael, K. Kanagasabapathy, M. Melhem, J. Milton, T. Moser, T. Ross, S. Rouai, C. Sia, X. Zhang. Assistants to Executive Directors: L. Cao, C. De Silva, H. Fabig, G. Francis, B. Gulbrandsen, C. Gust, R. Karki, S. Maherzi, M. Martinez, M. Nikitin, R. N'Sonde, L. Rizzotti, J. Salleh, A. Segura, T. Stucka, S. Vtyurina, A. Wong, Y. Wu.

1. EXECUTIVE DIRECTOR

Length: 2 minutes

The Executive Board welcomed Mr. Meissner as Alternate Executive Director for Germany.

2. GLOBAL FINANCIAL STABILITY REPORT

Documents: Global Financial Stability Report (SM/03/289, 8/11/03)

Staff: Häusler and Tran, ICM

Length: 2 hours, 40 minutes

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

Key Points

- Some favorable developments and better performance of the global financial system seem to be relieving risk pressures in a still uncertain environment.

- The recent increase in long-term bond yields in the United States may indicate improving expectations towards recovery. If sustained, the resulting portfolio reshufflings might end up drying up resources from housing finance, thus weakening a main support to domestic demand.

- Balance sheets of the corporate sector in major markets have continued the consolidation trend, but improvements in actual earnings need to support the enhanced expectations.

- Several sources of vulnerability prevail in advanced markets, including the financial health of the Freddie Mac and Fannie Mae companies, the insurance sector balance sheets, and the underfunding of pension funds.

- Cross-country correlations in equity and bond returns have sharply increased for developed economies, a signal of increased international integration.

- Private capital flows have been the main source of external financing for emerging markets; however, these countries have become net capital exporters since 1999. The retrenchment of inflows has included FDI, especially in Latin America, questioning the preconception that an adequate composition of foreign flows can hedge countries against sudden stops.

- The "boom-bust-cycle" in foreign capital flows to emerging markets is a consolidated reality, and the business strategy of foreign investors indicates that more of the stop-go pattern is to be expected.

- Emerging countries are devoting significant efforts to self-insure against this difficult environment, including through controlling domestic "pull factors" governing the volatility of capital inflows. Unfortunately, not much action is been taken against external "push factors," which seem to be central in explaining sudden stops.

We thank the staff for a thorough and candid report on the performance of the global financial system, signaling favorable developments in recent months amid a still uncertain global environment. We welcome the innovations introduced, but we continue to wonder whether the current format and timing allow the *GFSR* to fully comply with its goal of serving as a tool for multilateral surveillance by anticipating potentially disruptive events in financial markets, rather than describing developments. We consider that a GFSR discussion immediately ahead of the World Economic Outlook/World Economic and Market Developments (WEO/WEMD) discussion might imply a partition of the Board's attention and resources between these two fundamental blocks of analysis. In this sense, we wonder if a better approach would be to include the main financial developments as part of the WEO/WEMD, with the more structural elements of risk assessment in a clearly separate and more distant discussion. This approach would enable putting the GFSR in perspective, leading to a more efficient and informed evaluation by the Board.

Global Financial Market Developments

Global financial markets performance has strengthened in the first half of 2003, and notwithstanding continued sluggish global growth, investor sentiment in general has picked up, anticipating and giving some support to a recovery of the real economy. Nevertheless, there are many risks to the outlook, and the still weak improvement of financial indicators may very well be reversed. On the positive side, household and corporate balance sheets have improved while adjusting to better cope with the still uncertain macroeconomic developments. Accommodative monetary policies by the major central banks have allowed interest rates to reach postwar lows, supporting the balance sheet adjustment and diminishing fears of global deflationary pressures. Risk aversion has receded considerably, allowing investors to partially revert the abrupt flight-to-quality behavior that characterized much of the past two years. Finally, the realignment of currencies that has already taken place has reduced the likelihood of future disorderly adjustments of exchange rates.

In advanced economies, household balance sheets have strengthened, thanks to the continuing gains in real estate property values. The historically low interest rates have allowed households to refinance liabilities, thus reducing the debt service burden implied by high debt levels, especially in the

United States. Liquid assets in the form of deposits have also markedly increased over the past two years, allowing them to withstand, in better footing, any unexpected adverse developments. Moreover, the increased mortgage-related indebtedness has mostly been undertaken in fixed rates, thus enabling households to transfer the interest rate risk to investors. However, the recent increase in the steepness of the yield curve will dampen the households' mortgage refinancing spree, eliminating this source of additional aggregate demand, while risks of a real estate price correction have been intensified. In addition to higher mortgage interest rates that reduce the present value of housing services, rental prices have fallen, resulting in "price-to-earnings" ratios in real estate assets that may prove to be unsustainable.

Corporate balance sheets have shown encouraging signs of recovery. Expected profits and liquidity are improving, in the midst of already advanced restructuring processes that include cost-cutting measures and retrenched capital spending in order to control excessive debt accumulation and avoid even further buildup of excess capacity. Perhaps more telling is the adjustment in price-to-earnings ratios of stocks, which albeit high, have declined to more sustainable levels in the major developed economies, thus reducing the likelihood of new sudden adjustments. Moreover, resources are starting to flow once again into the equity market, reflecting a decline in the degree of agents' risk aversion and a recovery in the confidence on the corporate sector, following the corporate governance scandals that have led to improved surveillance and transparency. Nevertheless, we agree with the staff that disappointing corporate earnings failing to validate these expectations constitute a major risk to the outlook. Moreover, only as long as confidence is strengthened, investment, the missing piece to sustained recovery, will rebound significantly.

The rapid growth of the Fannie Mae and Freddie Mac companies in the United States, fostered by the historically low interest rates, has resulted in significant vulnerabilities. Given the size of these institutions, an apparent lack of an adequate capital base, coupled with dynamic hedging strategies, might end up generating negative externalities to the market by amplifying adverse movements in interest rates and securities prices. Defined-benefit pension systems are another worldwide source of concern, given the accentuating underfunding problems. In the United States, the United Kingdom, and the Netherlands, corporate pension plans have suffered from the equity price bubble burst, as well as from the sharp decline in interest rates that triggers an increase in the present value of pension obligations. Elsewhere, pay-as-you-go systems face even worse sustainability problems due mainly, but not exclusively, to demographic trends. In this regard, recent efforts by many governments such as those in France and Germany, to deal with the issue, are encouraging but far from being sufficient. As to the health of the banking sector in developed countries, indicators point towards a recovery in most cases, including in the United States, and even in Japan. German institutions, however, remain under considerable stress. The insurance sector continues to be troubled by negative spread, while the question still lingers on whether their risk management departments are prepared to deal with the increased sophistication of derivatives securities under stressed scenarios.

An issue of special relevance for emerging markets is the uncertainty with capital flows now that the long end of the yield curve is showing growing returns. Preliminary evidence suggests that investors, whose quest for yield triggered an increased demand for emerging market bonds after the pre-electoral uncertainty in Brazil, are now looking back towards mature equity markets as well as long-term bond markets. This potential reversal would add up, once again, to the volatility of financial conditions, and may add further strain to the recovery of emerging economies recently affected by financial difficulties. Moreover, given the increased cross-correlations in country returns, portfolio rebalancing may affect the whole asset class.

Financial Asset Price Volatility

We welcome the staff's analysis of the relationship between market volatility and financial instability, when triggered by factors within the financial system, as opposed to those that result as a consequence of macroeconomic imbalances. Even though the two phenomena are often linked, market volatility per se is not undesirable since it allows for asset price adjustments in efficient markets as new information arrives, unless it becomes excessive for the financial system's built-in resiliency. On the other hand, the reverse causation, from macroeconomic instability to volatility, is almost automatic. The paper also documents a significant correlation between unusually high equity market volatility and recessions, especially in the United States, falling short of establishing a direction of causality. In our view, the fact that extreme market volatility and significant financial instability did not lead to a recession points to a dominant causality going from recessions to market volatility. Recessions, in this context, could be interpreted as an environmental uncertainty that conditions developments in the financial markets. Comments from the staff would be appreciated.

While the paper finds strong evidence of international integration among markets, both in equity and bonds, paradoxically, within countries correlations between bond and equity returns have declined. The latter may be explained by a flight-to-quality response, which could lead to a substitution between bonds and equity in any given economy. The same pattern could also take place in other countries, maybe due to underlying global factors, leading to higher same-class international correlations, accompanied by negative bond-equity intra-country correlations. In fact, such correlations have been steadily declining since the early nineties, and have been mostly negative since 1998. Such a persistent downward trend deserves further attention, and perhaps the staff could provide some insights as to the underlying causes. The evidence indicates that integration seems to be heterogeneous in the sense that cross-country equity market correlations are much larger during recessions than during expansions. Thus, the transmission channels work better for transferring bad rather that good news.

Concerning ways to limit the negative effects of excessive volatility, we agree with the staff on the broad recommendations provided: adequate macro policies, especially monetary policy aimed at providing sufficient liquidity; strengthening risk management, in particular monitoring leverage and hedging strategies; enhancing transparency and aligning incentive structures to avoid investor behavior that goes against market stability; and striking a balance between market discipline and regulation that does not hamper innovation.

Volatility of Private Capital Flows to Emerging Markets

Since 1990, private capital flows have become the main source of external financing for emerging markets reflecting the opening of capital accounts, as part of a process of integration to international markets and the globalizing trend. In many cases, the decision that led to such an opening was conceived as part of a process to enhance the efficiency of such economies. But what was not anticipated is the major retrenchment that has led emerging markets to become net capital exporters since 1999, the western hemisphere being the only emerging markets region that still runs current account deficits on a consistent basis, albeit at much moderate levels than in past years.

The fact that capital flow volatility in the nineties was relatively high but did not reach historical peaks, more than indicating that we should not be worried since we are living through "normal times," constitutes a strong signal that we confront a deeply-rooted problem for developing countries: their dependence on historically unreliable and extremely volatile foreign capital inflows to implement their development strategies. As time goes by, even with refinements in international capital markets, their very nature indicates that very little has changed in this respect. In the last *GFSR* the staff recognized a "feast or famine" dynamic in foreign capital flows to emerging markets, particularly bonds. Now they refer to such a phenomenon as "boom-bust-cycles" of low frequency. Regardless of the label, emerging countries are subject to an on-off access pattern to capital markets that, as we stated in our preliminary statement on this subject last March, responds to some extent to insufficient investor discrimination on the performance of individual emerging market economies. However, regardless of the differing degrees of macroeconomic stability and resilience to shocks, all emerging economies are periodically subject to external bouts of risk aversion, which could potentially endanger their stability, policy implementation, and financing plans. More importantly, external "push factors" appears to be key: of the twenty-one identified events of market closures since 1994, most of them were linked to events in developed markets rather that in emerging markets.

Also, the so-called stable and resilient component of foreign inflows, foreign direct investment (FDI), has shown, as of late, that indeed it may as well suffer considerable swings and sudden stops. The drop in FDI has been concentrated in Latin America, where it has consistently declined since 2000. While the role that the Argentine crisis has played in it must be recognized, it is also undeniable that countries running sound macroeconomic policies have had to pay the bill as well. The developments of the past two years call to question the commonly held belief that the composition of the flows matter, and that countries should seek those components previously perceived to be more stable, as a strategy to hedge against sudden stops. Moreover, net capital flows to emerging markets have declined significantly from their peak in 1996, prior to the unwinding of the sequence of international crises. In the case of Latin America, we see a consistent downward trend since 1998, which has virtually driven them to zero in 2002.

On the diagnosis of the factors explaining the boom-bust pattern of capital flows and their volatility, the staff does a good job in qualitatively describing them, including some old usual suspects, which we have discussed on previous occasions (crises and contagion, privatization processes halts, FDI pattern shifts to services). Nevertheless, we consider urgent a deeper analysis of the subject. The staff mentions that capital account liberalization and deregulation efforts in emerging countries were closely associated with the surge in capital flows, i.e., the boom cycle. Since then, however, liberalization efforts have continued, or the policies have not been reversed. Thus, economies are at least as open as during the boom cycles. Therefore, the factors explaining the retrenchment lie elsewhere. The likely suspects are among the push factors that respond to supply conditions of external financing.

It is evident that international capital markets have changed significantly, thus we consider this diagnose extremely valuable. In a little more than a decade, international commercial banks have gone from being the almost unique lenders to emerging markets, with a 95 percent share, to being marginal players, with a share of approximately 5 percent. The investor base, on the other hand, has changed considerably as of late. While the increasing role of crossover investors is welcome as a means of amplifying the investor base, it certainly adds to the already high volatility in the flows, as they tend to gradually replace dedicated investors. All in all, the changing business strategy of the foreign investors, as well as their profiles, indicate unambiguously, in our opinion, that more, rather than less, boom-bust cycles are to be expected.

In emerging countries in general, significant efforts are being devoted to adapting to the changing environment, and to increase their appeal to foreign investors, as a process of self-insurance. Sound macroeconomic policies; better policy coordination; increased flexibility of exchange rate arrangements compatible with the increasing openness of the economies; enhanced regulation and supervision of financial systems; implementation of structural reforms including the second-generation type in many cases; improved liability management and innovation; new debt instruments; and development of local securities and derivative markets are just some of the lines along which policymakers in emerging economies have been working over the past years. Still, sometimes it seems as if all of us were searching the same elusive foreign resources. Could the problem not be related to the complete absence of policies and actions directed at smoothing out push factors and to rein-in the volatility of the "supply" of external financing? The staff's work on the subject could prove to be extremely productive.

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

Are Financial Markets Anticipating Recovery?

Market sentiment seems to be improving with long-term interest rates expected to pick up further as private sector balance sheets improve and are setting the basis for fully exploiting the recovery. Risks of disappointed expectations remain high, however, as the recovery has been delayed several times already and further delays could undermine profits.

An aspect on which the Report does not elaborate is the impact of the U.S. fiscal stance on the international financial markets. First, it is worth asking whether the recent firming of bond yields may reflect in part heightened concerns about medium-term fiscal sustainability, rather than improved short-term macroeconomic prospects. Second, there is also the related question of whether and to what extent the deterioration of the U.S. fiscal position risks to affect market sentiment in the future. Staff comments would be welcome.

The Dollar is Stabilizing. Are We Returning to a Previous Pattern?

While the euro continues to take on most of the adjustment, the dollar is stabilizing. This reflects increasing market perception that growth in the United States will be stronger than in other advanced areas. In itself, this is a welcome sign but it also implies that the dollar exchange rate determination pattern is reverting to the one prevailing in the late 90's when growth differentials rather than interest rate differentials were driving the value of the dollar. This contrasts to what was a common belief until recently according to which the value of the dollar was driven by interest rate differentials as capital inflows in the United States were shifting into bonds. Does this development also mean that we should be expecting the composition of the financing of the U.S. current account to shift back to equities?

Investors Are Not Really Discriminating Among Emerging Markets. Whose Fault Is It?

Lending to emerging markets has kept up in the first part of the year as investors have increased their risk appetite while investment opportunities in mature economies remain subdued. Sentiment has changed recently, however, raising concerns for the consequences of possible higher interest rates as growth prospects in the United States and other advanced economies improve.

This suggests that while markets are learning to diversify, most of the capital flows to emerging markets are only modestly correlated to good fundamentals. Main exceptions in Latin America are Mexico and Chile. But this is hardly new. What this behavior suggests is that it takes several years of continued strong policy performance for emerging markets to acquire a reputation and credibility which could offset general market sentiment in bad times. Is this because policy implementation remains weak or is it because market participants fail to notice improvements?

Emerging Market Issues

Developments in Brazil remain key for the entire region. This reflects the persistence of political contagion, which should also be seen as a positive development to the extent that policy implementation remains strong.

Foreign direct investment (FDI) inflows to emerging markets continue to weaken also given the declining role of privatization in attracting them. Emphasis on policy action should shift towards growth promoting environments, institutions and policies as well as the development of new service sector related opportunities

In Turkey investors seem to disregard weak program implementation. This reflects short-term perspectives by markets. They are not interested in fundamentals?

Chapter IV provides an in-depth analysis of changes in emerging markets market behavior. One point that can be stressed is that reserve accumulation as an insurance against crisis (see page 154) should not be seen as a substitute for stronger fundamentals and stronger transparency. Regarding the latter, it is important to highlight that recent research has found that spreads are correlated with the transparency policies implemented by emerging markets (see IMF WP/03/132). In particular, greater efforts in providing the public and markets with relevant and timely information on the country’s economic situation are associated with lower borrowing costs for the same country.

Convergence in Central Europe

Annex II discusses weak convergence in Central Europe. It suggests that interest rate convergence is still weak as CE interest rates are weakly correlated to the German Bund (taken as a sign of convergence in previous episodes). In this regard, we have the following comments. First, we note that -- though staff rightly point to fiscal policy concerns and to the need for fiscal consolidation -- fiscal policy variables are not included in the regression analysis. Why? Then, staff seem to suggest that markets are disappointed with the fact that inflation targeting is subordinated to exchange rate considerations in some cases. Obsession with inflation targeting?

All in all, it is important to highlight that delayed EMU entry should allow those countries to build up a more solid fiscal position while avoiding entry at unsustainable exchange rate levels.

Mr. Bennett submitted the following statement:

Key Points

- The overall quality of the report continues to improve. The annex on regulatory and supervisory challenges and initiatives is welcome, and the special topic chapters are very interesting and timely.

- The risks appear to be more balanced now than at the time of the last report. It would be useful in future reports to include a short text box or section in the overview which compares the current risks with those identified at the time of the last report (comparable to the *World Economic Outlook*).

- The risk of a further increase in bond yields could be of greater concern for financial stability in our view than disappointing corporate earnings. Given that hedging activity by Fannie Mae/Freddie Mac already appears to have accentuated rising long-term interest rates, we agree with the staff that continued monitoring is needed. In light of the government-sponsored enterprises' (GSEs') implications for financial stability, it would be worthwhile to devote more attention to them in future issues of the report.

- More attention to credit risk would also be welcome as would an examination of the reasons for and implications of emerging markets as a group becoming net exporters of capital.

The *GFSR* continues to evolve and improve in its semi-annual format. The staff deserves to be commended for its efforts to incorporate the suggestions made by Directors in previous meetings. In particular, I noted that in response to calls to improve co-ordination and co-operation across departments, the report includes an annex written by the Monetary and Financial Systems Department (MFD) on regulatory and supervisory challenges and initiatives. I found the annex to be quite useful and hope to see more cross-departmental inputs of this type in the future. The chapters on financial asset price volatility and volatility of private capital flows to emerging markets were also very interesting and timely.

Risks Now More Balanced

The high level of economic and geopolitical uncertainty that characterized the last report has abated considerably. Further progress has been made on strengthening corporate and household balance sheets, equity markets have recovered smartly from their spring trough, and credit spreads have narrowed sharply (and have not widened appreciably in recent weeks despite the sharp rise in long-term interest rates). The upshot of these developments is that the risks are much more balanced than they were six months ago when downside risks dominated. I concur with the staff's emphasis on the overall resilience of the global financial system in the face of a remarkable sequence of adverse shocks, noting that the performance of the financial system to successfully absorb shocks should not be interpreted as evidence of its invulnerability; indeed, its capacity to absorb further shocks has likely been diminished.

However, it would have been useful to include an update on major risks/issues in the overview which assesses the current risks compared to those identified in the last report (comparable to the *WEO*). This information is provided in the report, but not until Chapter II, Section B. Having a visible comparison of risks in the overview would help to ensure continuity for readers from one report to the next.

Since I am in broad agreement with the staff's assessments and recommendations, I will only focus on two issues with financial stability implications: Fannie Mae/Freddie Mac and credit risk, as well as a request for further work on the topic of emerging markets becoming net exporters of capital since 1999.

Rise in Long Bond Rates and Fannie Mae/Freddie Mac

It is not clear whether the recent increase in rates seen in 10-year U.S. Treasuries (as well as long bond rates in other mature markets) is mainly the result of demand factors, supply factors, or technical factors. The most likely answer is that all of these have contributed, but it seems difficult to disentangle the quantitative effects from each source. As noted in the report, the two major risks identified relate to bond yields and corporate profitability, with the corporate profitability risk characterized as the more serious of the two for financial stability.

In our view, the former risk is of greater concern for financial stability. The potential consequences of problems at Fannie Mae and Freddie Mac resulting from sharp increases in long-term interest rates could have significant and prolonged negative implications in the United States and abroad. In the event of a crisis, contagion is probable—Fannie Mae and Freddie Mac share the same line of business and each hold large amounts of the other institution's securities. In addition, their financial difficulties could lead to bank failures (FDIC-insured commercial banks held $395 billion in mortgage-backed pass-throughs and $184 billion in collateralized obligations and Remics (Real Estate Mortgage Investment Conduits) in 2003Q1), and significant problems in the financial derivative market (which is highly concentrated). We agree with the staff that continued monitoring of the developments in the mortgage-backed securities market is necessary. It may be worth examining in future issues of the *GFSR* whether the current core capital-to-asset ratios of the GSEs (at around 3.2 percent) is sufficiently high, and whether the contractual mortgage prepayment provisions, which confer an option on households, are appropriately (implicitly) priced. Given the size of the mortgage-backed securities (MBS) market, the hedging required to manage these prepayment risks can have substantial impact on other markets, even the large and liquid market for U.S. Treasuries.

More Examination of Credit Risk

Looking forward, it would also be useful in future editions of the *GFSR* to examine not only market risk and financial market developments, but also underlying credit risk and conditions. Banks and similar institutions are among the most potentially vulnerable of financial system participants, owing to the inherent leverage of their operations and close linkages with other parts of the financial system via credit and counterparty exposures, and through the clearing and settlement system. The risk that movements or volatility in asset prices will jeopardize financial system stability through its impact on banks, likely depends more on the situation prevailing at individual institutions, particularly the adequacy of internal controls, than on the magnitude of the asset price movements in themselves.

Capital Exports from Developing Countries

I noted with interest the statement in the report that emerging markets, as a group, have become net exporters of capital since 1999. However, there was no examination of the genesis of this phenomenon. It would be useful in future issues of the report to devote a chapter to examining the reasons behind this change in capital flows and how the staff interprets the implications of the change.

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

General Remarks

We thank staff for another high-quality report on Global Financial Stability issues. The report follows along the lines of previous reports, particularly the latest one, with comprehensive and systematic analysis of key developments and risks facing global financial stability. We welcome the way the report clearly discusses the major risk factors to the financial system, and makes policy recommendations based on the analysis.

The increased focus on financial stability issues in a more medium-term context is appropriate. In particular, we appreciate the analysis of the relationship between market volatility and financial stability. While price volatility is a necessary and generally desirable feature of markets, it is important to ensure that volatility is not amplified to a point where it triggers financial instability. Analyses that can provide lessons from the increased volatility in equity markets and the private capital flows to emerging markets in recent years will be valuable to both market participants and policymakers.

Overall, we feel that the report presents a balanced view of risks and vulnerabilities, and we broadly agree with the analysis and policy conclusions.

Developments and Risks in Mature Markets

We are pleased to note that financial markets have remained remarkably resilient in spite of the strong headwinds described in the report. The favorable performance of financial markets this year has made it possible to address some of the weaknesses identified in the aftermath of the bursting equity price bubble. Corporations in mature markets have made progress in their efforts to cut costs and consolidate their financial positions, and household balance sheets have generally improved, although households in the United States have become more sensitive to changes in housing prices. Banks' balance sheets have generally improved, while the situation for institutional investors seems to have stabilized. These improvements have been facilitated by significant reductions of policy interest rates in the major financial centers, and have increased the prospects for a stronger recovery in the real economy. The risks to financial stability that are created by the government-sponsored enterprises (GSEs) in the U.S. mortgage market are of some concern, particularly in light of the recent uncovering of governance weaknesses in Freddie Mac. A careful monitoring of these institutions is warranted. We share the interest of Mr. Padoan and Mr. Lombardi on the impact of the U.S. fiscal stance on financial markets.

We welcome the focus on regulatory and supervisory challenges coming from the insurance industry in view of its increased importance for financial stability. The rebound in equity markets in recent months has eased the pressure somewhat on insurance companies and other institutional investors. The improvements in balance sheets will be limited, however, and the low interest rate environment continues to put pressure on their financial conditions, making it necessary to change the legislation on guaranteed returns on insurance policies in many countries. While this alleviates the situation for the insurance companies in the short run, we agree with staff that such changes primarily can be seen as forms of forbearance which do not address the underlying vulnerabilities.

The interesting analysis in Annex I also discusses other challenges posed by the increased importance of insurance companies for systemic stability. In particular, we agree that supervisory and regulatory bodies, preferably on an international level through the International Association of Insurance Supervisors (IAIS) and the International Accounting Standards Board (IASB), need to develop better risk management practices, better disclosure and transparency practices of financial market activities, and other prudential requirements that address the increased systemic importance of the insurance industry. The organization and staffing of supervisory authorities should be adjusted accordingly.

The financial sector in many countries is developing towards increasingly large units crossing traditional sector dividers and national borders. These large and complex institutions can pose new risks, and supervisory and regulatory regimes need to be tailored to the specific nature of the risks faced by these institutions and to the potential macroeconomic consequences that problems at such firms might have. As is emphasized in the *GFSR*, this development underlines the need for increased cross-border supervisory co-operation and information exchange. The tendency towards larger units and increased cross-border activities within the financial sector is seen in many EU countries, including the Nordic region. This has already been reflected in formalized supervisory arrangements between the Nordic supervisory authorities for some years. In June 2003, also the Nordic central banks signed an agreement on the "Management of a financial crisis in banks with cross border establishments—Memorandum of Understanding (MoU) between the central banks of Denmark, Finland, Iceland, Norway and Sweden." This was a response to the recognition that the increasing prevalence of cross-border banks and bank establishments entails risks of a financial crisis in a Nordic banking group having repercussions for financial stability in more than one of these countries.

We also welcome the discussion of the underfunding of defined-benefit corporate pension plans in some countries, particularly the United States, United Kingdom, and the Netherlands. While current regulation has shielded the pension plans from short-term asset price movements, they have also reduced the transparency about firms' underlying financial position. We agree with staff that reforms of pension fund accounting and regulation to increase transparency and improve risk controls are necessary on a wide scale internationally.

Developments and Risks in Emerging Markets

Investor sentiment towards emerging markets has improved markedly and macroeconomic fundamentals have improved across many emerging countries, thereby giving them regained access to external capital markets. Staff emphasize, however, that there are wide inter- and intra-regional variations in the strength of emerging market financial systems, particularly the banking sector, that make the financial systems in several countries vulnerable to adverse macroeconomic developments or changes in market sentiment.

We concur with staff that it is important to avoid complacency within the improved external financing environment. High public debts and high deficits are a cause for concern in many emerging market economies. In this regard, we welcome staff's increased focus on debt dynamics and the development of more comprehensive debt sustainability analysis. Deep-seated structural problems also persist in several countries, thereby adding to the vulnerability. We fully agree with staff that emerging market countries must take advantage of the recent improvements, and pursue sound macroeconomic policies and structural reforms that will put public finances on a more sound and sustainable footing. The actions taken this year by a number of countries, including Brazil, Mexico, Poland and South Africa, to reduce or restructure part of their debt should serve as an example to other countries.

We welcome the inclusion of Box 2.2 on recent developments in the use of Collective Action Clauses. We were pleased to observe that a clear majority of issues of bonds in the second quarter of 2003 included CACs, and also notice that there is no evidence that the price on these bonds included a yield premium. We also find it interesting that investment bank representatives now seem to regard inclusion of CACs as the "default" in new sovereign issues in New York.

The discussion on convergence in Central Europe is both interesting and highly relevant. The prospects of EU membership have benefited the local currency debt markets in several countries, while at the same time making them more vulnerable to global market forces. The disciplining effects of the EU policy framework have shown up in financial market indicators in many countries. At the same time, the increased scope for financial market volatility underscores the need for a rebalancing of the policy mix through a significant strengthening of the fiscal policy in many of the countries and accelerating their structural reforms.

Financial Asset Price Volatility

The thorough analysis of the links between financial asset price volatility and the potential risks for financial stability provide valuable information on factors that can turn volatility into instability. We notice in particular that the four episodes that are studied suggest that financial authorities, particularly central banks, played a crucial role in restoring calm to the markets. The need for an appropriate balance between market discipline and regulation is also emphasized. We subscribe to the policy measures discussed on pages 106–107, noticing that they reflect measures that also have been pursued by countries in our own constituency in response to banking and asset-related crises in the early 1990s.

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

Since the previous discussion of the Global Financial Stability Report on March 2003, the factors behind rooted uncertainties in the market, such as the aftermath of the bursting of the equity bubble, geopolitical concerns, and a general mistrust in corporate governance, have gradually receded. This decline in uncertainties, together with restoration of financial system stability supported by worldwide unprecedented low interest rates and the recovery of corporate profits through firms' efforts to improve their balance sheets, have revived investors' risk appetite and funds have been redirected toward emerging market economies.

Major financial centers continue to face the challenge of strengthening their market foundations. The authorities should push forward their efforts to strengthen corporate governance, improve regulation and supervision of the financial activities of insurance and re-insurance companies, as well as increase transparency and improve risk controls of pension funds. On the other hand, emerging markets, against the backdrop of an improved market environment, have taken measures to accumulate foreign exchange reserves, strengthen the domestic financial system, and deepen domestic financial markets. Based on past crises, the affected countries have strived to ensure the development of a tolerant and robust economic structure that can weather rapid swings in international capital flows. As a whole, these markets have become net exporters of capital since 1999.

The staff report pointed out potential risks in current markets by utilizing various indicators. At the same time, it also emphasized, from a medium-term viewpoint, the importance of addressing preemptively such crisis-amplifying factors as excessive leverage, dynamic hedging strategies, rigid risk limits, and incentive structure of investors. All of the above makes this report informative.

However, as stated in the preface, the thrust of the report is to provide a regular assessment of global financial markets and to identify potential systemic weaknesses that could lead to crises, thereby contributing to preventing crises before they erupt. When taking this into account, the following points warrant consideration.

First, on the presumption of the current state of the global markets (a sign of revival of risk appetite and high liquidity in developed markets, and progress made in self insurance against crisis in emerging markets), the important points at issue are how risks are distributed at this time, and the effects of a possible future rise in interest rates associated with the economic recovery process and changes in investors' risk appetite on financial and capital markets. In this regard, the report would have benefited from trying to present a quantitative analysis on the current risk distribution profile of the world, as well as from the magnitude and transmission mechanism of the above-mentioned effects. In particular, an analysis on the impact that the potential swing of returning capital flows to emerging markets might have on the corresponding economy that should be strengthened as a result of its self-insuring efforts since the crises occurred, would be regarded as valuable.

Second, in our view, the analysis on price volatility and case studies of past incidents tend to confirm the results of past studies and not provide new groundbreaking results. Rather, by conveying at this juncture the message that what matters is not high volatility, but changes in volatility, might give the unwelcome impression that the staff considers the current state of affairs to be the eve of a crisis. While we appreciate that the report specified various amplifiers during crises and emphasizing the importance of addressing them, an approach that compares current market developments with those during run-up to the past crises might be useful from the viewpoint of crisis prevention. In addition, the price volatility analysis in light of economic cycles and analyses on crises that occurred independent of such cycles does not necessarily blend well. The report might prove more articulate by placing clear links between the two analyses, by placing more emphasis on the price volatility analysis, or by applying the results to an assessment of the current state of market developments.

Third, the report refers to the sheer size, high leverage, and complex hedging of interest rate risk of U.S. mortgage agencies, and emphasizes the possible systemic risks they might pose to future markets. In the last U.S. Article IV consultation discussion at the Board, the staff did flag the importance of closely monitoring the risk management and accounting practices of these agencies, but also stated that officials shrugged off this concern and expressed confidence, which left us with the impression that the emphasis on these possible risks is weaker than what we gather from this report. We would appreciate the staff elaborating on how they communicated with other departments in the process of compiling this report.

Fourth, the report's observation that investors are becoming less discriminating in the wake of low interest rates and high liquidity carries the potential risk of funds shifting abruptly in one direction during a crisis. However, we would like to point out that the quote "While low interest rates are needed to spur activity and investment, investors need to remain discriminating" (p.11) might be erroneously interpreted as if there is a relationship between interest rate policy and investors' judgment.

Finally, in general, both data availability and representation are important in analyzing market developments. Meanwhile, signals from the markets have become increasingly diversified through various new financial products being developed due to technological innovation. Bearing this in mind, we hope that future reports will present a comparative analysis on the effectiveness and limitations of various market indicators, and how to utilize them effectively in line with the thrust of the report.

Mr. Callaghan and Mr. Reddell submitted the following statement:

Key Points

- The report provides a comprehensive overview of recent financial market developments, along with essays on some important topics. However, further thought could be given to the structure and content of the *GFSR*.

- In particular, there would be benefit in more cross-referencing between the *GFSR* and the *World Economic Outlook (WEO)*. It does seem odd to prepare a report on financial market developments with so little reference to exchange rate movements.

- Some of the risks outlined in the report could have benefited from more analysis, along with an assessment of policy options.

- While continued progress is being made in repairing corporate and household balance sheets, we are less sanguine than the report about the improvement in household balance sheets, which relies on continuing rises in house prices.

- The sustainability of corporate earnings growth is open to debate, given that it has largely been driven by cost cutting.

- Reform initiatives underway, particularly improving corporate governance, have a role to play in limiting the potential for future asset price booms and busts.

Structure of the Report

The report provides a comprehensive assessment of recent financial market developments, along with a number of interesting essays on important topics. However, the *GFSR* is still evolving in its structure and content and, as such, we would pose (again) whether it is possible to achieve a closer linkage between the *WEO* and the *GFSR*, including more cross-referencing in terms of the implications of financial market developments on the real economy and policy implications. A striking element of the report is how little attention is paid to exchange rate issues.

This *GFSR* contains some interesting essays, including the annex covering regulatory and supervisory challenges in the insurance sector, and the chapters on financial asset price volatility and the volatility of private capital flows to emerging markets. However, as we have noted in the past, we wonder as to the best strategy in choosing the "selected issues" to be covered in the *GFSR*. Are they chosen on the basis of the most pressing issues confronting policymakers or, alternatively, is the *GFSR* seen more as a vehicle for publishing some interesting research material? By way of an observation, the historical focus and lengthy treatment of some of the material does seem a little misplaced alongside the conjunctional analysis that fills the rest of the report. That said, some of the issues covered are important and we fear that there is a danger that they may get buried in the *GFSR*. Moreover, some of the issues are insufficiently resolved and the material would benefit from further analysis. The cursory treatment of fair value accounting is a case in point.

Risks and Vulnerabilities

The report provides quite an upbeat assessment of the progress made in repairing the damage inflicted on both household and corporate balance sheets by the bursting of the equity price bubble—improvements that have been facilitated by the reduction of policy interest rates to post-war lows in the major financial centers.

It also highlights the changing tone of financial markets. In particular, perceptions that low interest rates will persist for quite some time have underpinned an increased appetite for risk and yield among investors—partially reversing the "flight to quality" capital flows of recent years. Investors have moved into corporate and emerging market bonds compressing credit spreads, and equity markets have also rebounded.

Since benchmark yield curves in the major financial centers had been pushed to quite low levels, some snap back in government bond yields was inevitable once investors sensed some optimism about growth prospects. The key issue is whether the improvement in financial markets is a portend to a strengthening in the real economy, or rather poses increased vulnerabilities and the possibility of a sudden correction, either via a continued rise in bond yields or disappointing corporate earnings. Perhaps the *GFSR* would have served as a more effective complement to the *WEO* if more attention was directed at assessing the factors behind the improvement in financial markets. Furthermore, some of the risks identified in the *GFSR* would probably have benefited from further elaboration, along with an assessment of policy responses. For example, on the surface, the risks that bond yields might rise in the face of stronger growth, creating a transition that "needs to be carefully managed," does not seem to be a convincing argument for policy intervention. In addition, what are the policy instruments that would be available to "ensure an orderly adjustment?" Alternatively, is the concern that interest rates have been held so low for such a long time that any increase will cause a considerable dislocation? Is there a need to educate markets that a more positive growth outlook would see a further adjustment in market interest rates and they should prepare their portfolios accordingly?

While we share the overall assessment that progress is being made towards a more sustainable growth trajectory, although with the concern that key financial prices may be vulnerable to rapid changes in sentiment, we are probably less sanguine about the balance of risks in the household sector. As a result, we feel the report underplays some of the uncertainties attached to future price movements and the implications for household wealth and spending.

Household Sector and the Mortgage Market

While statements such as “household balance sheets in the major countries show few signs of strain” (p. 19) are strictly correct, the risks surrounding higher household indebtedness may warrant greater coverage in the report. Debt-servicing burdens remain at “manageable” levels (in aggregate), but have recently drifted higher in some countries as household debt has risen. Furthermore, higher household gearing (graph 1) means that households are now more sensitive to given increases in interest rates and, more importantly, to an unexpected deterioration in employment conditions.

The observation that household balance sheets are “gradually strengthening” largely reflects the fact that house prices are rising faster than debt. Any correction in the recent rise in house prices in a number of countries could well result in some macro-economic fall-out as wealth effects impinge upon consumption. In addition, considerable uncertainties attach to the likely behavior of highly leveraged borrowers, in the event of a property price correction. If the decline in property prices is associated with an increase in mortgage rates, or a job loss, it is unclear whether the owners, particularly investment property owners, will choose to hang on to their investment by cutting back on other expenditures, or whether they will choose to walk from a property in which they now have negative equity. Owner-occupiers would be less likely to walk away from the ‘family home’ and more likely to make other sacrifices.

The comment on page 19 that “much of the interest rate risk in the housing market at this point would seem to have been passed to investors in the fixed-rate mortgage market” is “U.S.-centric”. In markets where variable-rate mortgages dominate, the household sector would bear the brunt of a sharp rise in interest rates. Nevertheless, the increased use of securitization markets—particularly for residential mortgage-backed securities—is helping to disperse risk more widely.

The report has raised important issues in relation to the activities of the U.S. mortgage market government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. As the report highlights, these institutions are owned by private shareholders and highly leveraged. They have no explicit government guarantee, yet many market participants assume they do, which has lowered their borrowing costs. This perception is reinforced by a line of credit from the US Treasury, exemptions from state and local taxes and other regulatory requirements, presidential appointments to their boards, and the belief that "they are too big to fail." The rating agencies have noted that absent their implicit government guarantee their ratings would be AA instead of AAA. Is this a case of where market perception of risk may be different to the underlying risk and, given their size, a source of systemic risk? The position of the GSEs did not receive much coverage in the U.S. Article IV staff report. However, as the report notes, the very large size of their balance sheets implies that their hedging operations can accentuate sharp market moves and their size and volume raise particular financial stability concerns. The report highlights that the activities of the GSEs pose significant regulatory issues, but there is little indication in the report that these are being addressed. In short, more attention needs to be given to the regulation of GSEs.

Corporate Sector and Equity Markets

The report is quite upbeat about equity market prospects. While there are positive supporting factors, downside risks remain. The commentary on page 43 suggests that expectations of U.S. corporate earnings have stabilized, but Figure 2.17 does not necessarily support that assessment: it shows earnings expectations following a comparable pattern to those in 2002. We suspect that the sustainability of earnings growth is open to debate, given that it has largely been driven so far by cost cutting. Consumption growth—a significant driver of overall growth in recent years—faces obstacles such as the "jobless recovery" and a fall in cash-out refinancing from the U.S. mortgage market (as noted on page 16).

Tax changes have made dividend payments more attractive for U.S. companies and investment funding needs have been low. Nonetheless, there is a risk that companies are playing to investors' recent focus on dividend yields in an environment of low interest rates and uncertainty about non-cash earnings. Over the past couple of years, the aggregate U.S. corporate sector has been paying out more in dividends than it has earned in profits over a period during which debt levels have risen. This leaves open the risk that this pattern may be reversed and may impinge upon the recovery in equity prices.

It perhaps also should be mentioned that there is the same risk to equity markets that has been emphasized for the corporate and emerging market bond markets, namely that reduced investor discrimination in the low interest rate environment has increased the potential for a sharp reversal.

Policy Implications of Recent Developments

The *GFSR* rightly emphasizes the importance of persisting with reforms to strengthen market foundations, particularly improvements in corporate governance. As the report notes, progress on this front will help restore investor confidence—a prerequisite for a stronger recovery in the real economy. However, we think it worth emphasizing that these reform initiatives will do more than simply enhance growth prospects—they also have an important role to play in limiting the potential for future asset price booms and busts—one of the major threats to financial and economic stability.

The lessons learned from the asset booms of the 1980s in many OECD countries, and in many Asian countries in the 1990s, were largely about poor banking practices—connected lending, concentrated risks, etc. In response, the Basel Committee led the way in significantly improving the risk management of banks and the regulatory oversight of banks. Partly reflecting this, banks do not feature prominently in the wash-up from the bursting of the "high-tech" bubble. Instead, a different set of problems have recently been revealed:

- There have been features that have given a very strong incentive for major players to push up asset prices. For example, the use of equity-based remuneration, particularly options, gave management a huge incentive to concentrate on short-term increases in share prices, particularly as they knew that this was demanded by the investment community.

- There have also been many means available to make profits look larger than they really were. The non-expensing of options being the most obvious, but others include the use of special purpose vehicles and off-balance sheet entities, the non-recognition of deficiencies in company-sponsored defined-benefit pension funds, and the bringing forward of revenue recognition.

- Thirdly, there was a failure of the checks and balances in the system to limit the excesses. In particular, the conflicts of interest in the auditing profession and the lack of independence or forcefulness of boards of directors meant that excesses were not detected.

The reforms are now being pursued by the 'conduct-of-business' regulators such as the Securities and Exchange Commission (SEC) in the United States. Some of this work is outlined in the report, and we believe it appropriate for the Fund to emphasize the macroeconomic relevance of these reforms because, as noted above, they will reduce the tendency for asset price booms to occur and/or shorten somewhat their duration.

The *GFSR* has also usefully highlighted examples of financial accelerators from past episodes of high volatility that may be a source of instability and pro-cyclicality. These examples include excessive leverage, dynamic hedging strategies, index tracking, rigid risk limits and structures that promote herding and "short-termism."

One message seems to be that risk management strategies, which might be appropriate for a small market player acting in isolation, may not be appropriate when all firms in the market are employing the same strategy creating a systemic risk. If this is the case, what are the policy messages? To what extent are such features the result of inadequate regulation, either under or over regulation and what are the policy prescriptions? For example, are their alternatives to dynamic hedging strategies and stop-loss selling that allow individual market participants to manage their risk, without creating systemic risk.

Insurance Regulation

As noted previously, the Annex dealing with the regulatory and supervisory challenges facing the insurance sector is particularly welcome. As the report notes, the insurance sector is becoming increasingly important to systemic stability because of three factors: increased investment by insurers in equities; consolidation between banks and insurers; and insurers' role as intermediaries of credit and market risk. A fourth factor might usefully be added. The experience of one of the countries in this constituency has illustrated that the failure of a general insurer could have macroeconomic consequences if there is a high enough concentration in a particular line of underwriting. Consequently, increasing attention needs to be directed towards the regulation of insurers, especially those involved in cross-border activities. As the report notes, while regulators have begun to move their focus from individual institutions to a more systemic view, a stronger policy response is still required. The Fund has a role to play in encouraging this policy response.

Emerging Markets

A major concern is that the improved investment climate for emerging markets may result in a degree of complacency. While such a climate provides a welcome opportunity to pursue reform in a favorable environment, countries that treat it as an opportunity to "catch their breath" risk leaving themselves vulnerable to a change in market sentiment, which would come when investors renew their appetite for equities.

The chapter covering volatility of private capital flows to emerging markets provides a concise overview of the financing challenges facing emerging markets over the past decade, and raises a number of important policy issues. We note in particular the observation that emerging markets have become net exporters of capital since 1999. What is the driver of such capital flows? Traditional theory suggests such countries should be importers of capital due to higher "convergence" growth rates and therefore higher returns. Does this suggest that markets now view developed economies as better investments and, if so, what does this imply for the ability of these economies to finance their growth potential?

The report notes that the experience with the volatility of capital flows during the 1990s has convinced authorities in many emerging markets to adopt measures to reduce their dependence on international borrowing, including increasing their holdings of international reserves. It is surprising that there is not a cross reference to the current *WEO* essay on the increase in international reserves in the East Asian economies. As we noted at the outset, there is still a need for a closer linkage between the *GFSR* and the *WEO*.

On a final point, we note that the report did not cover recent developments to establish an Asian bond market.

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

The *GFSR* continues to demonstrate a very high quality of analysis and represents a further improvement over the past reports. At the same time, it persists to expand and now accounts for over 200 pages. While, obviously, it is the quality and not the quantity that matters in the end, it should be pointed out that the quality of this report does suffer from the somewhat repetitive nature of several sections in the report as well as from the recitation of information widely researched and published previously elsewhere. We continue to believe that a shorter and more focused report would be more beneficial to prospective readers. In addition, it seems that the report, at times, only describes some of the risk generating events rather than anticipates them. It appears that there is room for trying to foresee the potential risks before they are already widely discussed in the press and academia. This should be the ultimate goal of the Fund’s surveillance and the GFSR.

Mature Markets

This time around the staff has done a better job in covering events more extensively in mature markets, other than the United States. However, one cannot escape the fact that some parts of the report still read like an extension of the U.S. Article IV consultation report. While we realize that “all roads lead to Rome” (or, in this case, New York, as the developments in the U.S. financial markets are the driving forces for the rest of the world), we would still encourage the staff to elaborate in more detail on the developments in other mature economies’ markets. This is especially relevant for the readers of the report in the United States, as the information describing the developments in the U.S. financial markets is widely available in this country.

As to the developments themselves, we are apprehensive about a significant jump in the mature markets’ government bond yields in the recent months. The reason for concern is not necessarily the rise in yields (which was not unexpected) but the speed at which this happened. It is somewhat unsettling to learn that in the United States, for example, much of the increase was due to the mixed signals sent by the Federal Reserve regarding inflation expectations. Other reasons for the increase, as stated in the report, were the anticipation by the markets of better prospects for economic growth and greater supply of U.S. government securities. While the strength of the U.S. economic recovery is still rather uncertain, the increase in supply of U.S. Treasuries is more than ensured (due to a significant increase in the U.S. fiscal deficits). This given, is there any way to distinguish better between the reasons that *most likely* led to increases in yields in the United States?

While the prospects for economic recovery may have increased in the United States, this is not necessarily the case for Europe or Japan (despite some recent upbeat news), and given low inflationary prospects, could the upward movements in these sovereigns' bond yields also be due to growing fiscal deficits? Or most of the rise should be attributed to the prospects for the recovery in the economies and equity markets? The staff views would be appreciated.

The corporate earnings in the United States have shown improvements, however, the staff is right to point out that the 2003 earnings have been revised downwards, at least, on two occasions. In Japan and Europe the situation is much more subdued. At the same time, the staff emphasized the point that the price/earnings (P/E) ratios in mature markets are at sustainable levels at present. As we have mentioned at the U.S. Article IV consultation discussion, there are plenty of skeptics regarding this assumption. Much of P/E calculations rely on the expectation of the significantly improved corporate profitability and continued unattractiveness of bond yields, which may not materialize.

Household balance sheets, in the staff view, show few signs of strain. This is good news, especially when supported by the continued buoyancy in the housing market. At the same time, it cannot be overlooked that the household debt levels are at all time high, and while mortgage interest rates are very low, same could be hardly said about the credit card rates. While much has been said about the U.S. housing market, there is a definite room to elaborate in a greater detail about the housing markets in Europe, as, according to the May 2003 survey in the *Economist*, the region harbors quite a few overheated ones.

The special emphasis placed on the analysis of the underlying conditions of the U.S. government sponsored corporations is welcome. Indeed, the impressive size of these corporations and their importance in the mortgage market calls for increased scrutiny of these enterprises. Therefore, we fully share the staff's conclusion that, given their very large exposures to interest, prepayment and credit risks and the need for significant hedging activities, a closer examination of the agencies' capital bases is warranted. The recent corporate governance and accounting problems at Freddie Mac also call for better supervision of the entities.

Banking sector shows signs of improvement in mature markets. Indeed, some of the large international banks, especially the U.S.-based ones, have showed impressive first and second quarter returns at the time of low interest rates and a slow pace of initial public offerings (IPOs), mergers and acquisitions, and corporate borrowing. At the same time, a more in-depth analysis of the situation in Germany and Japan seems to be warranted, given the continuing rather serious problems in these countries' banking sectors.

It is impressive that in the aftermath of Enron and WorldCom there have been no devastating effects on big banks' balance sheets. Apparently, one of the main reasons for such a success in avoiding crises is the continuing securitization of banks' loan portfolios and reinsurance of risks by other market players. While this may be seen as a prudent risk management strategy on behalf of the banks, the question arises regarding the new risk-takers and their ability to handle it adequately. According to August 16 survey in the *Economist,* this risk is being passed on to entities that are less well capitalized and have less expertise in analyzing credit risk. This is a potentially dangerous development, as these entities comprise of pension funds, mutual funds and life-insurance companies. Problems in these companies could lead to socially painful consequences. The fact that financial performance of all of these groups suffered in the past few years further raises concerns. In this light, we welcome the Annex I in the report, which includes the analysis of some of the risks in the insurance sector. The sober conclusion of the analysis suggests that the data on the size of the credit transfer market (CRT) is insufficient and information on the distribution of CRT risks is poor. In addition, the regulatory framework for the CTR and supervisory skills for assessing financial institutions' risk management systems and controls in this area are not sufficiently developed. In light of this conclusion, we suggest that the staff monitor carefully the developments in this area and provide updates in the next *GFSR*s.

Emerging Markets

While the "party" in the emerging bond yields may not be over yet, it is definitely winding down, as the first major consolidation occurred in these markets following sharp yield increases in mature bond markets. We share the staff concerns regarding valuation levels, further rises in the yields and apparently reduced investor discrimination. Emerging market countries' governments need to keep in mind that, while enjoying cheaper credit, they should prepare for the "rainy day" by further improving macroeconomic fundamentals.

In this context, there are serious concerns about the developments of the EU accession counties. These countries enjoy exceptionally low levels of sovereign bond yields not only because of an increased interest of investors in emerging market countries but also because of the EMU entry expectations which are firmly embedded in market prices of securities. At the same time, we fully share the staff's analysis in Annex II, which highlights the deterioration of macroeconomic fundamentals in these countries. Indeed, high and persisting fiscal deficits, riding debt levels and the direction of policies are a cause for a concern. The issue of no less importance for some counties of the region is the escalating dependence of these countries on foreign portfolio flows to finance their external deficits. This said, we conclude that a close monitoring of developments in this region should be a part of future *GFSR*s.

Other Issues

We found chapters III and IV of the report to be an interesting reading. While the overall analysis of the asset price volatility in the mature markets may have addressed the issues that have previously been covered in detail by the Fund or elsewhere, the case studies certainly presented succinct and up-to-the-point summaries of the major historical events, which hopefully provide lessons both to pubic officials and private investors on how to prepare for and minimize the volatility in the asset price markets.

The chapter on the capital flow volatility in emerging markets is a timely piece, which incorporates not only the historical evidence but also the experience from the most recent crises. It is most interesting to learn that, contrary to a common perception, emerging markets have become exporters of capital since 1999, and that the volatility of net flows was much lower than during the era of a gold standard. It is also encouraging to discover that the degree of contagion from Brazilian, Turkish, and Argentinean crises has been limited. According to the staff, this was, to certain extent, due to an increased ability of investors to differentiate among countries' fundamentals (page 142). This fact, indeed, somewhat contradicts the statement made by the staff at an earlier point (page 47) that in the most recent period investor discrimination between credit names has diminished. Same goes for the analysis in the report on the effect of herding behavior on volatility and contagion, where the results are mixed, at best. Herding, as described in the report, is the process in which investors follow sporadic and imperfect signals to change their portfolio allocations. The Argentinean crisis, however, did not show this type of herding behavior. Rather, the volatility and contagion came from the necessity for the banks operating in the region to cover their positions in Argentina by selling off assets in the neighboring countries. We would be, therefore, interested in the staff's view on how one can reconcile the two conclusions about investors' behavior in the past three years.

Given that the volatility of capital flows in many instances has been the result of broadly rational reactions of the financial markets to the developments that were not easily predictable and hard to control (such as changes in investor base, shifts in business strategies of international banks, and the impact of the incentive structures of institutional investors), it is most appropriate to call on emerging market countries to continue to provide for self-protection against capital flows reversals. Besides following prudent macroeconomic policies in general, they should be encouraged to develop local securities and derivatives markets and strengthen their banking systems.

Mr. Al-Turki submitted the following statement:

Introduction

I thank the staff for a comprehensive and perceptive update of recent international capital market developments, prospects, and policy issues. The presentation, which is at times demanding, captures the increasing complexities of highly integrated financial markets. I found the analysis of the interactions between the mortgage, insurance, bond, and stock markets particularly instructive. This underscores the importance of this exercise, which is central to the Fund's surveillance mandate.

Developments in Mature Markets

Recent international capital market developments are broadly encouraging, but vulnerabilities remain. On the positive side, equity prices rose sharply, the housing market remains buoyant, and interest rates are still at low levels. These developments have strengthened the balance sheets of households and reduced the funding gap of many pension funds.

The balance sheets of the corporate and financial sectors also continued to strengthen. In the corporate sector, the increased profitability and liquidity of companies should help the buoyancy in the stock market. Higher profitability could also lead to increased investment spending and further boost the recovery and equity prices.

I am assured by the overall improvement in the banking sector. However, despite the progress made, German and Japanese banks continue to face uncertainties and challenges. U.S. banks also need to remain vigilant in view of their large exposure to real estate lending. While the insurance industry has shown some improvement due largely to higher equity prices, it continues to face important challenges. The recent failure of a German insurance company illustrates the problems. In this regard, the passage of legislation in a number of countries to lower guaranteed returns on insurance policies should help alleviate the pressures on this sector.

These welcome developments notwithstanding, a number of risks and vulnerabilities remain. An important risk, at this stage, is a deceleration in consumer spending ahead of an increase in corporate profitability and business investment. A continuation of the rapid rise in interest rates, albeit from very low levels, could amplify the risk. Higher interest rates would likely lead to a slowdown in the real estate market which would not only reduce investment and employment in this sector, but could also reduce consumer confidence and consumption. While the continued absence of inflationary pressures, the recent improvement in industrial activity, and the rise in equity prices provide a welcome cushion, it is important to monitor developments closely and continue to gear policies to supporting the recovery.

The continued hesitancy in the European recovery is another risk. Indeed, lower growth would reduce corporate profitability and lead to a decline in equity prices. Lower European growth could also accelerate the recent appreciation of the U.S. dollar and further widen the U.S. external current account deficit. In this connection, it is important for the European economies to implement the necessary macroeconomic policies and structural reform to enhance their domestic demand and growth.

The underfunding of defined-benefit corporate pension plans poses another risk. While the staff rightly notes that higher equity prices and a rise in interest rates could greatly improve the financial position of these plans, many companies will still need to raise their pension contributions. This will reduce profits and adversely impact the stock prices of these companies. Here, it is worth emphasizing that this problem would have been much smaller if most corporations did not stop contributing to their pension plans when stock prices were rising sharply.

Another area that deserves careful monitoring is the U.S. government-sponsored housing enterprises. While Fannie Mae and Freddie Mac have been instrumental in the expansion of the mortgage market and home ownership in the United States, the sheer size of these institutions and the level and frequency of the hedging that they undertake do raise "particular financial stability concerns," as noted in the report.

To hedge for increased duration as interest rates rise, these institutions would need to sell conventional bonds thus adding to the pressures on interest rates and increasing volatility. That said, I am reassured by the findings of the Office of Federal Housing Enterprise Oversight that the capital of Fannie Mae and Freddie Mac consistently exceeded the minimum required to deal with severe conditions for interest rates and housing prices.

The informative chapter on volatility and instability underscores that while dynamic hedging strategies and rigid risk limits greatly improve risk management, they can amplify volatility. I agree with the staff's findings and recommendations regarding volatility. The staff also rightly notes that a number of issues still need to be addressed, and I look forward to further work in those areas.

Developments in Emerging Market Economies

I am encouraged by the overall favorable developments in emerging bond markets. Improved economic fundamentals in emerging markets economies and low interest rates in the major financial centers have led to higher prices, lower spreads, and increased issuance of emerging market bonds. I also welcome the increased inclusion of collective action clauses in the new issues. However, the consolidation that took place since mid-2003 underscores the risks to this market from rising U.S. interest rates. While investor discrimination by credit quality remained evident in the issuance market, reduced investor discrimination in the secondary market accentuates the risk of outflows if interest rates in the United States continue to rise. The risk to emerging market economies is cushioned however, by the rise of the local currency debt markets.

Unfortunately, the international equity issuance by emerging market companies and foreign direct investment (FDI) flows did not fare well. As noted in the report, the value of international equity issuance in the first half of this year was less than half that in the same period of last year. Moreover, FDI continued to decline in the first quarter of this year. This decrease is attributed to higher perceived risks emanating from unanticipated changes to regulations and contractual arrangements. These findings highlight the importance of putting in place predictable investment rules and a sound legal framework in addition to macroeconomic prudence. That said, I am puzzled by the sharp decline in FDI to Brazil, especially given the substantial improvement in investor sentiment towards the country and increased confidence in its economic policies. The staff's comments would be appreciated.

The finding in the paper that emerging markets have been capital exporters since 1999 is a concern. This concern is amplified by the shift in the composition of inflows towards bond financing and away from equity issuance and direct foreign investment. These developments could lead to not only lower investment, but also increased volatility of capital flows to emerging markets. While the measures taken by emerging market countries to self insure against volatile capital flows are welcome, more is clearly needed to reverse the above-mentioned trends. The staff's comments would be appreciated.

Mr. Bischofberger and Mr. Fabig submitted the following statement:

Key Points

- The report strikes a proper balance between being focused and being comprehensive. We appreciate the report's careful and balanced assessment. The two major risks to global financial markets are identified correctly, namely negative transition period effects of a continued rise in bond yields, and disappointing corporate earnings.

- We broadly endorse the policy implications for major financial centers. The report's call to further strengthen corporate governance is well-placed. The detailed discussion of the U.S. mortgage market is welcome, and we agree with staff that continued monitoring is warranted.

- Emerging market bonds are vulnerable to a correction. We support the report's policy implication that emerging market countries should take advantage of the recent improvement in access to capital markets to pursue structural reforms, to put public finances on a sound footing, and to improve the structure of liabilities.

We thank staff for their well-written update on global financial developments. As the second semi-annual *GFSR*, this fall's report strikes a proper balance between being focused and being comprehensive. However, we observe that a rather technical language is still prevailing in large parts of the report. Therefore, we would appreciate the very helpful glossary to be supplemented. In the same vein, more boxes like Box 2.1, explaining mortgage hedging mechanics, could be inserted in future reports.

We broadly agree with the general findings of the report. In particular, we appreciate the report's careful and balanced assessment of risks and vulnerabilities. The report rightly states that while on balance financial stability concerns have eased, significant concerns remain. The two major risks are identified correctly, namely negative transition period effects of a continued rise in bond yields and disappointing corporate earnings that would fail to validate the recent strong rebound in mature equity markets. We agree with staff that on balance a further steepening of government bond yield curves in the major financial centers would be a positive development if driven by prospects of stronger growth.

We broadly endorse the policy implications for major financial centers. The report's call to further strengthen corporate governance is well placed as reforms to strengthen market foundations are key to boosting consumer and business confidence in a sustainable way. Moreover, we would like to point out that low short-term rates and ample liquidity are a two-sided sword: While low rates certainly contribute to further balance sheet repair and underpin investor risk appetite, the sizeable build-up in liquidity could easily result in a concentration and mispricing of risks. Therefore, we welcome the report's call for particular vigilance of supervisors and risk managers which should be taken very seriously.

We welcome the analysis of the U.S. mortgage agencies. Given the boom in U.S. mortgage financing in recent years and the predominant role of

Fannie Mae and Freddie Mac in underlying and derivatives markets, we have the impression that risks related to these agencies may not have received sufficient attention in the past. Thus, we appreciate that the report spells out the risks related to the U.S. mortgage market and the capital adequacy of these agencies more clearly and we agree with staff that continued monitoring is warranted. In this context it is also worth noting that with regard to financial asset price volatility, the report concludes that "the lessons learned about the need to limit the impact of amplifiers...at present...are particularly relevant for the potential risk that the continuous hedging of mortgage-backed securities portfolios could amplify interest rate movements." (p. 11) It seems that without the implicit government guarantee, the two government sponsored agencies would not have gained such a crucial role in the U.S. financial market. Moreover, with a view to the important role of low-interest rate mortgages in households' balance sheets, it seems that to some degree strong private consumption in recent years has been bought at the price of increased financial vulnerability in this sector.

We found the report's analysis dealing with the insurance industry very interesting. However, we have a few comments for clarification, as German insurers are being singled out to illustrate the extent of earlier losses on their equity holdings that have not yet been fully recognized. As to our knowledge, the smoothing provisions granted to German insurance companies are in line with international practice. Therefore, we would consider it appropriate if a broader assessment of the situation in the insurance industry related to losses in equity assets could be made, in particular as U.S. pension funds' regulation allows for massive smoothing and underfunding. Moreover, we would like to mention that the German authorities are planning to reduce the guaranteed rate of return for life insurance products. We will provide staff with some more technical comments bilaterally.

Regarding emerging markets, we agree with the conclusion of the risk analysis that "emerging market bonds are vulnerable to a correction, given the rapid spread compression and the apparently reduced investor discrimination over issuer credit quality during the recent search for yield." (p. 9) There is a risk that a further increase of bond yields in mature economies may entail a drying up of inflows in emerging markets, as investors seem to have emphasized asset class considerations rather than country-specific factors and as bond issuance has gained importance in generating capital flows earlier this year. In a wider perspective, the current developments and vulnerabilities have to be judged against the finding in Chapter IV on capital flows that since 1997 market closures for emerging markets have become more linked with developments in mature economies.

In addition, there are also specific factors pertaining to emerging markets that may trigger a reassessment by investors: Some countries, notably Hungary and Poland, have accumulated large fiscal deficits which are increasingly financed by portfolio inflows. The increasing reliance on portfolio flows is accompanied by a broadening of the investor base with cross-over investors gaining in prominence. Another aspect is that Brazil has dominated the emerging economies bond market, and thus a shift in investor sentiment regarding the economic situation in Brazil could trigger sizeable adjustments for the whole asset class.

In view of these considerations, we support the *GFSR*'s policy implication that emerging market countries should take advantage of the recent improvement in access to capital markets to pursue structural reforms, to put public finances on a sound footing, and to improve the structure of liabilities. As staff notes, it is important to avoid complacency within the improved external financing environment. We welcome the report's mentioning of measures taken in emerging markets to self-insure against the potential volatility of external flows. Efforts in emerging markets to increase the stability of their financial systems will reduce the risks of capital flow reversals for the particular country, and, at the same time, contribute to global financial stability.

Regarding Chapter III on financial asset price volatility, we agree with the lessons spelled out to avoid mechanisms that amplify volatility in a crisis by forcing or creating incentives for asset sales into falling markets. We also agree that injection of liquidity by authorities can be a helpful measure to relieve pressure in an escalation situation. At the same time, however, it is worth noting that ample liquidity provision over a continued period of time may lead to mispricing and concentration of risk positions, as mentioned earlier. Furthermore, current experience suggests that in an environment of ample liquidity over-leveraging may just shift from one part of the financial sector (e.g. equity) to others (e.g. bonds and housing markets), and volatility risk in the overall financial market will remain high. We would appreciate it, if these thoughts could be added to the text of Chapter III and to the corresponding section in the Overview.

The lessons drawn in Chapter IV on volatility of capital flows to emerging markets are in line with recommendations of the Capital Flows Report of the Financial Stability Forum. We welcome this chapter as a reminder for emerging markets to implement self-insuring measures.

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

Key Points

- The *GFSR* provides a thorough review of potential risks to the global financial system. We concur with the conclusion that vulnerabilities in the global financial system have eased.

- We share the view that corporate profitability is of more concern than rising bond yields. The report could benefit from more attention to corporate sector vulnerabilities outside the United States.

- Financial flows to emerging markets have recovered somewhat this year, with the notable exception of equities and foreign direct investment (FDI). The discussion on volatility in capital flows to emerging markets highlights steps that countries have taken to strengthen policies to reduce the extent and impact of such volatility.

- The discussion on asset price volatility puts too much emphasis on regulation rather than market discipline as a way to safeguard financial stability.

We thank the staff for the latest version of the *GFSR*, which covers a number of important topics. At the same time, we again urge staff to strive for a more concise and 'value-added' product. The additional chapters are useful but not essential to the *GFSR*, and the length of the core vulnerability assessment should better reflect the balance of risks. We agree with Mr. Mozhin and Ms. Vtyurina that the report focuses too much on U.S. market developments, reporting on issues that are already well reported in the financial press. Given the overall length of this report, we ask that future editions be distributed to the Board at least two weeks before the Board date.

Major Financial Centers

We welcome and concur with the report's conclusion that "mature market vulnerabilities have eased," in part because of stronger corporate and household balance sheets. The report cites two major risks now as (1) a continued rise in bond yields and (2) lower-than-expected corporate earnings. In discussing both topics, Fund staff focuses heavily on the United States. While the report acknowledges that unexpectedly low corporate earnings could pose a greater risk than rising bond yields, the extent of analysis devoted to each risk does not appear to reflect this prioritization. And, some of the policy implications presented on page 10 may be too categorical, suggesting that all major financial centers need to take similar policy actions.

On rising bond yields, the staff notes that hedging activity in the U.S. mortgage market has contributed to a rapid rise in yields. Mortgage investors (including GSEs) have been selling long-term securities to reduce the duration of their portfolios. We note that current interest rates remain historically low, and a substantially larger increase in rates would be necessary to weaken the relatively healthy—and hedged—balance sheets of U.S. banks. Dynamic hedging does not necessarily involve selling treasuries or swaps—it can involve adjusting liabilities as well. Consequently, despite some added volatility in the short term, an excessive rise in long-term rates is unlikely. Thus, some shortening of the analysis on this topic is warranted, particularly when the staff report acknowledges up front that a further steepening in yield curves, driven by prospects for stronger growth, would be a positive development. It is also not clear that the pricing of adjustable-rate mortgages (ARMs) is inadequate; no evidence is cited for this assertion.

Corporate profitability, meanwhile, is a greater concern, especially in Europe and Japan. Thus, while yield curves have not shifted as much in these countries, this is largely due to the backdrop of low economic growth, deflation (in Japan), and weaker financial institutions. The pressing issue of weakly-capitalized banks and insurance companies should be further developed.

With regard to other risks, the brief section on credit derivatives does not add much new information to the discussion in the last report and could probably be deleted. We continue to believe that credit risk transfers have been a stabilizing factor, on balance. The issue of pension under-funding is of interest, particularly given the link to corporate profitability. We found the analysis too "U.S.-centric," particularly in light of the statement that many other countries that have "pay as you go" corporate pension schemes face even greater long-term funding shortfalls.

Emerging Markets

The presentation of data and analysis of flows to emerging markets remains the heart of the *GFSR*. The report notes the recent increase in bond spreads from the historic low levels early in the year, noting that additional increases in spreads are possible if yields in major financial centers increase further. While this is a risk, we would note that higher yields in advanced countries are likely to be driven by higher growth, helping to mitigate the impact on emerging markets. Of more concern is the low level of flows to emerging equity markets and ongoing downward trend in foreign direct investment (FDI), with Russia and China as major exceptions. We hope that the Board seminar on FDI will be scheduled soon.

We welcome the update on collective action clauses (CACs) and continue to encourage staff to engage in detailed discussions on CACs as part of the standard dialogue in surveillance and program contexts, building on input from the International Capital Markets Department.

The staff has done an excellent job of identifying risks in emerging markets, and we especially appreciated the concise analysis of emerging market banking systems. While noting a general improvement in many emerging market financial systems, staff notes that fundamental weaknesses remain widespread and warrant continued attention from policymakers.

The staff argues that contagion could arise due to a lack of discrimination among crossover investors buying into emerging market bonds in the past year. We have mixed views on this topic. On one hand, the decline in spreads in emerging markets to such low levels may suggest that they do not adequately reflect risk; on the other hand, an increased willingness to invest in emerging market bonds does not necessarily imply that investors have failed to perform due diligence. We concur with the suggested benefits of a "broader and more diversified investor base," and think risks of broad-based "contagion" remain low. We nonetheless agree that emerging markets should exercise caution to avoid unsustainable levels of debt issuance (noting the *WEO* chapter on this topic). In any case, we encourage the staff to continue to devote attention to these issues and welcome the staff's intent to pursue further analysis on the investor base for emerging markets.

Volatility

The discussion on asset price volatility acknowledges a trade-off between regulation and allowing market forces to work. Nonetheless, in our view, the discussion focuses excessively on regulation as a solution for financial instability. Some of the events cited are not purely financial market events—the bursting of both the Japanese and U.S. equity market bubbles were associated with recessions in the real economy. Rather than endorse central bank involvement as an appropriate response to financial instability, with the risk of creating an expectation of official rescues, the staff should emphasize ways in which policymakers can strengthen market discipline.

The chapter on volatility of capital flows to emerging markets is well presented. We note the various steps that emerging markets have taken to reduce the volatility of flows and mitigate its impact. These include strengthening domestic financial systems, building reserves, subscribing to SDDS, and undertaking FSAPs and ROSCs. The benefits of many of these actions clearly outweigh the costs.

Finally, we commend staff for taking steps to reconcile the capital flows data on emerging markets provided in the World Economic Outlook and the *GFSR*. The detailed statistical appendix will be useful to many *GFSR* readers.

Mr. Martí and Mr. Martínez submitted the following statement:

The report sets a positive tone on the prospects of financial developments for the next quarters, underscoring that the adjustment to the equity bubble burst and the ensuing slowdown in growth is well advanced and that financial and economic indicators point to a better environment. We broadly agree with this assessment and with the thrust of the report.

While the two major risks going forward namely a continued rise in bond yields and disappointing corporate earnings are appropriately highlighted by the staff, risks related to a continued rise in bond yields seem to emerge exclusively as a consequence of possible frictions during the transition to a new stage of high long-term interest rates coupled with sound economic growth. However, as mentioned later in chapter II, there is an alternative scenario where higher long-term interest rates are mainly caused by concerns over public finance sustainability and economic growth remains subdued. Given the general deterioration of fiscal accounts, most notably in the United States but also in some European countries, this is a risk worth mentioning and elaborating more thoroughly in the report.

The sustainability of housing prices and their consequences for financial stability are hardly discussed in the report. This could be an important issue for some countries, including the United States, particularly at a time of increasing long-term yields. This opinion is reinforced by the fact that household wealth has become more sensitive to the real estate market. Furthermore, the ending of the mortgage refinancing in the United States in a scenario of sharp increase in bond yields and the higher interests in new mortgages would put pressure on the demand side of the house market.

We welcome the analysis of the U.S. Mortgage Market, Fannie Mae, and Freddie Mac. These agencies hold on their balances $300 million of home mortgages and $1.2 trillion of mortgage backed securities that could pose a potential systemic risk and implies, among other things, a large exposure to changes in interest rates that need to be hedged. The report's suggestions for more comprehensive stress tests and a greater safety margin for operational risks within the capital requirement seem sensible measures that would increase the robustness of these agencies.

The report notes, in several instances, that the observed risk discrimination by investors has decreased as a consequence of the low interest rate environment and ample liquidity. This is an important point for financial stability as it could be mirroring a degree of inefficiency in financial markets. However, the evidence supporting this lower discrimination is basically the smaller dispersion of corporate and emerging-market spreads (Tables 2.2. and 2.5). A more detailed analysis would be necessary to reach this conclusion on safer grounds. This should take into account, among other factors, sector heterogeneity, changes in rating, and the potential non-linear and asymmetric effects of the business cycle. The staff's comments would be welcome.

We share the consideration that volatility does not necessarily lead to financial instability because it could be reflecting an intrinsic part of a well functioning financial system. This is particularly accurate in efficient markets, where prices embody all available information. In addition, as it is mentioned in the report, besides market and management adjustments that arrive from the risk owing to volatility, it may itself be an indicator of underlying market weaknesses, which can be indications of instability.

There are several instances where the volatility was rooted in financial market disturbances, or as a consequence of major market innovation, deregulation, or other structural changes, leading to financial bubbles that create volatility when they eventually burst. In this regard, we agree that policy makers and market participants could learn lessons about how volatility can become amplified in a crisis, and how to control factors such as leverage, market infrastructure, shortage of liquidity, and lack of transparency, which can turn volatility into instability.

Given the importance to strike a balance between regulation and allowing market forces to work, and possible trade-offs between transparency of mark-to-market values and volatility, as mentioned in the report, we look forward to the inclusion of these aspects on future editions of the GFSR. It would be also useful to include the role, if any, that the central banks might play in these issues.

We welcome the inclusion of the Chapter on Volatility of Private Capital Flows to Emerging Countries. Indeed, a fair assessment on this topic has been required for some time in order to understand better the dynamics of private capital flows to emerging markets given the impact they have on this type of economies. Unfortunately, the lack of information or its inadequate frequency imposes limitations on the analysis. This institution can and should play an important role in promoting or recollecting more ad hoc data on this topic in coordination with other financial institutions.

Some salient features of net private capital flows include their predominant role as source of external funding for many emerging countries since the 1990's and the fact that after peaking in 1996, flows have been maintained at a much lower level. Some relief is provided by highlighting that the 1990's was not the most volatile period, characterized by just one-third of the volatility posted during the classical gold standard era, a comparison that is not available in the analysis on gross capital flows. The latter is useful to confirm the boom-bust cycle in capital flows, the high volatility registered during the last decade, and the episodes of market closures. Particularly interesting is the assertion made by the staff that when closure did not involve adverse developments in emerging markets, closures were preceded by a rise in the volatility of U.S. equity markets or rising interest rate spreads on U.S. junk bonds.

While the report correctly assesses the importance of the FDI and highlights the stability and resilience of these types of capital flows, it notes that FDI has slowed down marginally after the Asian crisis. However, we are concerned regarding recent trends in this indicator, posting declines during the first quarter of the year. The report attributes the declines to cyclical movements reflecting growth trends in the world economy, poor regional and local prospects, and the bursting of the technological and telecommunications bubble. From the point of view of sustainability, FDI analysis could be linked to other variables, for example, the current account deficit. It is important to analyze if emerging markets are being able to finance their deficits—some of them very small in the aftermath of the crisis. Notwithstanding the above, we believe this indicator warrants a more thorough analysis and discussion. The Board has insisted on the importance of the analysis of FDI several times and we look forward to the long overdue and postponed seminar on FDI, which will not take place until the end of October.

We fail to see in the report an answer to the question on the desirability of countries' integration to international capital markets given the welfare consequences of boom-bust patterns and volatility of capital flows. In addition, we find the expose on determinants of the pattern and volatility of capital flows not fully supported by empirical or econometric evidence. This point may be made in particular with regard to the shift in business strategy of international banks and to the investors' base change, where many theories—often contradictory—are presented, and for which evidence is not yet clear.

Finally, irrespective of external economic and financial conditions, emerging countries have an essential role to play to self-insure against volatile capital flows and asset prices. With this view many emerging markets have adopted measures to reduce their dependence on international borrowing and to strengthen their financial systems. As the report notes a number of commentators suggested that emerging markets increase their holdings of international reserves (in some cases above the levels that would have been considered as appropriate according to some indicators) to provide a degree of self-insurance against sudden reversals of capital flows. In our view, this argument may be complemented with the significance of the reserves as a signal to investors that the country counts with sufficient resources to deal with a major financial problem.

In page 144 it is stated that, "global banks…have increasingly emphasized lending from local subsidiaries," and argues that this might be a reason for the reduction in cross-border lending even if the evidence is not conclusive. Whether foreign bank local activity and cross-border lending are complements or substitutes is a very important issue for emerging countries and, therefore, a more detailed analysis is necessary. The evidence is different across regions: at first sight complementarity seems to exist in Central and Eastern Europe where both local activity and cross-border loans have increased—albeit at a faster speed in the case of local activity—but this is different in other regions. In addition, the degree of financial liberalization and privatization also influences the behavior of foreign banks.

Mr. Kremers and Mr. Stucka submitted the following statement:

We thank the staff for an extensive and informative report on financial market developments. We welcome, also, the more systematic and explicit discussion on key risks that financial markets are likely to face in the future. Furthermore, we are glad to see that emerging markets where arguably the Fund has a comparative advantage, remain a considerable ingredient of the paper. That said, although already at a high level, further steps toward user friendliness are desirable, among other things, by more clearly emphasizing the main messages.

As pointed out by the staff, the two major potential risks are the transition to a higher level of bond yields and continuing flat corporate profitability accompanied by weak growth. The staff is invited to comment on how likely these events are, taking into account the growth outlook set out in the WEO; as the Fund is one institution, the GFSR and WEO should be seen as one entity. In addition, it is striking and, if indeed so, also worrisome, that, since the last report, investors seem to have reversed their attitude to discriminate emerging markets based on fundamentals; the staff's comments are appreciated.

The policies to promote financial stability in Chapter I seem to be in need of refinement—being too general, they fall short of delivering what was promised in the title. We would welcome a more explicit reference to those policy issues, along the lines of the approach taken in Chapter III, where policy lessons for limiting the effects of volatility have been intuitively outlined.

In general, we broadly agree with the staff's messages and would like to confine our comments to three areas: global financial markets, in particular the U.S. and the Netherlands, asset price volatility, and emerging markets' capital flows.

We welcome the extensive discussion on the government-sponsored enterprises in Chapter II. It is a well-known fact that Fannie Mae and Freddy Mac are huge players in the financial markets. The possibly strong influence on market outcomes gives rise to the question whether these agencies should return to their core business (securitization), instead of also investing in securities. According to rating agencies, if Fannie and Freddie would lose the implicit government guarantee, they would be downgraded from AAA to AA. Stress tests (recently published in the New York Times) show that increases in long-term interest rates would lead to a substantial decline in the market value of Fannie Mae. Could the staff indicate to what extent a downgrade from AAA to AA would affect the market value of Fannie Mae and Freddie Mac, and what this would imply for the interest rates charged to households for mortgage lending?

Stock prices reached a peak in March 2000 and in the United States now appear to be more adequately valued as shown by price-earnings ratios. These are now more in line with historical averages. However, the staff correctly points to the long-term earnings expectations. The 12 percent annual expected earnings growth still contrasts with the 7 percent earnings growth realized in the first quarter of this year (according to U.S. national income accounts). Moreover, a 12 percent earnings growth combined with a 4 percent to 5 percent bond yield implies a long-term equity premium of 7 percent to 8 percent; well surpassing conservative estimates of the equity premium. Is the market still too bullish about earnings prospects in the medium to long term?

With respect to the section on under funding of defined-benefit corporate pension plans, we would like to touch upon two statements concerning the Netherlands. First, the decline in interest rates may have negatively affected pension fund balance sheets in 'fair value' terms owing to their negative duration gaps. However, under the current accounting standards, the liability side of pension fund balance sheets is insensitive to interest rate movements. Second, whereas under funding is a problem for a minority of pension funds, on average coverage ratios in the Netherlands still exceed 100 percent. Moreover, the prudential supervisor has reacted strongly so as to make sure that pension funds overcome the current very sizeable market fluctuations.

In the section describing financial asset price volatility as a source of instability, the staff rightly points out that financial market volatility can, in theory, be exacerbated by, and ultimately leads to, financial instability. This can occur because of herding behavior, lack of robust risk management, lack of transparency, and weaknesses in market infrastructure. Nevertheless, the empirical causal link between financial market volatility and financial instability is not established convincingly in the staff paper. With the exception of the LTCM crisis, the case studies provide at best weak support for such a link. Especially the fact that volatility has been historically high in the past years, while the financial system has remained remarkably resilient is a point in case. Moreover, recognizing that the exposure of the banking industry to stock markets is limited, the direct risk to financial stability emanating from stock market volatility may be less important than we are led to believe.

It is important to draw the right lessons from extreme volatility, as it brings to light unforeseen risks (for example, LTCM), ineffective risk management practices, and/or gaps in regulation before they have a chance to become pervasive. Extreme volatility may also help to break institutional deadlock, as with pension reforms, which suddenly received widespread attention following substantial losses on pension funds' stock portfolios. That said, we agree that regulation (for example, by creating a level playing field) should work to prevent excessive developments in financial markets. Most importantly, an appropriate balance must be struck between macro-stability and micro-efficiency and continuity. In this light, the costs of macro-volatility must be well assessed and weighed against the benefits of risk-based micro-regulation.

As it is difficult to capture financial stability in a single measure, we encourage the staff to develop and make use of more indicators (in addition to exposures, stress tests, and asset prices). One could, for instance, think of linking asset price volatility in an econometric test to a measurement of liquidity, for example, the bid-ask spread as such, determining when volatility leads to financial instability. The staff's comments would be appreciated on whether such indicators are being developed in either the Fund or some other agencies with responsibility for financial stability.

Regarding emerging market capital flows, an important trend is the increasing share of FDI in total flows. This is generally considered beneficial, as these flows seem to be more stable than other components, most notably bank lending. However, we question whether the high inflow of FDI can be sustained. After all, an important factor behind the surge in merger and acquisitions in emerging markets, large privatization programs, may become less important. Hence, FDI flows may weaken, which is likely to increase the exposure to capital market sentiment.

Another important aspect is the increasing influence of developments in mature markets for emerging market financing conditions. Increased risk aversion and financial market volatility in the second half of 2002 confronted Latin American countries with sharp increases in spreads and even temporary exclusion from international capital markets. With their dependence on foreign capital owing to low domestic savings ratios, these countries were in a weak position to deal with fluctuations in capital flows. This again highlights the importance of healthy fundamentals for countries with a liberalized capital account.

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

The GFSR contains some encouraging news. Economic developments have largely been favorable to global financial stability over the last six months. Despite continued slow global growth and increased political uncertainty during the war in Iraq, financial markets have strengthened, risk aversion seems to have declined, and vulnerabilities, particularly regarding corporate balance sheets, have generally eased. Of course, there have been less favorable developments as well, such as the recent increase in volatility on mature bond markets, and corporate earnings expectations have created considerable scope for disappointments. On balance, however, we agree with the staff that the picture has improved since the last GFSR and that financial stability concerns have eased.

One recent event that is not much discussed in the report is the "roller coaster" ride in mature bond markets over the last few months. After dropping to their lowest levels in many decades, bond yields soared within a few weeks. In July, bond investors recorded one of their worst months ever. The main factors behind the sharp yield increase were certainly the dissipation of deflation fears and the perception of improved prospects for economic recovery. The most interesting point, however, is that the atypical movement in bond markets seems to have been triggered by the Fed's communication. Given the considerable space that the media and investment bank reports have devoted to this issue, the GFSR is rather quiet about the Fed's role in this episode.

The report mentions two alternative major risks going forward, a continued bond yield rise and disappointing corporate earnings. As the staff, we are less worried about the risks associated with rising yields owing to stronger economic growth. Should stronger recovery really materialize, it seems that most of the negative effects mentioned in the report, including the end of the mortgage refinancing wave and a possible correction in emerging bond markets, would be offset. However, apart from the mentioned risks entailed in the transition to a higher yield level, we are less sanguine about the risks associated with a higher level itself. We would appreciate if the staff could elaborate which market segments and/or groups of countries would be most seriously affected by higher interest rates. For example, Mr. Callaghan reminds us that mortgage borrowers in several countries other than the United States are also significantly exposed to the interest rate risk. We see the risk that higher rates could adversely affect debt sustainability of a number of highly indebted emerging market economies, even more so if this rise in global interest rates would be accompanied by a strengthening of the dollar. Some emerging market borrowers have thus wisely seized the "window of opportunity" in the first half of the year for liability management operations.

The more imminent risk, however, is the one of disappointing corporate profits, particularly in view of some weak data recently coming from European countries. Financial markets have priced in a strong recovery for some time and repeated disappointment might eventually cause an overreaction in the other direction.

We very much welcome the analysis of the U.S. mortgage market and its two dominating agencies. The size and structure of this market has substantially changed over the last years, and already for some time we have been expressing our concerns regarding the two large government-sponsored agencies, Fannie Mae and Freddie Mac. Recent debates about the capitalization and transparency of these agencies, and the strong market reaction to the news of accounting and governance problems in one of them, have further enhanced our concerns. We thus continue to believe that the U.S. policymakers should reconsider the special status of these agencies, such as the exemptions from SEC registration requirements and from banks' large-exposure limits.

In the section on crisis and contagion, the report states that "one particular feature of investor behavior that could potentially generate excess volatility and co movement across markets is herding behavior" (p. 142). While we agree that herding can generate excess volatility, we do not see how herding could generate contagion. True, in the literature one often finds this claim, but the explanations given usually either remain elusive or have nothing to do with herding. As to the three papers referred to in the respective paragraph, all they do is establish evidence for the tendency of some investors to follow occasionally other investors in and out of a single country. Contagion, however, is about investors pulling out of a country A because other investors pull out of a country B. This phenomenon cannot be explained by herding, that is, the mimicking of behavior. Kaminsky et al. (2000) manage to get a connection between herding and contagion by including cross-market hedging in their definition of herding (ibid., p. 15). Cross-market hedging, however, is not herding. Moreover, the "contagion trading" they find has to do with common lender effects. In our view, herding is neither necessary, nor sufficient for contagion to occur. However, we agree with the staff that a further understanding of these issues is necessary, and we are looking forward to a more thorough study of the structural determinants of the behavior of international banks and the investor base for emerging market assets.

An interesting finding of the report is that the extent of volatility of emerging market capital flows of the 1990s has not been extraordinary in historical perspective. While not much of a consolation for those countries that have experienced financial crises during this time, the finding nevertheless indicates that the international financial system might not be as flawed as some observers would argue, at least in comparison with previous periods.

The GFSR report concludes that in the recent periods of high asset price volatility since 1987, the prompt provision of liquidity by central banks was key in breaking the cycle of amplifying volatility in each of these cases. A different question, however, would be whether the substantial liquidity injections in one episode have contributed to the next boom-and-bust cycle.

In the last two decades, the composition of private capital flows to emerging markets has changed significantly. From the 1980s to the 1990s there has been a change from international bank lending to bond lending. One could argue that a possible factor contributing to this change was the establishment of a successful framework for the restructuring of international bank loans. The report finds that local emerging markets have recently attracted considerable interest among international investors. Given recent experience and ongoing efforts to facilitate the restructuring of international bonds, we wonder whether this could also have to do with investors' perception that local debt instruments get a more advantageous treatment in debt restructurings?

Mr. Wang submitted the following statement:

We welcome today's opportunity to discuss the issues and risks pertaining to global financial stability. We would like to make some general remarks before commenting on more specific issues.

First, we commend the staff for a very high-quality report. Quality has improved in that the staff has taken a more forward-looking approach in preparing this GFSR compared with previous issues, which tended to be more descriptive of past events. The fact that the GFSR is now a half-yearly—instead of quarterly—publication has helped the report focus on longer-term trends and reduced the need to monitor too closely the changes of high-frequency data. Hence, the improvement confirms that it was the right decision.

Second, there remains scope for enhancement. It is stated in the Preface that "the GFSR provides a regular assessment of global financial markets and identifies potential systemic weaknesses that could lead to crises. By calling attention to potential fault lines in the global financial system, the report seeks to play a role in preventing crises before they erupt, thereby contributing to global financial stability and the sustained economic growth of the Fund's member countries." We read the report and then read this paragraph again to see if we feel the report has achieved this objective.

The report certainly discusses many issues and potential threats to global financial stability. Our overall impression is that the risks are quite low. However, we are not sure if this is the staff's assessment or the message it is trying to convey, or if this is also the impression of other readers. One possible solution is to adopt a crisis warning system that has, say, five risk levels ranging from 'lowest' to 'highest', and that the staff assigns a level that would best characterize their overall assessment. It would also useful if the "potential fault lines" could be highlighted more clearly. The advantage of such a system lies in greater transparency of the staff's assessment of global financial stability. The concern, however, is that being crystal clear may run the risk of causing fears and chaos to financial markets. On the other hand, deliberately making our assessment less clear than can actually be achieved is definitely not the right approach. The staff may wish to give more thought to this issue.

The staff identifies two major risks going forward, namely, a strong economy and a weak economy. A strong economy would push bond yields higher and steepen the yield curve, which could impact property prices, consumption, bond portfolios, mortgage markets, and emerging bond markets. A weak economy means that corporate earnings might disappoint, which could spark an equity market sell-off. We are under the impression that the consensus is that the upside and downside risks to economic growth in the United States are roughly balanced. The FOMC meeting last week concluded with the view that is also broadly in line with the consensus. (In addition, it thought that the risk of deflation is slightly higher than that of inflation). Therefore, if the FOMC assessment is correct—at least not wrong by a wide margin—the risks highlighted by the staff do not look high for the foreseeable future. Does the staff agree?

First, we view the downturn—of both the economy and the stock market—in the past three years as not a bad thing at all. Riding the economic boom in the 1990s, mature financial markets around the world enjoyed a major bull phase buttressed and prolonged by the TMT bubble. The bursting of the bubble, reflected especially in the steep decline in equity prices, marked the beginning of a much-needed and overdue adjustment, both in the real sector and financial markets. The adjustment was subsequently deepened by a number of unfavorable (but unrelated) factors, including geopolitical developments and corporate scandals. Some of them were one-off in nature while others may have a longer-lasting impact. To some extent, it was a blessing in disguise. We have no doubt that the efforts we put in today will prove to be profitable, as financial markets—with enhanced infrastructure—would be made much more resilient to shocks and setbacks. For example, we have long been a strong advocate of increasing private sector transparency in parallel to the initiatives that we have developed at the Fund to encourage the public sector to do the same. Indeed, we feel encouraged that following the corporate scandals the authorities concerned around the world have been very responsive and taken preventive steps to address the issue, including reviewing and improving accounting standards. However, much more needs to be done. Hence, we support the staff's call for intensifying the reforms to strengthen market foundations.

Second, U.S. monetary policy has facilitated a smooth adjustment but also created problems. As economic activity slowed and the stock market fell, the Federal Reserve cushioned the economy with a series of monetary easings, which produced some of the lowest interest rates in modern history. Recent U.S. monetary policy has, in our view, delivered one positive as well as one negative outcome. The positive outcome is that it has successfully engineered a soft landing, providing the much-needed breaking space for the household and corporate sectors to consolidate financially. Economic activity slowed but did not stall. The stock market fell but did not crash. The second outcome, however, is that the easings created enormous liquidity, feeding many bubbles along the way when the effect ripples through the economy. Many market commentators also attribute some bubbles outside the United States to U.S. monetary policy. The staff has, in this GFSR, provided an insightful analysis of this flow-on effect, warning that pressure has been developing rapidly in various pockets of the economy (for example, the mortgage market) and overseas (emerging market bonds).

Third, we are delighted to see many positive developments over the past six months or so. The current GFSR notes a number of positive developments, which we will not list here. One important development we would like to highlight is that previous issues of GFSR observed that the household and corporate sectors had become increasingly risk-averse in mature markets. While this helps catalyze the repair process of their balance sheets and hence strengthen their financial positions, being overly cautious could prolong an economic downturn. It is therefore encouraging to see a retreat of such behavior in the past several months, with the household sector looking more ready to take on potentially profitable, though risky, opportunities. We believe that the increase in risk appetite is justifiable, especially given that geopolitical uncertainties dissipated quickly after the war. The recent bound of stock prices should thus be a welcome sign. However, we agree that the sustainability of this seemingly healthy development will critically depend on whether the earning upgrades by analysts could materialize. In other words, the emergence of clearer signs of a recovery across a wider spectrum of economic activities is important. It is worth noting that recent studies have revealed that analysts have notoriously tended to be overly bullish in their forecasts.

Fourth, the continued rebound in bond yields is not necessarily bad for emerging markets. The last GFSR spotted the phenomenon of excessive yields compression. While the compression helped ease the pressure on a number of financially-constrained emerging market economies, and hence aided their recovery, the particular concern was that in the chase for higher yields, investors and portfolio managers appeared rather indiscriminatory between instruments—both within and across asset classes—that have appreciably different credit, and, possibly also, other risks. In light of this phenomenon, when the recent rebound of equity prices triggered an outflow from bond funds, some compressing pressure must also have been taken off the yield spreads. True, if yields in mature markets continue to gather upward momentum, this squeezed sponge is likely to spring back further upon release. However, whether or not this would be bad news for emerging markets is less certain. First, investors and portfolio managers are likely to become more wary and conscious of credit risks, which would help restore the long-term health of emerging bond markets. Second, whether or not mature financial centers could continue to suck out funds from emerging bond markets will depend on the relative economic outlook for mature market versus emerging market economies. In our view, emerging equity and venture capital markets are very qualified competing candidates. In this connection, we hope to see in future issues some analysis of fund flows not only in and out of emerging markets but also, within emerging market countries, between bond and equity markets as well as between portfolio investment and venture capital (that is, direct investment).

Fifth, the authorities concerned should be on high alert to mortgage market developments. Many members of this Board, including us, have voiced their concerns in the past that there was a real estate or property market bubble in the United States in the making. The staff's response in past WEO discussions was that there were only a limited number of geographical pockets where property prices had gone up noticeably and that price increases were rather modest for the country as a whole and internationally. This gave the impression that real estate market developments should not be a concern. We are very pleased that the current GFSR points out that the problems associated with the property price boom could potentially be very disruptive to financial markets. The current legal and institutional arrangements for the GSEs certainly encourage moral hazard. In the current low interest rate environment, new financing and refinancing have kept ballooning, feeding the real estate bubble. As a consequence, the balance sheets of the GSEs expanded in phenomenal scale. The staff's excellent analysis and illustrations of their hedging needs and the probable amplifying effects sound pretty scary to us. We are of the view that the real estate bubble, especially the financial side of it, has developed to a stage that is now potentially threatening financial stability. While the OFHEO's stress tests found that the capital of Fannie Mae and Freddie Mac has consistently exceeded the minimum required, we agree with the staff that regulators need to examine closely whether their capital base is large enough to absorb risks on their growing balance sheets.

Finally, it is appropriate that the GFSR acknowledges the considerable efforts of the authorities of many emerging market countries in recent years in taking additional measures to strengthen their financial systems and to self-insure against volatile capital flows and asset prices. In particular, we welcome the GFSR's encouraging remarks about the increase in holdings of international reserves, especially in Asia, by emerging markets.

Mr. Reddy submitted the following statement:

We thank the staff for bringing out an analytically rich and a comprehensive Global Financial Stability Report (GFSR). We welcome several good features of this report, which have widened the range and depth of analysis. First, the report rightly focuses on issues relating to balancing of certain risks and vulnerabilities and policies to promote financial stability. Second, the report appropriately links the short-term risks and market developments with the medium-term outlook and challenges. Third, in this context, the report has identified the critical and contemporary issues of financial asset price volatility as a source of instability and also the volatility of private capital flows to emerging markets for focused discussion. Fourth, the most valuable contribution of this report is the highlighting of regulatory and supervisory challenges as well as initiatives, policy choices, and implications based upon detailed case study analysis of asset price volatility during periods of financial stress. We encourage the staff to keep up this trend and make the GFSR as a very vital contribution to understanding contemporary issues of global financial stability in a dynamic setting.

We broadly concur with the assessment of market developments and the policy conclusions drawn in the report. Based on the reading of the report, we would only like to make a few comments and observations on some general features of the report and how the value of the work could be taken forward. In this spirit, we seek some clarifications on a few aspects covered in the report and offer some suggestions for further research.

While crisis prevention is a critical adjunct to multilateral surveillance, and hence the GFSR's assessment of global financial markets has the objective of identifying systemic weaknesses and fault lines that could lead to crises, the surveillance has essentially the broader objective of understanding the market behavior, guiding markets and removing distortions in them to the extent possible and thereby above all contributing to public policy choices for Fund membership on developing markets and improving its orderly and efficient functioning. The globalization of the financial markets and services, which is happening at a faster pace than the integration of the goods and other services markets, in fact, outpaced the regulatory responses resulting in regulatory gaps and also some significant gaps in market performance standards including significantly in advanced financial centers. The GFSR therefore, has a rightful role in bridging this gap. In this regard, we commend the present report's focus upon financial market linkages with overall systemic and macroeconomic stability. As the preface to the report does not reflect these aspects, and gives unduly larger weight to predicting crises and preventing crises, we suggest that the first paragraph of the preface to the report may be edited to appropriately reflect the objectives and content of the GFSR as part of multilateral and regional surveillance of financial markets by the Fund, and the relevance to public policy choices.

Second, while we appreciate the need for some additional features and new topics for research in the GFSR series, the staff should consider maintaining some continuity from report to report on certain essential elements. While analyzing market developments, it would be useful to recall the assessments made in the earlier report and crosscheck the actual experience with the assessments. This would help to strengthen the possibility of reinforcing some of the understandings and conclusions and correct any possible and significant miscalculations. In brief, an overview of major contours of policy issues as analyzed in the previous reports and their current status would add both to the skills in the Fund and to the value of the GFSR to readers

Third, we appreciate the expanded coverage of analysis of financial markets in its primary and secondary segments over the period and also their regional dimensions. However, in the present report, analysis of developments in the foreign exchange markets is somewhat less than adequate. In the context of the highly integrated global marketplace, the influence of foreign exchange market on the other segments of financial markets and vice versa cannot be ignored. We recognize that the exchange market developments have larger significance for monetary and external sector policies of member countries and hence a significant part of this discussion has shifted to the World Economic Outlook. However, in terms of understanding the market behavior and linkages, in particular in relation to the capital flows, interest rate, and bond and stock market developments and volatilities, it is absolutely necessary to view and analyze the foreign exchange markets to the extent that they are relevant to financial markets and bring out aspects relating to systemic stability in some more detail.

Fourth, as far as the short and medium-term outlook is concerned, a broader consistency particularly in signaling overall assessment of the current outlook is to be maintained between the twin reports of GFSR and the WEO. Based on the reading of the two reports, we get a feeling that the former report appears to present a slightly better and more optimistic outlook compared to the latter. Perhaps, the assessment of outlook based upon the market expectations and analysis differs from the projections based upon statistical analysis of past trends and current trends in the real sector activity. Giving due weights for these two dimensions, it would be desirable to give a somewhat less inconsistent view about the outlook for the global economy. Similarly, the policy choices before the authorities analyzed in the two reports should also strike a reasonable consistency as well as balance. For instance, the suggestions for exchange rate management and management of foreign exchange reserves for emerging market economies as provided in the WEO may have implications for private capital flows and bond and stock market developments. Policy choices and strategies in this regard cannot be viewed strictly in isolation. The real challenge is to reconcile and harmonize separate analysis of financial market developments and real sector developments, with provision of an integrated view on policy applications and choices before the country authorities in different regions. We invite the staff's comments.

While there is still the lingering effect of the bursting of the equity market bubble, adverse impacts on account of geopolitical developments and corporate governance scandals have somewhat become less severe at this point of time. It is indeed encouraging that the financial markets remained remarkably resilient during this period to some of these shocks. Some of the other positive features in the recent period are lower yields in the government bonds followed by an increase in the risk appetite for corporate and emerging market bonds. The compression in the yield spreads on the latter is indeed very striking. Apart from the monetary stimulus, an overall improvement in the investor confidence is also reflected in this trend. The report talks about the possibility of some steepening in yield curve with a rebound in economic activity. While we agree with the possibilities of higher risks to be borne by the market participants and their need for hedging their portfolios adequately to cover these risks, as the compression of yield spread in the case of emerging market bonds has been equally owing to the positive rebound of the economies particularly in the Latin American region and stronger macroeconomic policies and strengthening of the external sector, we feel that any rise in yield spread should not cause any serious or substantial increase in cost of financing for emerging markets or any major difficulties in their accessing primary markets. We also do not feel that the over shooting witnessed in the past two years will be repeated again in the near future.

Given the very high level of liquidity in the system, we do not feel that a higher preference for equity by investors should lead to any serious short fall of resources flow for investment in fixed-income securities. In general, we feel that compared to what is stated in GFSR, the current trends portend a relatively better future for the emerging bond markets and higher flow of funds through capital markets to support emerging markets' economic growth and poverty reduction.

We also do not share the view that higher flows into equity could hurt emerging markets. After all, the equity capital forms the basic and underlying security for raising of borrowed capital and without a consistent flow into equity market, bond market flows cannot be sustained in the medium term. The equity and bond market developments should be considered as complementary also and not entirely as competitive. In our view, the short-term uncertainties that posed a threat to financial market stability at the time of the last discussion have been considerably minimized. The other risk in the form of continued lackluster corporate profitability is undoubtedly a matter of concern. Given the risk faced by insurance and pension funds, this could hurt the equity market.

The policies for promoting financial stability have indeed been very carefully thought out and discussed in the report. In particular, strengthening of the regulatory and supervisory standards of financial activities of insurance and reinsurance companies are based upon well-researched material. In this context, containment of interest rate risk and development of tools for interest rate risk management has become very important. The risk management practices need to recognize the level of market development, information, and database and the skills of treasury managers. It is not necessary that only very sophisticated Value at Risk (VaR) models will help in containing risks. The authorities may exercise their flexibility in recommending risk management or containment tools ranging from the traditional gap analysis or Asset Liability Management (ALM) models to VaR models. However, the risk of excessive accumulation of positions or exposures in certain instruments or credits will need to be contained and the policy advice for supervisors is well placed.

The report has provided an in-depth and comprehensive analysis of assets price volatility and the case study analysis of periods of financial stress is indeed quite interesting. We will rate this as an excellent contribution in understanding markets and promoting stability. We would like to raise one or two questions in this regard and expect the staff to clarify and also undertake in future, further research. In the international capital markets, the additional risk is the exchange rate risk and the consequent or associated risk of sudden reversals in capital flows. While the volatility in asset prices should reflect in a theoretical sense, the economic fundamentals in terms of soundness of financial systems and policies in different regions, we have witnessed quite often erratic behavior of markets and volatilities, not explained by the fundamentals. As a result, even while the financial markets have become more resilient and discriminating between regions and countries, the observed co-cyclicality and correlations between major markets reflect more of herd behavior rather than flows based upon economic fundamentals. At the international level, it is necessary to pick up such wrong signals thrown up provided by the markets and provide a proper feed back to the market players and in a way guide them by correcting serious deviations and erratic tendencies. This should be an important part of global economic policy to be promoted as a public good at the level of multilateral institutions such as the Fund. In this context, the chapters on both Volatility of Asset Prices and Volatility of Private Capital Flows in Chapters III and IV are very valuable seminal contributions.

Containing volatility, including in asset prices, and maintaining an orderly functioning of financial markets, have assumed importance at the national level. This is evident from the fact that during most of the crises periods in the past, central banks were on the forefront providing liquidity and containing contagion and systemic risks. Many of the central banks including in the emerging markets have assumed responsibility for maintaining financial system stability, apart from the price stability. Probably, this should provide a base for evolving standards for financial stability and evolving best practices for financial policies as in the case of monetary policy transparency. As pointed out in the recent paper on financial soundness indicators, some of the central banks have already been publishing periodic financial stability reports. It would be worthwhile to collate and analyze such country experiences to help each country evolve policies toward financial stability.

One of the suggestions is that emerging market economies should pursue appropriate liability management measures to extend and smoothen their maturity burdens in the government securities market. The opportunity of restructuring debt at soft interest rates should be utilized by emerging economies saddled with high level of public debt. As many countries are restructuring and rolling over their debt, the estimation of Debt Laffer Curves may be considered to ascertain the appropriateness of such debt restructuring. Such debt restructuring as rightly focused, needs however to be supplemented by expenditure reform, broadening of tax bases and improving tax administration, strengthening governance, and reducing contingent liabilities.

While recommending policies for injection of liquidity by the authorities, it should be recognized that it could pose a moral hazard problem and too much of interference with the sound settlement systems for the sake of safety could prove to be excessive if the pricing mechanism is disturbed. The better way of strengthening settlement systems is to set very high standards for settlement practices and risk management systems including strengthening of capital base for participating financial intermediaries as in the case of credit and insurance markets. Central banks intervening in the securities market except for liquidity and monetary management through open market operations should be purely as the last resort under very extreme situations.

While analyzing asset price volatility one of the aspects worth pursuing would be to study in more detail, the impact of institutional turn over and the institutional behavior (for instance herding or short-termism as pointed out in the report) on asset price volatility. We appreciate the report's observation that these aspects are difficult to address in practice for a variety of reasons. However, some further research into the intensity of these influences in markets will provide lessons for developing healthy incentive structure and practices for institutional investors and professional fund managers.

The over all policy implications for emerging markets have been well brought out. It is useful to note in this regard that the Group of 20 has launched selected case studies in financial market and institutional developments in emerging market economies that could provide useful case study experience.

Overall, we welcome this report as a significant contribution to understanding of international financial markets and regional trends. The report also has provided excellent leads in giving directions to policy makers and financial market regulators. As a document, this should be projected as a study that also provides valuable lessons to the market intermediaries enabling them to manage their risks in an orderly fashion. We have made a few suggestions for consideration in clarifying some aspects and making further improvements.

Mr. Rutayisire submitted the following statement:

We thank the staff for the Global Financial Stability Report. We found the description and analysis of the financial system developments, the analysis of the volatility of asset prices and that of private capital flows to emerging markets very informative and thorough. We also found the Report well focused on issues that are helpful to our multilateral surveillance exercise.

Overall, we note the favorable performance of financial markets in recent months. Household and corporate balance sheets have continued to improve gradually while corporate default levels have decreased. Amid uncertainties about the direction of future changes in corporate earnings, corporations in advanced economies have improved their financial positions through restructuring and financial consolidation. These positive developments have translated into favorable trends in the mature financial markets with ample liquidity. Equities markets rally have reinforced insurers and pension funds in those markets, while emerging market countries have increased their bond issuance. The latter have also benefited from low interest rate policies in industrial countries and attracted investors in quest of better returns. However, attention should be paid to the downside risks that remain. Investors might move out from equities markets should corporate earnings not meet expectations stemming from positive economic prospects, this could pose a serious risk to market confidence and increase the likelihood of equity sell-off, which in turn could threaten the recovery that is beginning to emerge. Furthermore, confirmation of a rise in interest rates in major financial markets could halt the current trend of mortgage refinancing and bring down the cushion that has existed throughout the economic slowdown by consumers. In addition, mortgage agencies in advanced economies would increase further their sizeable hedging activities, putting the liquidity of fixed-income and derivatives markets under pressure. This would also have an adverse impact on emerging market economies.

We are of the view that current favorable trend should be sustained through appropriate monetary policy supportive of consumer and business confidence in the advanced economies, and regulatory and supervisory mechanisms aimed at reducing reckless activities and herding behavior without amplifying volatility into financial instability. The case studies of crises described in the annex of Chapter III make full evidence of the need to contain the effect of amplifiers. In light of the downside risks to the global outlook as noted in the upcoming WEO, and given the unbalanced nature of the current economic recovery—both threatening the stability of financial markets—continued effort in designing schemes to alleviate the amplifiers is mostly welcome.

Developments in the emerging markets and developing countries also leave scope for adroitness in policy adoption as well as in structural and institutional reforms. The measures taken by emerging market countries to improve the structure of their liabilities and to self insure against the volatility of external flows, including the development of more efficient and liquid local and regional markets, are in the right direction. However, the current trend that makes emerging countries as a whole net exporters of capital needs to be reversed—in an orderly manner—to ensure their access to the often highly needed additional resources while reducing the risks of adverse reversals of capital flows.

On the question of whether financial asset price volatility is a source of instability, empirical evidence shows a clear correlation between volatility of financial markets and economic recessions. Although investor uncertainty and perceptions carry weight as high market volatility occurs also without a noticeable change in macroeconomic factors, it would be useful to deepen the understanding of these links by paying attention to the direction and degree of causality, if any, in the relationship between market volatility and the state of the economy, and vice-versa. In this regards, research beyond concordance statistics and correlation coefficients would be instructive.

As noted above, the rally in the longer-term equity markets was a positive development but vulnerabilities in advanced markets highlighted in the recent GFSRs remain. It is important that actions be taken to alleviate these risks given the systemic and global importance of those markets. The heavy dependence of equity markets recovery on corporate earnings' ability to meet expectations poses a threat to financial stability. Likewise, the negative spreads between insurers' assets and their guaranteed liability returns and the funding gaps faced by pension funds—albeit an improvement of their respective balance sheets—are subject of concerns, given the relative importance of these sectors in mature financial markets. Finally, in the US the systemic importance of mortgage market and the increased sensitivity of household wealth to the real estate market (Table 3.2) call for solutions to curb the interest rate amplifier effects of their common strategies to hedge the prepayment risk in mortgage-backed securities.

The historically high level of household indebtedness in some countries is cushioned by liquidity build-up as evidenced by accumulating deposits. However, in case of an increase in interest rates, the household situation will worsen. This would also widen corporate credit spreads of a sector already suffering from high leverage and restrict its access to new funds. As regards government-sponsored housing enterprises (GSEs) that raise financial stability concerns, we would like to know the extent to which the perception of implicit government guarantee and the belief that they are "too big to fail" create moral hazard, if any, among market participants. We also wonder if a "disaggregation" of the agencies' sizeable portfolios - and thus their large hedging operations- through the introduction of competition into the sector is an option that the authorities in advanced economies would consider to reduce its systemic risks and thereby reduce its ability to generate financial instability. Finally, the lack of transparency and corporate governance problems of the GSEs also carry weight in the risks of market correction or adverse reaction, and outline the need to address regulatory and supervisory issues along with capital adequacy requirements.

Concerning the amplifying factors of volatility such as the dynamic hedging strategies of the large GSEs, banks, other agencies and their counterparties that potentially augment interest rate movements, the lessons drawn from the case studies in the annex of Chapter III are instructive and should be used to address the amplifiers problem if interest rate volatility (Figure 2.11) were to accelerate. In this regard, we see two main avenues, often complementary, that can be used to design well-suited mechanisms by the official sector: on the one hand, the monetary authorities should stand ready to provide the necessary liquidity – directly or indirectly- to the financial system at the onset of financial turmoil. On the other hand, financial institution regulators should be able to use volatility circuit breakers that have been successful in past crises, such as price or rate limits, position restrictions and trading freeze, should asset price volatility turn into instability.

More generally, national regulators and standard setters in advanced countries and emerging market economies should design stability mechanisms specific to each type of markets. They should also engage forcefully in cross-border and cross-market cooperation to identify incipient risks as increased globalization and the ability of market participants to change their investment decision criteria make cross-border and cross-market contagion more likely.

The activities of credit derivatives in advanced markets are unreasonably concentrated among a few large financial institutions. Standard setters need to give closer attention to the matter by streamlining the legal and regulatory framework of these activities with the view of reducing concentration, deepening these markets, and alleviating the systemic risks associated with the collapse of a given participant.

In many advanced economies, although household debt rose slightly in the first months of 2003, the consumer borrowing market remains little concentrated, and the household sector as well as the corporate sector have stronger preferences for more liquid and less risky assets. While earnings improvements are expected in 2003, corporate uncertainty remains, as reflected in the widening of dispersion in the earnings growth projections. Bank performance has improved owing to cost-saving measures, and the capitalization levels are strong. The favorable situation should be sustained by accommodative policies to ensure a stronger recovery of European economies.

The banking sector in some industrial countries remains a daunting concern for financial stability. It is encouraging to note the reduction in non-performing loans during the first half of this year in some of those countries but more efforts need to be done to bring their banks’ asset quality to sustainable levels. The adoption of corporate governance procedures consistent with the Basel Committee guidelines would be helpful.

While mature markets should seek to break amplifier effects of unbalanced self-insurance strategies, emerging markets should aim to adopt measures to reduce the impact of adverse exogenous shocks from international markets. Improved economic fundamentals in many emerging markets coupled with favorable policies and bond yields in major financial markets have attracted large amounts of funds into emerging bond markets during the first half of the year, with the noticeable exception of Asia. The reversal of capital flows in emerging markets in the mid-1990s remind of the need for these markets to address the vulnerabilities they face, namely the bond overvaluation, the reduced investor discrimination, a renewed investor appetite for equities and an increase in yields in the major financial centers as hinted by the mid-year developments. The increased correlations between mature bond markets and emerging markets clearly indicate the risk of sell-off in emerging market securities on the part of the non-discriminatory investors would the situation in developed centers sharply improves.

In contrast to bonds, equity issuance and syndicated lending in emerging markets remain insignificant. More worrisome is the weakening of FDI flows to these markets and developing countries. Although volatility is likely to become a trait of the increasingly integrated international system, it is important for these countries, particularly in Africa and Latin America, smooth out the boom-burst pattern and volatility of capital movements and ensure stable and sufficient capital flows to their markets. This should also be achieved by reducing the perceived risks stemming from unpredictable rules for investment and weak legal framework, and promoting local securities markets. The quality of the investment environment and financial institutions remains a key to this end.

As regards the banking sector, Box 2.3 underscores the importance of effective regulation and supervision for the health of financial intermediation. Compliance with the Basel Core Principles should be reminded in all instances to national supervisors in emerging market economies and other developing countries. In this regard, the banking systems in Latin America, the Middle East, and Africa continue to bear structural deficiencies reflected in the financial soundness indicators and credit quality measures. For these countries, banking sector restructuring and reforms are mostly desirable. In addition, technical assistance is highly needed in Africa where data limitations makes it difficult to compile and interpret financial soundness indicators. Finally, we concur with the insights and recommendations of Annex I in Chapter II on the need to harmonize financial sector regulations as well as accounting standards and practices, and advance cross-border supervisory cooperation and information sharing so as to improve the soundness of financial institutions.

Finally, it is encouraging to note the progress being achieved by emerging market economies and developing countries to reduce the volatile nature of their access to financial markets. These positive steps include greater transparency through the increasing subscription to the SDDS, participation to FSAP reviews and adoption of ROSCs. This increased transparency should help develop and deepen local securities markets by providing information to investors. Finally, regarding the capital account liberalization, it is important to bear in mind the lessons drawn from financial crises in emerging markets during the 1990s and to avoid a universal approach by using strategies that pay attention to the regional and country disparities and the level of development.

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

We thank the staff for a well-written report, which provides a balanced and comprehensive coverage of developments and issues in global financial markets, dealing both with mature and developing countries, with an appropriate emphasis on systemically important economies. In its two years of existence the GFSR has already proved itself an important component of the Fund's multilateral surveillance and complement to the WEO. It is unfortunate, however, that the report was circulated late and the Board date did not respect the minimum three-week circulation period.

We are pleased to note that since the last GFSR corporate and bank balance sheets in mature markets have generally improved, while household balance sheets have not deteriorated. This welcome turn of events has been driven to a great extent by a loosening of monetary policy and by a strengthening of equity markets. The staff persuasively argues that a major downside risk has to do with corporations not being able to deliver on the profits that would make the recent rebound in equity markets sustainable. In that regard, one can only hope that policies in mature markets will continue to be accommodative. The report also points out other important risks and issues to which policy makers in industrial countries have to remain attentive. Amongst them, the situation of large U.S. government-sponsored housing financing agencies, the difficulties that the insurance sector continues to face, and the under-funding of defined-benefits corporate pension funds.

With regard to emerging markets, the report shows that since 1999 this group of countries has become a net exporter of capital, which is very unfortunate as capital is flowing from countries where it is scarce and more productive to countries where it is abundant and, thereby, less productive. This may also be indicative that, for the emerging markets group as a whole, the correction of macroeconomic imbalances has probably gone too far. In a future issue of the GFSR, the staff might wish to look at this issue in greater detail, explicitly identifying the roles played by fiscal and monetary policy, as well as by imperfections in global financial markets.

In several parts of the report the staff suggests that emerging bond markets are susceptible to a correction, and that since late 2002 there has been spread compression as a result of reduced investor discrimination. While it is obviously true that all bond markets are vulnerable to correction, a more important contribution would have been identifying when such a correction could happen, what would be its likely size and implications, and what might be an appropriate policy response. With regard to reduced investor discrimination, we wonder whether events in the recent past differ from previous episodes. Are markets becoming less discriminating, and, if so, why? Our intuition leads us to believe that spread compression is a regular phenomenon when spreads are going down, whereas spreads tend to take divergent paths during downturns. If in fact there is herding behavior in the good times, could the staff speculate on the technical reasons why this happens, and if it is deemed to be a problem, could the staff advance any suggestions as to how to deal with it? We look forward to the next issue of the GFSR, which will discuss in detail aspects of the institutional investor base for emerging market securities.

Recently, FDI flows to emerging markets have lost momentum. According to the staff, this partly reflects higher perceived risks, including unanticipated changes in regulations and contractual arrangements, but we have some difficulty in understanding how something that has little variation—risks of changes in contractual arrangements—can explain volatility of FDI. To be sure, the level of FDI to emerging markets would be much higher if property rights were better upheld. However, trying to explain the recent decline in FDI on issues of property rights can only make sense if protection of those rights has recently deteriorated for emerging markets as a group. If there is no evidence of a general deterioration of support for property rights in the group of emerging markets, then something else ought to explain the recent decline in FDI. Several studies have suggested that re-labeling of capital flows is a common practice, so a distinct possibility is that the recent decline in FDI does not have much to do with contractual arrangements but, instead, it is the reflection of the renewed vigor of portfolio flows. Another possibility for lower FDI flows to emerging markets refers to the intense balance sheet "repairing" that is taking place in mature markets, in particular in the utility sector, affecting this once very active FDI conduit.

Turning to the banking system, we would like to reiterate a suggestion made by us in previous discussions of the GFSR that the staff could provide value added to the analysis of banking issues in emerging markets by discussing efficiency, market discipline, the workings of the credit channel, among others topics.

We found Chapter IV on volatility of financial flows to developing countries quite useful. The staff shows that volatility has increased in time and, more importantly, that primary market closures have become more linked to developments in mature markets. It is for this type of reason that Fund surveillance of mature markets is at least as important as its surveillance of emerging markets and the present report represents a valuable contribution in that direction. Unfortunately, experience has shown that the Fund has little leverage over policy decisions of developed countries, a problem that becomes even more relevant given that, with time, the effects on emerging markets of policies followed by mature markets has increased.

On the issue of self-insurance, the report appears to be very supportive of the fact that there has been a significant build-up of foreign reserves on the part of emerging markets. We are not fully convinced with this line of reasoning, particularly because the reserve build-up has coincided with a general move toward floating exchange rate regimes. While a high level of reserves is a prerequisite to sustaining a pegged exchange rate, it appears to be a rather inefficient way of allocating savings and financial resources in the context of floating exchange rate regimes. With more appropriate levels of financial support available from the Fund and better conceived precautionary arrangements to confront situations of crisis, emerging markets should be able to hold lower levels of reserves and make better use of their financial resources.

Mr. Usman submitted the following statement:

We thank the staff for a well-written report on developments in global financial markets over the last six months. This report adequately captures improved global financial conditions in both mature and emerging market economies, while it reiterates that significant risks still remain. As previous GFSRs expressed cautious optimism pertaining to the global financial environment, and that optimism did not always translate into improved financial market conditions, we urge that continued vigilance be exercised by policy makers during the period ahead. This report also includes detailed analysis on financial assets price volatility, and volatility of capital flows to emerging market economies. We welcome these interesting and analytical reports as they enhance our understanding of financial market vulnerability in mature and emerging market economies.

This report echoes previous reports that notwithstanding weak growth performance in mature economies, which was, inter alia, increased by a sharp decline of equity markets, governance problems in the corporate sector and geopolitical uncertainties, the global financial environment still remained fairly resilient. The authorities in mature economies appropriately relaxed monetary policy and interest rates are currently at record low levels. This policy stance contributed to restoring financial stability in mature economies, and made a major contribution to lower interest spreads in emerging economies. The very low interest rates, combined with historically low inflation in mature economies, increased disinflationary concerns in some countries. While this risk is considered to be low, a word of caution would be in order, as recent experience suggests that disinflation is difficult to brake, once it has taken root in an economy.

Mature equity markets rebounded from its previous lows during the last six months, and corporate and financial institutions' balance sheets also improved significantly. These improvements are welcome, as they contribute to the resilience of these sectors to withstand vulnerabilities. Notwithstanding these improvements, we have yet to observe a concomitant improvement in corporate earnings. In this connection, the staff rightly observes that continued absence of improved corporate earnings could pose a risk to the sustainability of the recent improvement of mature equity markets. A reemergence of volatility in the mature equity markets could undermine confidence both in equity markets and in the real economy.

We broadly concur with the staff's analysis that policymakers in mature economies should, in the period ahead, continue to strengthen corporate governance to restore investor confidence, as well as carefully monitor U.S. mortgage agencies, which because of their size, could pose a considerable systemic risk to the global financial environment. There should also be increasing supervision of insurance and re-insurance companies. The Fund should also intensify its surveillance of systemically important countries, an issue that the Board discussed most recently. In this regard, it would be important to highlight the impact that industrial country policies might have on developing countries.

The improved global financial climate, coupled with sound macroeconomic policies and financial reforms, and improved credit ratings, contributed to improved financial market conditions in emerging market economies. Many emerging markets successfully accessed global financial markets during the last six months, and bond issuance almost doubled from the low levels of mid-2002. Bonds were successfully issued by many Latin American countries including Brazil, Mexico, and in our constituency, South Africa. Indeed, South Africa used the proceeds of a 10-year bond issue to close out its net open forward position, thereby reducing short-term vulnerability.

Emerging market economies, in particular, Brazil, Mexico, and Poland also utilized the more favorable financial market conditions to strengthen their liability management operations by conducting debt swaps, replacing Brady bonds, and in the process extended the term structure of debt obligations. The longer-term structure of obligations will make these countries less vulnerable to short term volatility. The favorable conditions, coupled by improved risk appetite by institutional investors, and stronger polices in emerging market economies, also contributed to a surge in sales of bonds in the secondary market, which contributed to a significant decline in the interest spreads of emerging market bonds in general. Many emerging market economies, including South Africa, also included CACs in their bond contracts, to strengthen their relations with creditors.

While bond issuance during the last six months increased, FDI to emerging market economies, as well as all other developing countries continued its downward trend since 2000. This disappointing trend could be attributed to the risk-averse approach by investors in the real economy. While FDI to Asia remained stable over the last number of years, it remained disappointingly low to Africa. Having observed this trend, many countries in our constituency are implementing reforms to ensure an environment more conducive to FDI.

We welcome the inclusion of the assessment of the banking sector in emerging market economies by region, including that of Africa in the report.

The staff report notes that data problems in Africa make proper assessment of financial soundness indicators difficult, and this assessment highlights the need for improvement by our member countries. Where sufficient data was available, the staff concluded that banking sector indicators were generally sound.

Concerning policy commitments by emerging economies, the staff report notes that many countries increased their level of self-insurance, improved liability management, increased capital account openness, strengthened financial institutions, and enhanced prudential supervision over the last six months. All emerging and developing countries should continue along these lines.

Mr. Duquesne submitted the following statement:

We thank the staff for a comprehensive, very informative, and candid report. The juxtaposition of a discussion on global financial developments with the WEO/WEMD remains fruitful. We regret, however, that little space is left to exchange rate developments in the present report. We particularly appreciate the introduction of a section on policy recommendations: it is important that the GFSR provide clear guidance to policymakers to identify systemic risks and prevent them from materializing. We agree with the staff's general assessment on the improvement of the global balance of risks. The market sentiment is likely driven by lower geopolitical concerns and indications of a gradual recovery. We only have a few remarks on the staff's diagnosis and conclusions.

We note that the report focuses mainly on US financial developments. Does the staff justify this by the high correlation between mature financial markets? Regarding the two main risks identified in the report, we believe that a weak corporate profitability in the US could have more severe consequences than a further increase in long-term interest rates. The report might even prove to be a bit optimistic regarding the former ("not negligible, but does not appear to be very high").

In our view, the pickup in profitability for the first semester of 2003 does not necessarily prefigure a short-term recovery. On the demand side, households remain highly indebted. On the supply side, better profitability is largely owing to productivity gains and there is no clear sign of a rebound in investments. More generally, geopolitical risks should not be minimized, as well as sustained high-level oil prices. Overall, we think there is a probability that market expectations might be disappointed.

The risk of a prolonged increase in long-term interest rates should not be overemphasized. Interest rates were previously at historically low levels and technical factors can partly explain the current increase (bond sales by the

GSEs for instance). Furthermore, the movement could lose momentum, as the shift to equities will crucially depend on future corporate profitability.

We welcome the policy implications identified in the report. The staff seems a little hesitant on its first recommendation (corporate governance must be strengthened but at the same time there should not be too many constraints on investment opportunities): we believe that at the present juncture, the emphasis should be put even more clearly on stronger corporate governance. We agree that the capitalization of the U.S. mortgage agencies should be closely monitored, as well as their risk management (dynamic hedging) and their potential pro-cyclical effects on financial markets, which are well described in the report.

The chapter on asset price volatility is most welcome. It reflects a widely shared preoccupation within the official financial community. The study is very interesting but ambitious and therefore deserves to be pursued. It would be valuable to establish a clear distinction between volatility in times of financial crises from volatility owing to structural factors related to some specific financial products or to market functioning features (including the role of rating agencies in market dynamics). We encourage the staff to exploit the entire range of expertise of central banks in this field.

Chapter IV well highlights the diversity and the complexity of capital flows toward emerging economies. Regarding FDI, there is no evidence that the ongoing downward trend toward most emerging economies is likely to stop. This is worrisome and we expect the forthcoming Board seminar on FDI to provide some elements of reflection to refine our assessment. Indeed, considering the "feast or famine" dynamic developed in the last GFSR report, FDI flows seem clearly beneficial in terms of stability. We agree with the report's analysis that emerging market bonds are vulnerable to a correction caused by a further increase of bond yields in mature economies: investors' behavior would then prove to be driven more by asset class considerations than by country-specific factors. It is likely that emerging countries would benefit from relying to a greater extent on local sources of growth. In particular, strong and sound local securities markets are a means to reducing dependence on foreign currencies. However, it will probably not be sufficient in itself to overcome the "feast or famine" dynamic.

Ms. Indrawati submitted the following statement:

We would like to thank the staff for the wide-ranging report on the global financial environment. We welcome the general discussion on financial market developments as well as the specific chapters on the volatility of asset prices and private capital flows to emerging markets. However, the voluminous nature of the sections that focus on updates of recent developments tends to overwhelm those portions that discuss the policy implications derived from identified risks. The latter, in our view, could be strengthened somewhat. The areas of our concern are highlighted below.

This GFSR has a largely optimistic tone, highlighting in most part favorable developments. Financial markets are assessed to have remained resilient, there are better prospects for recovery across financial and corporate sectors, and the risks presented in the previous GFSR have subsided.

The staff has highlighted areas in major financial centers that require further reforms to strengthen market foundations, and we fully agree with these points. Nevertheless, in our view, these issues and major risks in the developed economies still appear to be understated or without clear views expressed by the staff. Our concerns include the risks posed by the U.S. government-sponsored housing enterprises (GSEs) which, faced with rising bond yields, could cause knock-on effects on the bond market; the systemic stability of the insurance sector owing to the current low interest rate environment; and the uncertainties surrounding the use of credit derivatives. Given the size and importance of such sectors in the financial system, in-depth analysis on the impact of shocks to the stability of these sectors would be welcome.

In addition, expectations of stronger earnings growth have begun to cause a swing in the flow of funds to mature markets. This development has made bond markets in emerging economies vulnerable. Given the high level of portfolio managers' exposure to the emerging markets, we share the view that the swing of funds could hurt these markets. Further analysis on the extent to which such a market correction would translate to financial system instability would have been useful. The possible policy options to address this issue should also be discussed.

With the anticipated stronger turnaround in financial market performance, we also note that steps taken to strengthen prudential regulation, corporate governance and supervision of financial activities may not be in tandem with a renewed upsurge in market activity. As such, it is essential that authorities accelerate efforts to ensure financial system stability. The market mechanism alone is not sufficient to address this issue. The staff's comments would be welcome.

With regard to the presentation of regional financial market developments, we think that there is some asymmetry between the discussion on developed and developing economies. The broadly positive tone in the sections on mature markets is not extended to emerging markets, even when it is warranted. In our view, the comments on Asian markets in particular are more negative than it should be. This is reflected in the discussion on capital flows to emerging markets, as we point out below.

We found this chapter very useful in gaining a better understanding of the basic concept of financial system instability, the amplifying factors, responses from market and official sector, and the policy lessons that can be drawn from the past periods of financial distress. We support the idea to include the analysis of other aspects of volatility and the policy reform agenda in future editions of the GFSR.

The report notes that financial volatility has been increasing over the recent years, and some measures have been taken to limit its effects. Nevertheless, we note that there are still many issues to be addressed that have been left inconclusive. The four policy factors are serious and worrying but the recommendations highlighted by the staff each leave some questions unanswered. For example, the non-uniformity of regulation standards in investment banks and the balance that needs to be struck in strengthening corporate governance remain areas of concern.

We welcome the chapter on the volatility of private capital flows to emerging markets and concur with the staff on the relevance of this chapter in drawing policy lessons to help strengthen the resilience of financial system, particularly in emerging market countries.

Aside from sound macroeconomic policies, FDI flows depend on the pull factors such as political stability, predictable investment rules, sound legal framework, and the availability of the skilled labor and infrastructure. We think that it should be noted in the report that Asian countries have these fundamentals very much in place or are rapidly putting them in place, as evidenced by the relatively quick and strong turnaround in the crisis-hit countries. Reforms and restructuring while still going on, have already resulted in stronger institutions and improved business environment.

We note that earlier in the report the staff highlights declining FDI flows to several Asian countries, with the exception of China, which has received the bulk of recent inflows of investment. As has been pointed out often, the FDI flows to individual countries are not a zero-sum game, but there are significant positive spillovers into the rest of the region. We are confident that given the strong growth prospects in this “bright spot” of the world economy, FDI flows will increase.

We share the view that the volatility of capital flows during the 1990s is likely to be a feature of the increasing integrated international financial system. The policy adopted by most emerging countries of increasing their holdings of international reserves has indeed provided a degree of self-insurance and confidence against a sudden reversal of capital flows. In addition, the development of regional capital markets will also help reduce volatility and promote stability. For example, the setting up of the Asian Bond Fund is a step in this direction. The development of regional financial markets would help reduce the impact of external shocks on these markets.

Mr. Brooke and Ms. Stuart submitted the following statement:

The quality of the GFSR has continued to improve and though now perhaps a little bit on the long side, we welcome the depth of analysis and the greater focus on key risks.

We broadly share the views expressed in the latest Report. In particular, we agree that financial stability risks have diminished somewhat since the spring, reflecting reduced uncertainty about the macroeconomic outlook, the recent gains in equity markets and the beneficial effects of low interest rates, which have helped firms to address some of their balance sheet weaknesses and underpinned household consumption. Despite a large number of adverse shocks over the past two years, the international financial system has remained resilient. Consequently, we continue to believe that the central case scenario is for a gradual global economic recovery together with manageable risks to the international financial system.

It is also encouraging that a substantial adjustment in exchange rates has taken place in an orderly manner; this should help to reduce global current account imbalances. If global growth picks up as expected, the risks to financial stability are likely to be reduced further. That being said, the strength of the global recovery remains a key uncertainty. Given the strong relationship between macroeconomic risks and financial stability risks, we agree with Mr. Callaghan and Mr. Reddell that the overview section of the GFSR would benefit from a closer mapping with the discussion of risks in the WEO. We feel that Mr. Bennett's call for a closer examination of credit risk conditions is related to this point.

Clearly, the risks to the global recovery are closely linked to weaker-than-expected corporate profitability. Here, we note that stock market valuations in a number of countries are still high compared to some historical measures, growth has continued to disappoint in Europe and SMEs in many industrial countries may be vulnerable because their profits have been low for sometime.

For the industrial countries we welcome the increased focus of the Report on sectoral balance sheets. The analysis of US mortgage markets is timely. It emphasizes the need for the Government Sponsored Agencies to be regulated in a transparent manner and for there to be a level playing field in this sector. The recent experience has also provided a test of swaps and options market liquidity. As an indication of market distress, we would be interested to hear from the staff whether the Agencies were unable to meet any of their hedging requirements during this period at an acceptable price? Going forward we also wonder whether banks and other mortgage providers might be able to compete more effectively in this market if they issued more callable debt?

In terms of the corporate and banking sectors, we tend to agree with Ms. Jacklin and Mr. Baukol that the Report could have included a little more on Europe and Japan and a little less on the United States. For example, it would be interesting to know the extent to which larger companies in Europe may now have begun to repair balance sheets.

We continue to feel that the risks to the Japanese financial system are significant. Here, the GFSR could usefully provide a few references to the recently completed Japanese Article IV consultation and FSSA reports, to ensure that the tone of the Fund's messages to financial markets and the general public are consistent. In the section on European financial sectors, it would be helpful to explain a little more of the diversity in performance across countries as well as differentiating between the challenges faced by life and non-life insurers.

Emerging market economies (EMEs) have clearly benefited from the increase in investors' risk appetite and the search for higher yields. We strongly agree with the staff that these countries should take advantage of the currently favorable market conditions to lengthen debt maturities and retire expensive debt. We welcome the fact that many EMEs are actively pursuing such objectives. We also take note of the warnings in the WEO that public sector debt in many countries remains well above the level that would be sustainable if they were unable to improve on historical growth and budgetary performances. In these cases there remains a pressing need to address medium-term vulnerabilities.

We agree with the staff that the increase in international investors' risk appetite may lead to reduced investor discrimination. Here, the GFSR highlights the increase in cross-correlations between the movements of EME securities. While we accept this as a useful starting point for the analysis, we would encourage the staff to monitor developments in this area closely. For example, an increase in cross-correlations could also reflect a genuine convergence of macroeconomic fundamentals.

We agree with the concern expressed by other Directors about the low level of FDI to EMEs and low-income Countries. This underscores the need for continued improvements in macroeconomic frameworks, regulatory and judicial certainty, and enhanced transparency. We would be interested in the staff's views on the extent to which risks of unanticipated regulation changes are inhibiting a recovery in FDI.

The Chapter on financial asset price volatility usefully emphasizes the lessons from past periods of financial stress and we strongly agree with the policy conclusions that limiting the effects of volatility involves strengthening risk management practices; aligning incentives; enhancing transparency and improving market infrastructure and discipline. A particular lesson of the 1998 crises was the need to improve transparency and we strongly support all of the suggested areas for further improvement.

The Chapter on the volatility of private capital to emerging markets is a useful contribution to an under-analyzed area. The finding that the volatility of flows in the 1990s was little different from previous epochs is an interesting one. We agree with the staff's emphasis on the importance of self-insurance measures—including strengthening financial systems, adapting exchange rate arrangements; developing local securities markets and enhancing transparency (through the use of the SDDS, ROSCs, and FSAPs).

Finally, we would like to note that during the period since the previous GFSR the UK has also issued a U.S. dollar-denominated bond that incorporated the new Collective Action Clauses endorsed by the G10 working party. For completeness, it might be helpful to add a reference to this in the Box on page 56.

Extending her remarks, Ms. Indrawati expressed regret that the three week minimum circulation period for policy-related staff papers had been violated, which had narrowed the time for Directors to formulate and express views. With regard to the substance of the *GFSR*, the staff's tone seemed to be that of a "cheerleader" when assessing mature economies but a "whistleblower" when assessing emerging market economies. The candid discussion of many of the ASEAN economies should be balanced in tone with other sections of the report.

With regard to Indonesia, the staff had asserted on page 61 of the *GFSR* that the capital base was persistently weak and that there was high credit risk in the banking system, Ms. Indrawati continued. This assessment was not consistent with the most recent Ninth Review of Indonesia under the Extended Fund Facility, which had indicated that Indonesian banking soundness had continued to improve. It was recognized that weaknesses remained, but it was inaccurate to suggest that the capital base was still weak, given that the level of the capital asset ratio was recently as high as 22–24 percent, well beyond the 8 percent minimum regulatory level. Credit risk had also declined, with the ratio of nonperforming loans falling to 5 to 8 percent. The negative assessment in the *GFSR* would impede the IMF-supported program in Indonesia, which was focused on bank restructuring. Accordingly, the staff should review the statement carefully, and consider a correction based on the most recent statistics.

Mr. Shaalan supported Ms. Indrawati's concern about the breach of Board work procedures on the three-week minimum circulation period for staff papers. The staff paper for consideration at the current Board meeting was dated August 11, 2003, and had been circulated to Executive Directors on August 12, which was only ten days before the scheduled Board discussion. It was ironic that on the same day that the draft *GFSR* had been issued to the Board, the Secretary had issued a compendium of Executive Board procedures stating that a minimum circulation period of three weeks was required for all policy papers. In January 2003 the Agenda and Procedures Committee had also detailed the rules for breaching the minimum three-week circulation period, specifying that in such cases the Secretary would provide a brief explanation of the delay in issuing the paper, and the rationale for the urgency of proceeding with the discussion. None of this had been done in the current case, and it was unfortunate that decisions agreed to by the Board had not been carried out. On a related issue, the period following the August recess and preceding the Annual Meetings was one in which many policy papers were scheduled for consideration by the Board. Accordingly, an agreement had been reached that non-urgent Article IV consultation staff reports would not be discussed during this period. However, 19 country items had been scheduled for discussion during this period in the current year; 11 were staff reports on Article IV consultations, and the others were mainly staff papers on items pertaining to use of Fund resources. In addition, there were eight policy papers for consideration. As many Directors had frequently stated, a serious scheduling problem existed for the Board, and this should be controlled through corrective measures taken by management to safeguard the efficiency and workings of the institution.

Mr. Portugal supported the statements of Ms. Indrawati and Mr. Shaalan about the circulation period, noting that in the case of late country-related staff reports, Executive Directors were obliged to request a waiver of the minimum circulation period. The current procedure called for information to be provided if the minimum circulation period for policy papers was breached, but apparently this system was not working, and thus it would be more appropriate if management required the same waivers rules to apply to both country and policy items. With regard to the substance of the *GFSR*, it was a balanced and comprehensive report, with full coverage of developments and issues in the global financial markets, and in just two years it had proved itself as an important and high-quality component of multilateral surveillance.

Mr. Daïri supported Ms. Indrawati and Messrs. Shaalan and Portugal on the circulation of policy-related staff papers.

Mr. Yagi did not object to what had been said about the circulation process, but pointed out that the *Global Financial Stability Report* addressed developments in the financial markets, which tended to change quickly. The current *GFSR* was based on information available up to August 4, 2003 while the *World Economic Outlook (WEO)* included information available only up to mid- or late July. Even during that short interval there had been some significant developments in financial markets that the *WEO* had seemed to miss. Accordingly, at least in the case of the financial stability report, Directors should be more flexible about the circulation period guidelines. If the draft *GFSR* were to be circulated three weeks in advance of the Board meeting, the paper might need to be updated and extensively revised before publication.

Mr. Andersen, while agreeing that there was scope to improve the process of circulating staff papers, pointed out that, with regard to the timing of Board consideration of Article IV consultations, there were frequently reasons for scheduling some items during late August and September. As discussed previously by the Board, it was important for the Fund's surveillance to have an impact on its members, and some of the Article IV consultation items had been deliberately scheduled to coincide with the period when political discussions on the budget were occurring. Thus, it was regrettable that important policy-related staff papers had breached circulation requirements, but some scheduling flexibility should be maintained.

The Acting Secretary (Mr. Linde) commented that the draft *GFSR* had been issued only two weeks before the Board meeting because the staff had a strong conviction that it was important to incorporate the most recent data. Accordingly, the *GFSR* was the only exception to the guideline that policy papers should be issued to Directors at least three weeks before the scheduled Board meeting. With respect to the guideline against the Board's consideration of country items during the period leading up to the Annual Meetings, the Secretary's Department did not consider that this should be a rigid rule, as some members needed the Board to consider their Article IV consultations before the IMFC meetings. The Secretary's Department generally allowed some flexibility in such cases, although exceptions were kept to a minimum.

The Director of the International Capital Markets Department (Mr. Häusler) noted that he had little to add to the Acting Secretary's comments on the reason for the two-week circulation period. In the past, *Global Financial Stability Reports* had always been circulated only two weeks before the scheduled Board discussion. With regard to the current *GFSR*, there had been a regrettable one-day slippage in the circulation period, owing to efforts to incorporate comments from management.

Ms. Vtyurina suggested that one way to reconcile Directors' preference to receive the draft *GFSR* at least three weeks before the scheduled Board discussion with the staff's wish to include the most recent information would be to separate the report so that the specialized chapters were circulated earlier than the more time-sensitive ones. Another approach would be to issue the entire volume three weeks in advance, but then to distribute a supplement with the most recent information, as was already the practice in country-related cases.

The Chairman noted that Directors' concerns regarding the circulation period would be given serious consideration, and thanked Ms. Vyturina for her constructive suggestions, which would be taken into account when the topic was further considered. The Secretary's Department should review the staff's compliance with the established policy on work procedures, and management would investigate ways to improve the circulation process.

Mr. Shaalan thanked the Chairman for his concern.

Mr. Szczuka made the following additional statement:

> I would like to briefly comment on two issues that we failed to mention in our preliminary statement, which in part reflects the heavy pressure resulting from the busy Board agenda. First, in Annex II of the *GFSR*, on convergence in Central Europe, the situation described in the report has prompted grave concerns for Mr. Mozhin and Ms. Vtyurina. I found this annex interesting, and I fully share one of its main conclusions: that the fiscal consolidation in Central Europe should proceed regardless of the new entry date. However, the overall tone of this annex may be too pessimistic and it is not entirely supported by the

presented data, and perhaps this reflects the staff's incentive to be the whistleblower, as mentioned by Ms. Indrawati. I fail to see in the graphs, for example, a marked increase in the risk premia for most of the countries, and I also have some problems with the way the risk premia are being assessed. For example, the high yields on local currency instruments may simply reflect the stance of monetary policy, while the yields on foreign currency instruments are lower as a result of the tight policy stance. I am not quite sure about the methodology. If there was some widening of spreads it probably reflected the general trend for emerging market securities after the recent uptick in mature market yields rather than a deterioration of fundamentals. As noted in the World Economic Outlook, the outlook for EU accession countries continues to be generally favorable. Growth is expected to accelerate, inflation remains fully under control, and banking systems are sound. Even if the external imbalances are relatively large in some countries, they are not expected to deteriorate in the many countries that are financed by foreign direct investments. Public debt levels are rising but are still far below the average for EU countries. The large fiscal deficits in some of the Central European countries in part reflect the struggle between pursuing real and nominal convergence, and are certainly a source of concern, but the authorities are fully cognizant of the importance of medium-term fiscal consolidation. In my own country, for example, the constitutional ceiling on the level of public debt will help to ensure the long-term sustainability of the fiscal position. I note also that my country was both criticized and rewarded for the same thing in the *GFSR*, which states that the recent increase in the share of portfolio financing reflects debt management operations more than increased financing of the current account deficit. There should be some consistency. Either we should praise or criticize the country for its debt management operations. To summarize, while there are some reasons to be concerned, such concerns should not be seen as grave, and the EU accession countries do not appear to be sources of regional or global instability. I also have some more technical comments on this Annex II that I will discuss bilaterally with the staff.

My second comment is on the data in Table 2 of the appendix, on page 184. These data seem to show that in 2002 the euro already became the most important currency for international debt securities issuances. The role of the euro became even more prominent in the first quarter of 2003, when issuance in this currency was more than two times higher than the dollar. These developments warrant some comment in the report. Could the staff explain the main reasons for this change, and in particular to what extent it may reflect the progress in unifying and improving the functioning of the euro area capital markets, and not just a change in currency and interest rate trends?

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

> On behalf of the International Capital Markets Department (ICM) staff, I want express appreciation for the many preliminary statements and the many ideas that we received, and we will work many of these into our future work. This is the first fully fledged semi-annual *GFSR*. You will recall that in March 2003 I indicated that we were in a transition period. The difference is that there are more analytical topics, and we are trying to incorporate ideas from various quarters.
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> With regard to Mr. Callaghan's question, volatility and instability in financial markets are a matter of interest to many, and management specifically requested ICM to address this issue. This was one of the issues that we had wanted to tackle for a long time, and we finally came around to it. Work on this topic has been done by other institutions as well, and we will continue to try to cooperate with them, although it remains to be seen how willing they are to cooperate with us. Further work will be done on these issues. We also tried to incorporate more policy implications into the *GFSR*. This will be an ongoing process, because we need to be comfortable with those before we put them into writing.
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> The new format of the report also has updates on risks and vulnerabilities identified in previous *GFSRs*, as requested by the Board. We also included a survey of a regulatory and supervisory responses to those problems, where we draw on the expertise of colleagues in the Monetary and Financial Systems Department (MFD), which is also something that the Board wanted. As a consequence, the *GFSR* is about ten to fifteen pages longer than the March 2003 issue. We are sensitive to the length issue that some Directors raised, and we will try to make it more concise going forward and, where possible, even more user-friendly. Writing short papers is not always easy in the existing culture of the Fund.
>
> On the division of labor between the GFSR and the World Economic Outlook (WEO), ICM works on the premise of strictly avoiding issues that come up in the WEO.
>
> I would like to take a step back and highlight the common theme that has run through all issues of the *GFSR*, including the present one: a focus on financial conditions, the health of key sectors of major economies, as well as on corporations, financial institutions, and households. One problem, however, is data availability, which is uneven across regions. Therefore, it is true that the *GFSR* is somewhat "U.S.-centric" at times, but we are trying to remedy that. On the other hand, one has to accept—and I am responding to the French preliminary statement—that U.S. financial markets have a huge influence over other markets in the world. The influence that emanates from the United States

in financial markets is even higher than the one in the real economy. But we need to build up our staff that knows enough about Europe, Japan, and other parts of the world, and to travel to those regions regularly. Monitoring changes in financial conditions in these sectors, especially among the major players, is a key part of our assessment of the risks and vulnerabilities facing the international financial system. This assessment is to a large degree a matter of judgment, as it is not based on scientific models. We probably have less models for the financial markets than one has for the real economy, and I am not aware that other institutions that address these issues have a model either. In the financial sector, and when assessing financial stability, there is a lot of judgment necessary, perhaps more so than in other areas. It takes considerable experience in financial markets to have that judgment. I hope, and I believe, that so far our track record over the last two years is not that bad.

The *GFSR* is also forward looking, which was another issue raised, including in the context of the circulation period. Directors discussed a two-week versus a three-week circulation period for the *GFSR* prior to the Board meeting. The time that elapses between when the ICM staff writes the *GFSR* until the press conference and publication is about two months, so the topics must be forward looking. For example, the March *GFSR* already discussed the implications of rising bond yields, which looked quite audacious against the background of the Iraq war and talk about deflationary pressures. The *GFSR* also talked about the implications of hedging activities by investors in the mortgage-backed securities market, and about the equity markets regaining optimism, somewhat audacious topics at the time. In 2002 the *GFSR* addressed the insurance sector and European banks, also topics that were somewhat ahead of the curve. The staff is trying hard to be forward looking. Our approach also gives us insight into the state of investor confidence and risk aversion, factors that strongly influence the asset allocation process in financial markets, and specifically private sector capital flows to emerging market countries. The asset allocation decision process is something that we intend to look into more as a forward-looking indicator of changes in capital flows, but ICM first needs to enhance its expertise in this area.

In the first quarter of 2002, when we started the *GFSR*, weak corporate balance sheets, poor earning prospects for many banks, and the need for banks to make credit provisions for a record number of bankruptcies and defaults led us to be relatively more pessimistic than many financial market participants about the economic and financial outlook. Since the fourth quarter of 2002, looking at the big picture, there has been growing evidence that many corporations and financial institutions have undertaken restructuring to lower their cost bases and focus their businesses, and to improve their balance sheets, in particular the ratio of short to long-term debt.

We were asked by Mr. Callaghan about the factors behind the improvement in financial markets. The improvement in credit quality was first reflected by a rally in corporate bond markets, as credit spreads narrowed. Spreads continued to narrow throughout the mid-June to July period, when longer-dated U.S. Treasury security yields rose by roughly 140 basis points, as investors continued to expect the quality of credit to improve with stronger growth. When corporate bonds perform well, in the context of asset allocation, crossover investors will have less interest in emerging market assets, which again demonstrates the interlinkages between mature and emerging markets.

The global equity markets started to rally in March. The earnings recovery has been broadly based. As an illustration of this, the U.S. companies in the Standard & Poor's 500 index posted nearly 10 percent earnings growth in the second quarter of 2003, on a year-over-year basis, with 6 percent gross revenue growth. Europe's 30 largest companies, all members of the Dow Jones Stoxx 50 index, showed a year-over-year rise in earnings of 71 percent in the second quarter, and in Japan large companies posted a profit increase of about 80 percent for the fiscal year 2002/2003, although from a very low base. These percentages are a bit misleading. For the current fiscal year, 2003/2004, earnings growth of about 12 percent is expected. The difference, however, between the United States on the one hand and Europe and Japan on the other is that in Europe and Japan gross revenues have been more or less flat, which reflects the still-weak economic recovery. However, the improvement also shows the fruits of corporate restructuring in recent years in the United States as well as in other parts of the world, including Japan. Nonetheless, the risks have to be highlighted: if gross revenues do not rise at some point there may be a setback in the equity markets.

Improvements in corporate balance sheets and profits have gone a long way to strengthen the international financial system, particularly major banking systems. If we take into account the fact that the global financial system has already shown remarkable resilience despite a series of shocks in the past three years, the developments of the last 12 months or so give us a degree of comfort. This is the basis for the conclusion that global financial vulnerabilities have declined, notwithstanding some pockets of weakness.

On the balance of risks, while the risk of rising interest rates is the more likely of the two major risks, it would be far less severe in impact than the risk of disappointing earnings. In other words, a fall in equity markets is less likely but would have far more serious consequences than rising interest rates. It is not realistic to extrapolate that the pace of the recent jumps in interest rates will continue in the future, particularly as the recent rise in U.S. Treasury yields started from an extremely low yield level—reached in mid-June when investors had come to the conclusion that the bond market had no downside potential. In the jargon of the market, Treasuries were "overbought." Therefore, the yield increases over the last six to eight weeks may represent a return to normalcy.

Inflation and inflation expectations remain low, hovering around about 2 percent when inferred from yields on the Treasury Inflation-Indexed Securities (TIPS) in the United States. The federal funds rate will stay where the Fed has set it at 1 percent for the foreseeable future, as repeatedly stated by the Fed, although the market has started to price in interest rate hikes in early 2004. Under these circumstances, normal countervailing forces in financial markets should limit the extent to which bond yields can rise. In the past few weeks, investors have been buying U.S. Treasuries whenever ten-year yields climbed toward 4.6 percent or so, as the yield spread against the 1 percent short-term interest rate is very attractive. In fact, such a steep yield curve has been an important source of income for banks and other financial institutions engaging in carefully managed maturity mismatches, which again help these financial institutions to get some muscle and some capital.

One caveat is that it would be a different picture in the interest rate markets if Asian central banks stopped investing the proceeds of their foreign exchange interventions in the U.S. Treasury market. With regard to yield increases, we cannot distill out the relative impacts of individual factors, such as the extent of the increase that is attributable to growth expectations, or the larger supply of bonds given fiscal policy trends, or the decrease in risk aversion. It is attributable to a combination of these factors.

On the rebound of the U.S. dollar, as discussed at previous World Economic and Market Developments (WEMD) sessions, U.S. economic growth is pulling ahead of European growth, and U.S. bond yields exceed those in the euro area. Foreign exchange markets are still driven by growth differentials, and not only by current account imbalances, at least for the foreseeable future. I do not want to speculate on how these relationships will evolve in the medium term. Unless growth expectations fundamentally shift, we are not too worried about the dollar falling through the floor. It is too early to say whether this translates into a recomposition of capital flows back to equities, as in the late 1990s, including portfolio investments and long-term mergers and acquisitions. We have a mixture. Foreign exchange markets react instantaneously to economic data releases, whereas the asset allocation process for investors is a fairly lengthy process. The ICM staff deliberately did not venture into evaluating the medium-term aspects of foreign exchange markets because it is too speculative, and also because it has a lot to do with the real economy, an area that we try to avoid.

The main risk is to manage a transition from a historically-low interest rate environment to a somewhat higher rate environment, or a somewhat more normal environment. Complicating this transition is the amplification of yield increases caused by the hedging of mortgage-backed securities. To clarify, neither hedging in general, nor any specific mortgage institutions should be regarded as villains. Hedging is a necessary and prudent behavior of investors, and therefore should be applauded. The problem lies in the fact that the mortgage debt market has grown so large in the past five years that it is almost twice the size of the U.S. Treasury market. In other words, to use that picture, not only does the tail wag the dog to some degree, but the tail is almost twice as big as the dog. Owing to the prepayment risk, the expected duration of mortgage securities increases when yields rise, causing a much larger volume of hedging—the famous convexity risk. My colleague, Mr. Tran, can discuss this in more detail, but the convexity risk is something that one needs to understand when one wants to understand all of these technical points.

With regard to the prospects for emerging market finance, so far there are no indications of difficulties in market access. At most one or two countries may have difficulty accessing markets. One of those countries is in the Far East. Risk appetite remains neutral, broadly speaking. The yield spreads on the Emerging Markets Bond Index (EMBI) have not changed much since mid-June, and the average borrowing costs for emerging countries have risen by about 130 basis points, but still remain much lower than historical averages, or the levels prevailing at the beginning of this year. So there is no reason to cry wolf. Nevertheless, we should expect less bond issuance in August and perhaps in September, as most sovereign borrowers have completed their 2003 issuance plans and can afford to take an opportunistic approach at present. Later this year issuance activity will be driven by the plans for prefinancing for 2004.

On the policy implications for a period of excessive volatility bordering on instability, in response to Ms. Jacklin's concern, we should clarify that we do not favor supporting specific asset markets *per se*, to add liquidity at whatever cost, not the least because of moral hazard considerations. For somebody who worked in the Bundesbank for 18 years, it would be amazing if I were too lighthearted on this matter. In fact, I am opposed to unconventional operating techniques for central banks, but there may be times when liquidity tends to dry up in markets, and the normal multipliers for high-powered central bank money tend to collapse. Under such very specific circumstances it may be advisable to avoid a crisis by injecting liquidity into the money markets without trying to mop up any specific assets. In such a case, a somewhat higher liquidity may be warranted. For example, if one looks back to the last quarter in 1987, one will remember how efficiently liquidity injections were executed by some central banks, including the Federal Reserve.

There was a concern that Chapter 3 may sound as if the Fund were advocating too much regulation. We will look at the language very carefully, because it would be a misunderstanding. I have gone on the record as somebody who believes in the self-correcting forces of the market, so I support everything that can be done to use these healthy self-correcting forces. However, the last couple of years have also shown that there were sometimes limits to these forces, in areas such as corporate governance, auditing, accounting, transparency for certain instruments and players, insurance, and reinsurance. Some regulations tend to be pro-cyclical, like Basel 2, and in this case the self-correcting forces of the markets cannot work or have not proved to work. So there is also an area where regulation is appropriate.

A Director said that we did not touch upon fair value accounting enough in the *GFSR*. We will do so going forward. There is a lot of work going on in the world at the moment. Fair value accounting is so complicated, we would have to have a separate seminar of several hours to give this important issue full credit.

The topic of foreign direct investment (FDI) was raised, and there was some implied criticism that the seminar on FDI for the Board had been somewhat delayed, until after the 2003 Annual Meetings. I am indirectly not quite innocent, and therefore let me explain. It could have taken place now, but there was not enough time, so it had to lapse into October. As many Directors know, the Chairman has commissioned a report from the Capital Markets Consultative Group (CMCG) on FDI. There was a survey asking many multinational firms how they address FDI. This study is just now being completed, and will go to the CMCG in the next meeting with the Managing Director, in about two weeks, and then will be ready and it can be published, as well as incorporated in the work for this seminar, together with other work done by other departments here in the Fund.

A few Directors asked why the *GFSR* did not directly address the reasons that emerging markets have become net exporters of capital since 1999. This is a relevant and critical topic, but it is something that one cannot address unless there is enough time, and enough space in the report. Given length constraints and the fact that the report was already long, that topic had to be saved for the future.

On Ms. Indrawati’s point about the tone of a cheerleader versus a whistleblower, I try to be neither. I want to be whistleblower where necessary, but I do not want to be a cheerleader unless there is a reason to cheer. She considered that on the mature markets we were more cheerleaders than elsewhere. If one looks at what we have been saying about insurance companies, and some European banks—particularly German banks—and a few other topics in mature markets, we have been employing evenhanded surveillance.

Our philosophy is that we are talking about stability, and so we only raise issues when there is a concern about stability. There are always financial markets that could be more efficient in specific countries, and I would have very concrete ideas about this. But that is not the point of a report on stability. Accordingly, there needs to be a certain threshold breached for an issue to appear on the radar screen for a stability report.

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

> I would also like to thank Executive Directors for sending us several comments of a more technical nature. As always, we have found them to be very useful, and we are very grateful for them. We are, of course, ready to have discussions with you in case you want to clarify issues or to look at language better.
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> I would like to address the questions raised in the preliminary statements following the structure of the report. First, does the staff have any concrete ideas or views in terms of the policy instruments that would be available to ensure an orderly adjustment of financial markets? This question was raised in the context of the risk that we highlight about the transition from a lower interest rate environment to a higher interest rate environment. What we have in mind here—and maybe we should have tried to be more specific about it—is not necessarily new policies or new measures, but rather that in the conduct of business supervision regulators and supervisors should pay particular attention to institutions in their jurisdiction for any signs of stress or losses. What happened in the past eight weeks produced substantial losses, and therefore a monitoring of these developments would be warranted. In addition, and more importantly, they should look at the standard stress tests done by financial institutions to make sure that these tests include the sudden and big jump in financial asset prices—such as those we saw from mid-June to July—to make sure that these management procedures are updated and in line with most recent market developments.
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> There was a request for the staff to provide its view on which market segments or group or sectors would be more seriously affected by higher interest rates. In terms of sectors, the mortgage-backed securities market remains at risk because it is highly complex, and higher rates tend to raise the average duration of the market. In addition, the institutions that have been engaged in so-called carry trades—meaning buying long-term mortgage securities or treasury securities and funding them with short-term money—also remain at risk. However, rising yields would also be somewhat beneficial to some of the players, for example insurance companies. Again, they would have to cope with the transition from low to higher rates, but higher yields going forward would give them an opportunity to invest in higher yielding assets so that they can match those with the obligations they have on their liabilities. Moreover, higher rates would give them a higher discount factor so that the net present value of their liabilities, both for the insurance companies and the pension funds, would be alleviated.
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> In terms of countries, of course it depends very much on the structure of their external indebtedness. Those countries that have more variable interest debt tied to short-term rates would be much more at risk than those already

taking advantage of the more favorable financing conditions so far this year to extend maturities and to lock in long-term borrowing at lower long-term cost.

The next question concerned the sustainability of equity valuations, particularly in terms of rising yields, and the degree to which we feel comfortable about assessing the sustainability of corporate earnings going forward. Let me complement what the Director of the International Capital Markets Department said earlier about the earnings in the United States. Last year, when we were discussing the prospects of earnings with you, there was a big problem with respect to the dichotomy between what companies report through their financial reports every quarter and what we can obtain from the national income account numbers; sometimes the two measures of corporate profits move in the opposite direction. However, so far this year that is no longer the case. In the first quarter, as some Directors pointed out, on a national income and product account basis, corporate earnings grew by 7 percent in the first quarter. In the second quarter, with 2.4 percent GDP growth and given the strong net export performance in the second quarter, it is, in my view, very likely that that the GDP figure will be revised upward to at least 2.9 percent. If that is the case, then the implied corporate earnings figure from that higher GDP number would be at least 25 percent, using very conservative assumptions. Thus, we feel that the earnings story that we have discerned and analyzed is supported by a widened body of evidence, and that gives us comfort that it is more sustainable than what happened last year.

In addition, in terms of the balance sheet strength of companies, the corporate sector, and households, I want to take this opportunity to highlight to you that the net worth of the U.S. household sector at the end of the second quarter—we do not have data yet from the flow of fund data, but if we use what happened at the end of the first quarter as an estimate—will have increased by \$1.7 trillion at least. Of course, this depends significantly on the improvement in equity markets as the improvement in net worth would decline if markets decline. However, if one takes a snapshot of the financial health of the household sector today—and for that matter even other sectors of the key economies—compared with a snapshot of a year ago, it is a clear that things have improved, and that is the key message that we tried to get across in the report.

The next question concerns the issue of whether or not a downgrade from AAA to AA for the government-sponsored agencies in the U.S. mortgage markets—Fannie Mae and Freddie Mac—would impact the spread of these agencies' instruments, their market value, and the interest cost charged to households for mortgage borrowing. Let me give you some estimates. At the moment, if you look at the liabilities of AA financial institutions compared to Fannie Mae and Freddie Mac, which of course enjoy AAA status, the difference is 20 basis points for a one-year bond and 60 basis points for ten-year bonds. Thus, if these two institutions were to be changed from AAA to

AA, they would incur higher borrowing costs. This higher borrowing cost would have to be split between less income for them and somewhat higher costs for their borrowers. However, in our view, given the large and still diversified sources of earnings of these institutions, this kind of increase would not be a very significant problem. Second, even though these two institutions are very big, there are also other mortgage bankers ready and able to lend, which would probably make sure that the overall impact would be not very significant.

Turning to emerging market issues, there was a question as to why does it take several years of continued strong policy performance for emerging markets to acquire a reputation and credibility that can help them offset general market sentiment in bad times? The answer that we can provide here is that it takes a country time to demonstrate a track record and to achieve the credibility in the eyes of international investors. Unfortunately, however, while it takes time to earn a good reputation, it does not take much time to lose it.

There was one question concerning FDI, particularly in the context of Brazil, where we reported that FDI has continued on a somewhat downward trend and has declined in Brazil. The decline is difficult to understand, particularly in light of the improvement in market sentiment vis-à-vis Brazil. One clear observation is that FDI tends to be very lumpy, and it is not a continuous process like investment in portfolio investment. Moreover, in Brazil as well as in many other emerging market countries, several privatizations, and IPOs have already been completed in recent years. Therefore, for this year and going forward there are fewer opportunities for these kinds of big-ticket items to boost FDI flows.

Concerning Chapter 3, there was a question about whether or not the higher global correlation among some asset classes between, for example, equities in more mature market countries or bonds and the correlation of different asset classes in a country between stocks and bonds may behave differently. One key factor that explains this, particularly the negative correlation between bonds and stocks in one country, the United States in particular, has been the flight to quality and the rise in risk aversion that we observed for most of the last two years until very recently.

Another question that drew on Chapter 3 of our report was whether the risk management strategies that may be appropriate for a small market player acting in isolation would still be appropriate when all firms in the market are doing the same thing. We agree that that is a problem, even though we agree that risk management tools and techniques that have been employed so far work very well when the movement in asset prices tends to be small. However, when there is a sudden and unexpected jump in price that causes other market participants moving in the same direction to start hedging, there could be a situation where the liquidity of the market—either the cash market or the derivative market—can be impacted, as we have seen in the past few weeks. Therefore, this is something that the international community, including the official community, will have to look at and to find ways to live with it going forward. For example, the circuit breakers that were put in place after the October 1987 stock market crash that the Director of the International Capital Markets Department mentioned is something that has been useful, and things of this nature should be investigated for future application.

Turning now to the last chapter, volatility of private capital flows to emerging markets, there were several questions about how the staff can reconcile the observation that in some parts of the report we say that investors are increasingly discriminating and in some other parts we provide a different assessment. This apparent dichotomy is owing to the fact that we examined different time horizons. As we discussed in previous GFSRs, for most of the 2001 and 2002 period there was high risk aversion, and when there is high risk aversion investors tend to be very discriminating, and we can observe that by the dispersal of the spread of different credits against U.S. treasuries. However, since October of last year when the search for yield began in earnest, the tendency to buy more indiscriminately into this asset class has become observable, and we can see it in the statistical evidence that we presented. We will try to refine the tools and the statistical measurement of this going forward, but evidence of this behavior also emerges from our discussions with market participants—both intermediaries and final investors in this market.

There was a question on whether local debt securities markets in emerging market countries have become more attractive to international investors because international investors think that local debt instruments get a more advantageous treatment in debt restructurings. We have so far seen no indication of this sentiment or assessment. However, the feedback we have received is that people were attracted to local debt securities market because of the high yields available there. Again, the search for yield phenomenon coupled with the sharp devaluation that these currencies have undergone over the past two years makes these countries a very attractive option for investors.

To conclude, I would like to make two more comments. First, given the somewhat different tone between the recent U.S. Article IV consultation staff report and the GFSR concerning the risks among the GSEs, there is a question about the communication and collaboration among the staff. I would like to point out that ICM staff participated in the U.S. Article IV consultation process and met with the relevant agencies, the Federal Reserve Board, the Office of the Comptroller of the Currency, and so on to discuss a variety of issues, particularly mortgage-backed securities and the risk therein during the spring Article IV consultation process. In addition, the Western Hemisphere Department as well as other Departments have reviewed and commented on the draft GFSR. The information in the GFSR pertains to the events that took place between mid-June and July, which is most recent than the Article IV

> consultation staff report, and therefore these issues receive a fuller treatment in our report.
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> Lastly, I would like to come back to the two specific issues that Ms. Indrawati raised this morning on Indonesia and an issue raised by Mr. Szczuka. We are very happy to discuss with Ms. Indrawati the fine-tuning of the language. Nonetheless, we feel that the language in the GFSR is not different from what we had in the section on emerging market banking sectors and financial soundness indicators in the March issue of GFSR. In addition, we did not see any new developments since that time to warrant any change in the assessment, and therefore we used the language that we had used in the March issue, but we are happy to discuss this further with Ms. Indrawati.
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> In response to Mr. Szczuka's question as to how we measure risk premia, we use the spread between the Central European countries and the German bond yields as a measurement of risk premia. There is a question as to how valid this is and whether there is a better way to capture these things, and again we would be very happy to have a discussion with Mr. Szczuka to clarify this issue.

Mr. Portugal noted that, as emerging markets had become net exporters of capital since 1999, it was unfortunate as well as counterintuitive to see capital flowing from where it was scarce and therefore more productive to areas where it was abundant and supposedly less productive. Another counterintuitive development was the very significant buildup in foreign international reserves by emerging markets in a period when there had been a substantial move toward floating exchange rates. Those counterintuitive developments could be indicative of some other forces or problems in the international financial system that should be examined more carefully. Perhaps the correction of imbalances in emerging markets had gone too far, perhaps there were imperfections in the global financial markets, or perhaps a well-developed cooperative insurance scheme that would lead countries to insure themselves by building up international reserves had yet to develop. Although those issues were beyond the scope of the GFSR, the Fund should consider them in more detail, because emerging markets becoming net exporters of capital and countries that adopt floating exchange rate regimes accumulating huge international reserves could be indicative of something that went beyond the domestic policies of those countries, which was something the Fund should examine.

While there had been a substantial decline in FDI since the shock of last year, the figures for July—$1.2 billion—indicated a pickup, Mr. Portugal explained. FDI in August could also exceed $1 billion. As FDI decisions had a longer lag than other types of financial investments, it was possible that going forward there could be a transition to higher levels.

Ms. Indrawati asked whether the staff's view that there was less instability in emerging markets was because there was less volatility or because of increased confidence in the ability of authorities to take the necessary policy measures to strengthen the resilience of their economies.

Mr. Baukol commented that he was struck by the comments of the Director of the International Capital Markets Department that a different story might have emerged with respect to interest rates if Asian countries had not purchased as much reserves as they had been doing. However, there would have also been different developments in Asian economies with regard to growth and the current account.

A two-week circulation period for the GFSR was appropriate given the need to have timely market information, Mr. Baukol noted. It was hoped that the two-week deadline would be met in the future.

The U.S. authorities did not share Ms. Indrawati's view that the staff was too much of a cheerleader with regard to industrial countries, Mr. Baukol said.

The Director of the International Capital Markets Department (Mr. Häusler), in response to Ms. Indrawati's question, replied that the staff was fairly comfortable with respect to volatility in emerging markets at the moment as a range of measures had been implemented or at least were under implementation. They included the floating of exchange rates, and the progress made under Fund-supported programs since the Asian crisis. In addition, measures at the microeconomic level had also been undertaken, such as improving risk management in many companies.

It was now critical that those initiatives be carried out, the Director continued. While steps had been taken in the areas of corporate governance, accounting, and auditing, at both the national and international level, complacency had to be avoided.

However, there were some positive aspects to volatility, the Director explained. For example, the draft Basel II guidelines contained pro-cyclical requirements that were positive from an individual microeconomic view of banking supervision. However, that pro-cyclical element could also exacerbate potential volatility in financial markets. Therefore, it was important to try to find an optimal level of desirable volatility.

The Chairman asked whether improved global governance as well as strengthened auditing and accounting practices could make investors reluctant to invest as the legal risk had increased.

The Director of the International Capital Markets Department (Mr. Häusler) replied that some investors were concerned about those new initiatives as they considered that some of them went too far. However, while it was important that entrepreneurship should not be throttled, at the same time it would be important to err on the side of corporate governance when making business decisions. The new initiatives would certainly strengthen the functioning of the international system and it was hoped that their implementation by national authorities would not stymie entrepreneurial activity.

Mr. Martí asked why the hedging techniques employed in the market that led to a sale of assets, particularly treasuries, and therefore to the rise in the yields of U.S. treasuries and the present devaluation of long-term rates was not noticed earlier, particularly as the U.S. mortgage market had been booming for several years.

How would the decline in mortgage refinancing affect private consumption in the U.S., particularly as mortgage refinancing, either through the release of funds owing to lower interest or through the so-called mortgage equity withdrawal, had been a very important support for U.S. private consumption and therefore for the sustained rate of growth of the U.S. GDP, Mr. Martí asked. How would private consumption be sustained in the period ahead? That was an important issue if one was hoping that the United States would be the locomotive for the recovery of the global economy in the very near future.

Mr. Kiekens made the following statement:

> I thank the staff for its thorough and interesting report. I will begin with comments on the main risks to global financial stability, and then address the specific issue of the convergence of accession countries.
>
> The staff rightly observes that a potential threat to financial stability arises when the markets' expectations concerning future growth and profits are disappointed. Apparently the gap between the actual economic data and the expectations reflected in market prices and forward-looking surveys has become wider in recent weeks. Equity prices have risen significantly from their low point earlier this year owing to expectations that the global economy is finally on the mend. Up to now, however, such expectations are only partly based on facts as opposed to the projections of future developments. The latest data showing that European growth remains weak illustrates this concern. In addition, the relatively strong earnings growth in the second quarter was largely achieved by cutting costs, including labor costs. However, cuts cannot be a sustained source of earnings growth. What is needed to meet the current optimistic profit expectations is a revival of sales and revenues.
>
> The staff correctly argues that if the markets' expectations of robust future profit growth are disappointed, this could cause a new decline in equity prices, with several negative effects on financial stability and global economic prospects.
>
> First, it would deal another blow to market confidence. Insofar as strong confidence is a sine qua non for increasing investment and growth, disappointed expectations can have serious effects on the prospect to global growth.
>
> Second, many insurance companies and corporate pension plans have seen their assets seriously eroded by the collapse of equity prices, and the recent partial reversal of that collapse have helped prevent still more serious problems. The fact that many corporations and insurance companies hold a large share of their assets in the form of equities creates the possibility of a

mutually reinforcing process in which a general decline of equity prices reduces the value of their asset holdings, which in turn reduces their expected profits and thus their own share prices, further worsening the general weakness of the equity market. Of course, such a process can also work in a positive direction, which only underscores the great importance of pursuing regulatory and macroeconomic policies that bolster market confidence and minimize the risk of additional rounds of equity weakening.

Another source of risk lies in the present environment of very low interest rates. Low interest rates result from the specifics of the present business cycle, characterized by the bursting of the equity and investment bubbles. Today's low interest rates contrast with the more classical pattern of high interest rates in periods following overheating and rising inflation. However, as Mr. Bischofberger and Mr. Fabig observe, low interest rates are not an unmixed blessing. They assist the balance sheet adjustment, but we must be aware of the risks resulting from investors' search for yields and from their reduced risk aversion, which could lead to indiscriminate lending, including excessive exposure to the housing sector, and problems later on.

The staff notes another risk related to a sudden large increase in interest rates, which would have adverse effects on the value of bond holdings. To the extent that an increase in interest rates reflects stronger economic activity and higher expected inflation, it may be less of a problem. The staff notes that real problems will arise if this interest rate increase is not accompanied by a robust economic recovery. Two questions arise which are not fully addressed in the report. First, what causes other than recovery can bring about an increase in interest rates? Second, what--if anything--can be done to reduce the risk of a rate increase unrelated to recovery? I wonder whether the hedging strategies of U.S. government sponsored institutions could also create this kind of risk. The staff notes that these hedging practices can aggravate interest rate increases triggered by other events, but I wonder whether these institutions by themselves are capable of triggering interest rate increases that are not related to a stronger economic recovery. Several Directors rightly observe that the need to finance a larger fiscal deficit could cause interest rates to rise.

I wonder if the staff could comment on the behavior of investors in Japan. It is my understanding that Japanese investors are very conservative, with a strong home bias. Having recently been disappointed by the return on their investments in Europe, they were repatriating their money to Japan and using it to buy Japanese equities. But if Japan's own economic performance continues to disappoint, or continues to offer meager returns to domestic investors, or if there is a perceived risk that the domestic public debt will become unsustainable, is there a risk of large outflows of domestic savings into (for example) dollar assets? In addition, what would be the global financial and economic implications of such developments?

I have one comment on developments in the global banking system. It is recognized that on the whole banks have survived reasonably well the consequences of the equity price collapse, the recession, and a series of negative shocks. This resistance of the banks is explained by several factors. For one thing, they built a strong capital base during the previous expansion. For another, they improved their management of risks. Moreover, more recently they have begun to use a growing range of credit derivatives and other instruments to transfer credit risk to other financial institutions. One could argue that this transfer of risk is a positive development. In addition, risk is better distributed, being allocated to those who are more willing to carry it. However, this transfer of risk is also a mixed blessing. As Mr. Mozhin and Ms. Vtyurina also note, two negative side effects stand out. First, the risk may be transferred to institutions that are less closely supervised; and second, these institutions may be less capitalized, and less capable of assessing and understanding the risks they are taking. Is it possible that stronger resistance in one part of the financial system can be gained only by reducing the resistance of other parts of the financial system? In addition, is there also the risk that, to the extent that they are counterparts to the banks, these non-bank institutions will see the risks that they threw out of the doors coming back in through the windows?

Now a brief word on the question of the emerging market countries (EMCs) and their access to the international capital market. I agree with the staff that the presently favorable market sentiment should not lull the EMCs into complacency. They have already taken important steps to protect themselves against increased market volatility. However, it is a fact of life that the availability and terms of foreign capital will probably remain volatile, depending largely extent on exogenous factors that sound policies and reforms in the EMCs cannot fully remove. The EMCs therefore need to hedge against such volatility, and for many countries the accumulation of foreign reserves is an important tool to that end. However, holding excessive amounts of foreign reserves can also be costly, and alternative ways of protecting against the unsteady availability of capital should be actively sought. One important way of doing this would be to keep the external debt and debt service at relatively low levels, making it easier for the economy to service it without creating undue problems, and without giving up too much flexibility in the conduct of countercyclical macroeconomic policies when needed.

Finally, I would like to offer some comments on the staff's analysis of convergence in the accession countries. This analysis shows that yields in central Europe are mainly driven by domestic fundamentals. However, this analysis explains the compression of yields until mid-2003. The question now is how to explain the increase in yields during recent weeks.

The staff argues that this increase may be related to concern about the fundamentals, to the continuing fiscal laxity, and to the expectation that the entry into EMU will be delayed, which could lead to increased exchange rate volatility and higher local yields to compensate the investors for accepting a higher exchange rate risk. However, this does not appear to be the whole story either.

We have recently observed a difference in the behavior of yields and spreads among the four candidate countries, even though they should be uniformly affected by the prospect of delayed EMU entry, by fiscal laxity, and by the risk of greater exchange rate volatility. The increase in spreads and yields was quite large in Hungary, moderate in Poland and Slovakia, and almost nonexistent in the Czech Republic. Yet the Czech Republic is expected to be one of the last to join the EMU, because of fiscal problems. Apparently we must look beyond the expected delay in EMU entry to explain the widening spreads. A possible explanation lies in the structure of external financing. Hungary relies more on portfolio flows, and foreign ownership of the securities of its government is the highest, making it more sensitive to conditions in the global financial market than, say, the Czech Republic, whose external deficit is largely financed by FDI flows, and where foreign holdings of government securities remains low. Another explanation could be that the Czech Republic's still low level of public debt (compared to other countries) makes Czech investors more willing to accumulate government securities.

Mr. Daïri made the following statement:

I thank the staff for its excellent work on recent developments and prospects in mature and emerging markets and on the related policy issues. I also welcome the improvements to the GFSR.

The main thread of the staff report is the evidence of the resilience of the global financial system in the face of recent adverse shocks and geopolitical events. I welcome this conclusion and support the staff's call for sustained policies in mature economies to support confidence and jump-start investment. I also agree that the emerging market countries should remain vigilant, persevere with sound policies, and avoid any complacency in light of the recent improvement in the external financing environment.

I am encouraged by the indications of declining uncertainties in mature markets, which is reflected in improvements in investor sentiment and household and corporate balance sheets. Here I have two points. First, the staff points to the risks to the recovery in the United States stemming from a possible decline in the pace of mortgage refinancing. As there is already evidence that such a decline has started and, as requested by Mr. Martí, the staff may wish to update their assessment, including on potential implications. Second, the staff indicates on page 6 that corporations have made good progress in financial consolidation and are in a better position to increase investment spending. This assessment needs to be reconciled with what is indicated in pages 23 and 189. While it is true that the share of short-term debt has declined, the debt-to-net worth ratio has increased and debt-to-equity has also continued to rise at a fast pace at a time when investment is slowing down.

As other speakers, I continue to see a need for vigilance and urge regulatory authorities in mature markets to continue their efforts toward improving corporate governance, strengthening supervision of the insurance sector, and increasing transparency and risk control of pension funds. The Fund should play a proactive role in this area. As Mr. Al-Turki, I am concerned by the staff's conclusions that the U.S. government-sponsored housing enterprises raise particular financial stability concerns. I join the staff's call for careful monitoring of their capital base and encourage keeping this issue under review.

As other speakers, I am also concerned by the fact that emerging markets have become net capital exporters. The report points out that emerging markets have made good use of the recent improvement in the external financing environment to increase the resilience of their economies and strengthen their financial systems. In this connection, I welcome the successful liability management operations conducted by a number of sovereigns, including Morocco in our constituency, with the objective of improving the structure of external debt and achieving net present value savings.

I welcome the staff's analysis of the volatility of private capital flows to emerging markets and support its policy recommendations. As Mr. Portugal, I would appreciate the staff's elaboration on the extent and the reasons behind the decline in investor discrimination. As other Directors, I also encourage further analysis of the declining trend of FDI flows to emerging markets. However, the staff assessment that one of the reasons for the declining trend is higher perceived risks, including unanticipated changes in regulation and contractual arrangements, is not substantiated. Such a general assessment could be extremely damaging, and a more balanced assessment is called for. For example, the recent sale of the tobacco company in Morocco for $1.4 billion, about 4 percent of GDP, does not fit into this description. Is this why this transaction was not referred to in the paper?

I have also some reservations regarding the coverage of the Middle East and North Africa region. First, country categories differ from one table to another, with North Africa classified sometimes within Africa and sometimes within the Middle East, and this is a problem that we have seen on several occasions. Second, the assessment in page 62 that banking systems in a number of the countries in the region remain weak is not consistent with Box 2.3 indicating that the banking systems in the region exhibit relatively strong positions. In fact, it is one of the best positions after the advanced economies. Moreover, the reference to Morocco is not substantiated. These public banks represent only some 10 percent of total assets of the financial system and have very little financial links with the other components of the financial system.

Moreover, the weaknesses in the public banks are being addressed. A more updated assessment is therefore necessary.

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

Mr. Daïri, I suggest that we discuss this issue of the Moroccan banking system bilaterally, not the least because this part comes from our colleagues in the Monetary and Financial Systems Department. We in ICM do not write about banking systems in particular. Thus, I would feel uncomfortable to do that here. So, with their help, let us take it up bilaterally.

On the other issues, Mr. Kiekens, I could not agree with you more on practically everything you said. However, when you mention credit risk transfer mechanisms and the downside of that, I cannot resist to say this is what we said in our GFSR last year. While we are in favor of this—and I do not want again to sound as if we are against it, we think this is a very beneficial new instrument—it is very intransparent, and the question remains of where has the risk gone. Therefore, is there undue risk or not? The simple answer is that we do not know, and thus I could not agree with you more.

I would like to come back to a point that Mr. Martí made earlier on the GSEs, and why had we not noticed this earlier. First, we have to be very careful, as hedging operations do not necessarily increase interest rates. They are exacerbating potential volatility. They are pro-cyclical instruments, and over time the interest rate level will go back to the equilibrium with or without those hedging activities. Thus, I want to be very specific that this is not something that comes on top, such as a spread on interest rates, but is rather because the amplitudes of the swings are somewhat exacerbated. Over the last six months or so, what we have seen—and I think that this is the uncharted territory—is interest rates falling very rapidly. I am not talking about short-term interest rates so much, but longer-term interest rates. We have seen unprecedented amounts of refinancing in mortgages, and therefore we have seen unprecedented changes in duration on the balance sheets of GSEs. Moreover, the market for mortgages here in the United States has just grown so tremendously over the last couple of years, so this growth in the market plus this unusual sharp downward trend in interest rates that is now being reversed somewhat has simply brought to light that there are institutions that are employing hedging techniques—which is a normal thing to do—but they are just so big that whatever they do has a bearing. One can have doubts whether this will occur again anytime soon because if interest rates do not change that much, and already the expectations for prepayments are down considerably with maybe 20 percent or so of mortgage refinancing expected in 2004 as opposed to this year.

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

> Let me try to provide a bit of clarification on the issue of hedging. We do not want to leave the impression from our report that any of these GSEs as an institution was the one that really actually engaged in selling treasuries, securities, cash, or future derivatives. Our point is that the investors in the mortgage backed securities market would have to hedge to protect the value of their assets. Therefore, we are emphasizing the systematic impact of the hedging and not that by any one particular institution, because any one institution can engage in a variety of techniques and tools to hedge. Selling treasury securities in the cash market is one, selling it in the futures market is another one, and using options is another one. When one uses options, one is not directly selling anything in the treasury market, but one's counterpart will have to do so in order to hedge itself. One can also improve the need to hedge, from the GSE point of view, by changing the structure of liabilities, which they have done significantly in the past few years and months. They have included a higher degree of optionality into their liabilities, such as issuing a significant amount of callable bonds. Thus, if they issue callable bonds and use that money to fund their mortgage holdings, when rates come down they have a very excellent tool to reduce the duration on their liability side. The duration risk is therefore being transferred to someone else who buys these callable bonds and might have the need again to hedge their own portfolio. What we tried to convey in the report is that the systemic nature of this device and strategies do give rise to concern. The concern is volatility. However, volatility means that if rates rise quickly in a very short time frame it can produce a lot of financial stress, as we have seen in the past eight weeks.
>
> Mr. Martí asked whether the decline in mortgage refinancing activity will have an impact on the economy. We do not think so. As I said before, the household sector in the United States should feel very rich and very happy right now. Therefore, the fact that there will be less refinancing does not mean that it does not have the wherewithal to spend. Second, mortgage refinancing is only one means for U.S. consumers to liquefy the equity in their house. They can also do home equity loans using the equity portion in their house as collateral for borrowing at cheaper rates than the credit card rates they have to pay. Thus, there are ways and means if they want to spend through borrowing. The fact that the mortgage refinancing index has declined by 60 percent or so in the past few months is not really an indicator of anything.
>
> Mr. Kiekens had two questions. The first was regarding the potential flow of funds in and out of Japan. What we have seen in recent months, particularly since the beginning of this year, is a huge capital inflow into Japan, particularly foreign purchases of equities in Japan. The improvement in Japanese equities has been to some extent driven by foreign investors investing

into Japan. However, as Japanese investors are moving out and foreigner investors are moving into Japan, there is somewhat of a disconnect between the assessment of the prospective return and risks between domestic investors in Japan and foreign investors looking at Japan, but overall we do not see any indication that there would be any significant change in terms of the risk of the outflow from Japan diminishing.

On the EU convergence process, we agree with Mr. Kiekens that the spread has been developing differently recently across the four countries he mentioned. We also agree with the other statement he made about Hungary and the Czech Republic, and there is not very much we can add to that.

Mr. Daïri asked for clarification of how a sharp increase in bond yields in the major financial markets would end the wave of mortgage refinancings in the United States and thereby unsettle the support extended throughout the downturn by consumers.

The Deputy Director of the International Capital Markets Department (Mr. Tran) replied that while the staff would look further into that issue, the events in the housing mortgage market should be seen in the wider context of an improvement in the net worth position of households overall.

Mr. Yagi, responding to Mr. Kiekens's concern about the potential impact of capital outflow from Japan, agreed that an increase in interest rates on Japanese government bonds could have an adverse effect on financial soundness and be harmful to the economy. However, there should also be some impact on the exchange rate, leading to a weaker yen, which in turn would promote exports and ameliorate the effects of deflationary pressure. Thus, such a scenario would lead to both pros and cons for the economy. Moreover, as had been discussed in the context of the Japanese Article IV consultation, the impact would not differ much whether the purchases of foreign currency assets were done by the private sector or by the Bank of Japan.

Mr. Kiekens, noting that Mr. Tran had observed that the sharp decline in mortgage refinancing activity in the United States might not cause a significant change in consumer spending trends, pointed out that households' incentive to refinance was to lower both the interest rate and the monthly payment on a mortgage, thereby leading to an increase in disposable income, or, if the same level of payment were maintained, to build capital that could be used for consumption or investment. However, if interest rates were no longer declining, there would be no incentive to refinance, which should in turn reduce disposable income and consumption.

With regard to Japan, a worst-case scenario would be that Japanese holders of public debt would come to the conclusion that Japanese public debt was no longer sustainable, Mr. Kiekens continued. During Japan's 2003 Article IV consultation a number of primary surplus gaps had been noted, suggesting that the primary surplus target should be increased substantially to about 7 percent of GDP in order to stabilize the net public debt at 100 percent of GDP in the coming years. Under a worst-case scenario, where an increase in the primary surplus did not occur, investors in Japanese bonds might panic and it could have enormous ramifications for the global capital markets and economy. Meanwhile, a further decline in the exchange rate of the yen would not be conducive to global adjustment. Such a worst-case scenario should not be dismissed.

The Chairman noted that some of the topics discussed at the current Board meeting might also be taken up again in the context of the Board's upcoming consideration of the World Economic Outlook.

Mr. Daïri asked the staff to respond to his earlier question on the strengthening of corporate sector balance sheets.

The Deputy Director of the International Capital Markets Department (Mr. Tran) responded that there were two important indications of improvement of corporate sector balance sheets. First, the balance sheets of large companies, which tended to set the pace for other companies and for the equity markets, had strengthened when measured by key yardsticks, including short-term rates, short-term debt to long-term debt, and others mentioned in the *GFSR*. Second, anecdotal evidence suggested that indicators of corporate balance sheet health had strengthened through the second quarter of 2003.

The representative from the European Central Bank (Mr. Wijnholds) made the following statement:

> The European Central Bank broadly shares the staff's cautiously optimistic tone on the risks of global financial stability, and it agrees on the policy prescriptions offered in the report. I have a few remarks on the situation in mature markets.
>
> I certainly agree with the view that the recent rise in bond yields is not necessarily a threat to economic recovery, particularly because I would tend to view this as a sign of underlying strength in a number of areas, and also as a general improvement in sentiment. Whereas theoretically, higher interest rates have some impact in terms of demand, the other factors that are apparently at work and also reflected in the buoyancy of financial markets point in a different direction.
>
> On the improved access of emerging market economies to international capital markets and the resulting policy implications, I would share the view held by the staff and endorsed by a number of Directors that these countries should seize the opportunity to implement sound policies and reforms. Many are doing this. Indeed, the forceful pursuit of structural reforms has progressed. The consolidation of public finances is highly desirable and increases the resilience of these economies to adverse shocks, and in this regard the analysis in the *World Economic Outlook* of what constitutes prudent levels of public debt for emerging market countries is pertinent.

Regarding developments in the countries of Central and Eastern Europe that are acceding to the EU next year, the ECB concurs with the staff's analysis. In particular, the ECB concurs on the need for fiscal consolidation, which is facilitated in the current environment of economic growth and is rightly emphasized as key in underpinning financial stability in these countries. Moreover, a credible medium-term fiscal program would contribute to reducing uncertainties and to adjusting external imbalances, which are rather large in some cases. Although exports have been resilient so far in most of these countries, weaker-than-projected external demand could exacerbate current account imbalances. In addition, the challenges posed by rapid credit growth in acceding countries and the risk of sudden capital outflows require particular attention. As emphasized in the *GFSR*, the rise in portfolio flows heightens the risk of sudden capital flow reversals, as well as the risk of increased exchange rate and interest rate volatility. This underscores the need for closely monitoring developments in specific cases. The recent increase in yields and in financial market volatility experienced in Central Europe should, however, be seen in the broader context of globally rising yields. Therefore, it needs to be noted that the rise in spreads since last June has been a phenomenon across emerging markets and is not specific to the acceding countries. Mr. Kiekens made that point clearly.

Finally, on a more analytical point, but one with potential policy implications, as Mr. Portugal also noted, the *GFSR* contains a statement that the emerging markets as a group have become net exporters of capital since 1999. This is an interesting statement, but it needs to be looked at more closely, perhaps also in the context of the WEO, as it is a statement that—without further qualification—could cause misunderstandings and lead to the conclusion of a negative resource transfer, which is not the case. We understand that the staff is simply saying that, as this group of countries now has a current account surplus, they are exporting capital. However, this is not what Table 4.2 on page 129 indicates. Although considerably reduced, there were still net capital inflows to these countries of more than $100 billion in 2002. What happened was that reserves increased tremendously, particularly in Asian countries, and this is discussed in the WEO. To the extent that the investment of accumulated reserves would be considered as capital exports, the staff statements hold true. But it seems that it should be clarified, because such transactions in official reserves were in the past recorded as compensatory financing flows, which were distinguished from normal capital exports, as they are not the same thing. To lump them together might be a little misleading, and therefore some clarification would be useful in the text.

The Chairman made the following concluding remarks:

Executive Directors welcomed the opportunity to discuss the global financial situation and prospects. They broadly agreed with the staff's assessment that financial markets had remained resilient during 2003, notwithstanding continued lackluster economic growth, geopolitical uncertainties, and high market volatility. However, they noted that some concerns remain, associated with risks related to the macroeconomic outlook, rising long-term bond yields, the potential for weak corporate earnings, and the vulnerability of emerging bond markets to a correction.

Recent Developments and Risks

Directors noted that further progress continued to be made by different sectors of the mature market economies in addressing the effects of the bursting of the equity price bubble. Household and corporate balance sheets continued to improve, as these sectors built up liquidity further and locked in fixed-rate borrowing at longer maturities. In addition, banks' balance sheets generally strengthened as corporate defaults declined and earnings began to recover. Many Directors also observed that the improved balance sheet positions of corporations placed them in a better position to contribute to the global economic recovery by increasing investment spending.

Directors agreed that historically low policy interest rates in the major financial centers had helped improve financial soundness. At the same time, low interest rates had prompted a search for yield in early 2003 that had led investors to be increasingly willing to take on credit risk and market risk, which had left those investors vulnerable to an upturn in longer-term yields. Flows had also been attracted to higher-yielding emerging markets, allowing many borrowers from these markets to complete their borrowing programs for 2003. In addition, international equity markets had recovered since March.

Directors agreed that the rebound in bond yields in major markets since mid-June had been accentuated by the unwinding of carry trades and other technical factors, including a large volume of hedging of exposures in the U.S. mortgage market. Many Directors noted that there were signs that credit spreads on corporate and emerging market bonds might have become compressed, making them vulnerable to further increases in government bond yields, and that a rotation of funds away from fixed-income instruments and toward equities could make financing more difficult for emerging market borrowers.

Directors noted that, ultimately, a further steepening of government bond yield curves could, on balance, be positive for financial markets, including the emerging markets, if it were driven by prospects of faster economic growth. Stronger growth would allow further improvements in the balance sheets of firms and households, while higher yields would benefit financial institutions. Meanwhile, low short-term rates could contribute to further balance sheet repair and underpin investors' risk appetite. Directors cautioned, however, that there were risks in the transition to higher long-term yields, including capital losses for some investors and rising bond market volatility, even though they noted that to date the market reaction to increasing yields had been relatively orderly. Some Directors also warned that a key source of concern could arise if higher yields were prompted by worries about the magnitude of fiscal deficits in systemically-important countries.

Directors observed that in the household sector a further sharp increase in bond yields would prompt steep falls in mortgage refinancing in the United States. This would reduce households' ability to further access home equity values and the saving on mortgage payments, which have provided important support to consumer spending of late. Furthermore, concern was expressed by some Directors that, in this scenario, the liquidity of cash and derivatives markets might be tested given the unprecedented size of hedging needs arising from the U.S. mortgage markets. As had been demonstrated in recent weeks, a rise in bond yields could be amplified by the need to sell fixed-rate assets to hedge the increasing duration of mortgages and mortgage-backed securities. Some Directors encouraged regulators to assess whether the capital bases of the U.S. and other mortgage agencies are adequate to absorb the risks that would arise in volatile market conditions.

Directors noted that additional risks could emerge if corporate earnings disappointed expectations. Such an outturn could undermine progress made earlier this year in strengthening balance sheets. However, many Directors observed that equity valuations were in general more sustainable than they had been for several years. Overall, most corporations and financial institutions were better prepared to cope with slower economic growth than they were last fall.

Directors welcomed the increased inflows into emerging markets in early 2003, which had reduced borrowing costs and improved access for many countries. Local markets as well as international markets for emerging debt had benefited. More recently, the yield increase in mature markets had caused some consolidation in emerging bond markets. Nevertheless, most Directors noted that yield spreads in many cases remained well below historical averages, and there were signs that the search for yield had led recently to reduced investor discrimination among issuers. They cautioned that the recent increased correlation between mature and emerging bond markets raised the risk of a generalized weakness in emerging markets should yields in the major financial centers rise further.

Directors noted that, for several Eastern European countries, strong expectations of EMU entry appeared to be embedded in their secondary bond yields, thus keeping borrowing costs down. Nevertheless, they warned that increased reliance on foreign portfolio inflows had increased the risk for market volatility, and this underscored the need to persevere with sound economic policies, including further fiscal consolidation.

Directors expressed disappointment with the continued decline in foreign direct investment. They noted that, although the downturn largely reflected cyclical factors such as the weaker investment climate in mature markets and diminished growth prospects in some emerging market regions, there also appeared to be some indications of an increase in investors' perceptions of contractual risks in some recipient countries. Directors stressed the importance of predictable inward investment regimes and sound legal frameworks.

Directors welcomed the indicators of improved stability of banking systems in a number of emerging markets, particularly in Latin America, Asia, and Eastern Europe. They noted that the risk of contagion in Latin America had subsided, although vulnerabilities remain, including those relating to dollarization. Improvements in Asia have been more robust, while some financial institutions in the Middle East and Africa continue to exhibit structural weaknesses. Directors stressed the importance of continued efforts to strengthen regulation and governance in the financial sector in all regions.

Policy Implications of Recent Mature Market Developments

Directors urged authorities in major market financial centers to persist in reforms to strengthen market foundations.

Directors stressed that corporate governance must be strengthened further to restore investor confidence. They urged full implementation of recent measures to enhance the independence of corporate boards from management and dominant shareholder influence and to encourage more active participation by institutional investors in corporate decision making.

Directors emphasized the need for further improvements in the regulation and supervision of insurance companies. They noted that increased participation by insurers in financial markets had heightened their importance for systemic stability and that, although the recent rises in equity markets and long-term interest rates had likely strengthened their financial position, they remained vulnerable. Directors urged the strengthening of regulations for the valuation of financial assets and liabilities, and greater cooperation between supervisors, both cross-border and cross-sector.

Directors called for improvements in the accounting practices and regulation of defined-benefit pension funds. They acknowledged that the policy choices were not always easy, and that the magnitude of fund shortfalls meant that they could only be eliminated gradually. Nevertheless, it was important to improve transparency and risk management. Directors also urged that firms be encouraged to build up prudent pension fund surpluses over time to guard against future financial risks, and a few Directors observed that pay-as-you-go systems faced particular long-term funding risks owing to demographic developments.

Policy Lessons from Past Episodes of High Volatility

Directors agreed that price volatility in markets should not necessarily be of concern to policymakers, unless it is amplified to a point where it triggers financial instability. They noted that past episodes of extreme volatility offered lessons about the amplifying mechanisms that could lead to instability, for example, by forcing or creating incentives for sales into falling markets.

Directors noted that amplifying factors could take a number of forms. Weak corporate governance, lack of transparency by market participants, benchmarking, and index tracking can also increase herd behavior during both a boom and a subsequent crisis. It was suggested that the staff should conduct further work on the effect of volatility on financial stability and ways to achieve the appropriate balance between market discipline and regulation.

Policy Implications for Emerging Market Countries

Although the external financing climate for emerging market countries had improved somewhat this year, Directors cautioned that the public sector debt in these countries remains high and that there was no room for complacency by borrowers. They urged countries to take advantage of enhanced access to press ahead with the implementation of sound policies, and improve the structure of their liabilities, including extending maturities and reducing the dependence on dollar-linked debt. Directors noted that several countries had undertaken successful liability management operations. They also welcomed the use of collective action clauses in recent debt contracts.

Directors welcomed the discussion in the *Global Financial Stability Report (GFSR)* of the volatility of capital flows to emerging markets, and agreed that foreign direct investment should be encouraged. They noted that changes in the composition of the investor base for emerging market assets had increased the volatility of overall capital flows and expressed concerns about the persistence of boom-bust cycles for investment. Directors recommended that the staff continue to work on analyzing the sources of volatility in the supply of funds to emerging markets.

Directors pointed out that, while volatility of capital flows seemed somewhat inevitable, sound economic policies and transparency could help to make flows more stable. There was also much that emerging countries could do to "self-insure" themselves against the effects of volatility, including through asset and liability management; adapting exchange rate arrangements to the degree of capital account openness; strengthening domestic financial institutions; enhancing supervision and regulation; and developing local securities markets. Some Directors also felt that self-insurance efforts might also be complemented by increased holdings of international reserves. Directors noted that developing efficient and stable local sources of finance had become all the more relevant now that emerging markets as a group had become net exporters of capital in recent years.

Looking ahead, Directors saw merit in future staff work in the next *GFSR* on a number of issues raised in the discussion, including on the factors behind and the implications of the shift in the status of emerging markets as a group to be net exporters of capital, including through the accumulation of external reserves. It would also be important to assess the recent slowdown in foreign direct investment and the rise in international reserves in emerging markets, in the context of floating exchange rates.

The Chairman observed that Executive Directors supported the proposal to publish a revised version of the paper together with the concluding remarks on the Fund's external website.

3. CZECH REPUBLIC—2003 ARTICLE IV CONSULTATION

Documents: Staff Report for the 2003 Article IV Consultation (SM/03/284, 8/11/03; and Sup. 1, 8/21/03); Selected Issues and Statistical Appendix (SM/03/285, 8/11/03); Report on the Observance of Standards and Codes—Fiscal Transparency Module—Update (SM/03/286, 8/11/03); and Report on the Observance of Standards and Codes—Banking Supervision—Update (SM/03/287, 8/11/03)

Staff: Schadler, EU1; Kincaid, PDR

Length: 1 hour, 30 minutes

Mr. Kiekens and Mr. Jonas submitted the following statement:

With its transition from central planning to market economy largely completed, the Czech Republic now faces another milestone: entry in the European Union and eventual adoption of the euro. This prospect has now become the major force steering macroeconomic policies and driving structural and institutional reforms. The disciplining effects of EU/EMU membership are already visible in financial market indicators, and are contributing to the Czech economy's increased resilience to external shocks. But these benefits do not come automatically: significant policy efforts are still required to enable the

Czech Republic to fully capture the benefits of economic and financial integration with Western Europe.

Recent Developments

Despite the weak external environment and the further slowing of growth in Western Europe, growth in the Czech economy accelerated somewhat during the first quarter of 2003, mostly due to household consumption. In addition, exports to Western Europe continued to grow rapidly, supported by the koruna's slight weakening against the euro. But fixed capital investment remained weak due to weak external demand and uncertainty about the timing and strength of eventual recovery.

But despite its first quarter rally, growth did not gain sufficient strength to head off a further year-on-year decline in employment and rise in unemployment. New graduates entering the labor market in June pushed the unemployment rate up to 9.9 percent. But productivity is rising briskly, and together with progress in structural reforms is creating favorable conditions for faster growth later on.

After dipping below zero in early 2003, consumer price inflation began to increase gradually, only to fall again in July to -0.1 percent year-on-year. Producer prices also continued to fall, reaching -0.6 percent year-on-year in July. The reason for such low inflation was a decline in foodstuff prices and an appreciation of the koruna against the dollar that lowered the koruna prices of imported energy.

Despite the weakness of Western demand, the Czech trade deficit is still declining. During the first half of 2003, it fell to CZK 18.1 billion, compared to CZK 22.4 billion in the first half of 2002. There are three reasons for this decline. First, both the volumes and prices of imported oil have fallen. Second, the relative weakness of investments has reduced the importation of investment goods. And third, despite weak demand in Western Europe Czech exports remain robust, particularly those of foreign controlled companies. The negative factor income balance resulting from the repatriation of the profits of foreign investors pushed the current account deficit to CZK 60.6 billion in the first half of 2003, slightly higher than CZK 59 billion of last year. This deficit is still fully covered by net foreign direct investment, which—though much less than the record CZK 207 billion in the first half of 2002—reached CZK 64.5 billion in the first half of 2003.

Based on the latest data, the near term outlook has economic activity remaining relatively robust, driven mostly by consumer demand. In June, retail sales increased by a strong 7.5 percent, supported by strongly growing real disposable incomes. June industrial production rose 6.2 percent year-on-year, and industry sales rose even higher, by 7.5 percent. Despite weakening external demand, the latest Inflation Report of the Czech National Bank (CNB) left projected GDP growth in 2003 unchanged at 2.1 - 2.9 percent. It expects a further acceleration to 2.1 - 3.8 percent in 2004, with stronger investment demand and a slowing of consumer demand.

Monetary and Exchange Rate Policy

The CNB has responded quickly to continuing weak inflation and moderate economic growth by cutting interest rates. At the end of June, it cut the repo rate by 25 points, to 2.25 percent, and again at the end of July to 2 percent. This later rate cut was a response to the postponement of EU-related tax adjustments to 2004 and the reassessment of their primary and secondary effects on inflation. It is now expected that these effects will be milder than formerly thought. Given the expected persistence of the negative output gap, the CNB does not expect a significant acceleration of inflation anytime soon. In 2004, inflation is projected to reach only the lower part of the target band.

The CNB is presently conducting its monetary policy in a framework of inflation targeting with a managed exchange rate. The CNB does not target any particular level of exchange rate, but has sometimes intervened in the forex market to correct a perceived overshooting of the koruna. It is hard to say with certainty whether the interest rate cuts or the forex interventions were the more effective tool for arresting and partly reversing the koruna appreciation. What is important is that the CNB used both instruments and succeeded in reaching its objective.

In preparation for next year's EU entry and the eventual adoption of the euro, the CNB has begun working on its monetary policy strategy for the period between 2005 (the last year for which an inflation target has already been set) and the adoption of the euro. Inflation targeting framework has worked well in the Czech Republic, and the CNB continues to improve its functioning. This being true, there are good reasons for maintaining this framework right up until euro adoption. The CNB would consider pursuing inflation targeting even within the ERM2 mechanism, as long as the fluctuation band used to assess the criterion of exchange rate stability is sufficiently wide. Of course, the CNB is fully aware that the existence of two nominal targets, the exchange rate and the inflation rate, could affect the clarity and credibility of monetary policy. Therefore, it does not intend to remain in the ERM2 mechanism any longer than necessary.

At the end of 2002, the CNB has submitted to the Government a document entitled "The Czech Republic and the Euro—a Proposed Strategy for Euro Adoption," intended to become the basic document of the euro adoption strategy. Thereafter the Government asked the Ministry of Finance and the Ministry of Industry to collaborate with the CNB to finalize this strategy by September 30, 2003. The new document should define the strategies for participating in ERM2 and for meeting the Maastricht exchange rate criterion. After consultations with representatives of the European Union Commission and the European Central Bank, the CNB is recommending the following:

It is not desirable to stay in the ERM2 for more than two years. Therefore, the Czech Republic should not join ERM2 unless there are sufficient assurances that two years later it will be able to adopt the euro.

It is not desirable to join the ERM2 immediately after EU entry. Doing so would lead to the assessment of the exchange rate convergence criterion in mid 2006, but it is projected that the fiscal deficit for 2006 will still be above 3 percent (see below). This makes progress with fiscal consolidation a crucial factor for setting the time of the euro adoption. The CNB recommends continuing to pursue fiscal consolidation and structural reforms, so as to strengthen the competitiveness and efficiency of the Czech economy.

The strategy for euro adoption to be submitted by September 30, 2003, should contain mechanisms for regularly assessing Czech compliance with the Maastricht criteria and the degree of convergence of the Czech economy with the euro area.

Fiscal Policy

The general government deficit continued to rise in 2002 and a further significant increase to 8.6 percent of GDP (without adjusting for the cost of transfers to transformation institutions) is projected for 2003. Until now, privatization revenues and ample liquidity have kept the financing of the growing deficits from becoming a problem. Low inflation and low nominal interest rates on government borrowing have limited interest payments to about 1 percent of GDP. The relatively weak growth and the negative output gap mean that fiscal expansion does not threaten CNB's inflation target. But the current fiscal trends are clearly unsustainable in medium and longer terms. Fund missions have repeatedly warned the authorities of the eventual risks created by the absence of fiscal consolidation; and more recently, the approach of EU entry and eventual euro adoption have become prominent topics in the public discussion about the need for fiscal reforms.

The authorities have now taken the crucial step from recognizing the problem to addressing it. In June 2003, the Government approved a public sector reform strategy which has now been submitted to Parliament. Its main objectives are (1) to reduce the general government deficit to 4 percent by 2006 (the year of the next parliamentary election); (2) to improve the efficiency of government spending and strengthen longer term budgetary discipline by introducing medium term expenditure ceilings; (3) to reduce corporate taxes and implement reforms harmonizing the Czech taxation system with the EU requirements; and (4) to increase the transparency of the public finances (see measures described in paragraph 22 of the staff report.).

One advantage of this somewhat delayed beginning of fiscal reform is that the extensive discussions of recent years, and the unmistakable deterioration of the public finances, both now ensure strong public and political support for it. The most important political question is no longer whether to undertake fiscal consolidation, but how fast it should proceed and how it can best be accomplished. Given the rapidly growing contribution of mandatory spending to the widening deficits, and given the already relatively heavy burden of taxation in the Czech Republic, the government is relying mainly on spending constraints. Naturally, such a policy is never politically easy to implement. But the government is explaining to the public that further delays of fiscal reforms will not make them go away but will make them still more painful later on.

Structural Issues

Following the completion of privatization, and the removal of most bad assets from banks' balance sheets, the situation in the banking sector is significantly better. At the same time, the banks have become more careful about lending to companies, particularly small and medium sized enterprises, and prefer to invest in government and CNB securities instead. And most recently they have begun a rapid expansion of their lending to households. The authorities are well aware that even though household bank debt is relatively low now, its rapid growth must be monitored carefully. It is expected that the consolidation of banks' balance sheets and the improved protection of creditors' legal rights will lead to a revival of banks' lending to enterprises.

Now that the privatization of banks has been completed, the authorities are focusing on completing the sale of the state's stakes in several nonfinancial strategic companies, including Czech Telecom and Unipetrol. As the privatization process nears its end, the authorities are thinking of terminating the National Property Fund by the end of 2005, and the Czech Consolidation Agency by the end of 2007.

The authorities are closely monitoring developments in the labor market, and remain concerned about the growth of unemployment. The Czech Republic's participation rate remains high, which suggests that there are no significant labor market rigidities. Growing unemployment can also be seen as reflecting the continuation of structural reforms under relatively weak growth conditions. But there are serious and persistent problems in the Czech labor market, including regional pockets of high unemployment; skill mismatches caused by shifts in the structure of demand for different skills; and the low regional mobility of labor due partly to rent controls. These problems have yet to be effectively addressed.

Mr. Callaghan and Ms. Amador submitted the following statement:

Key Points

- The economy has displayed resilience amidst difficult global conditions, with output rising at a moderate clip, inflationary pressures remaining low, and financial indicators strengthening.

- The central priorities for the authorities are to strengthen the fiscal position and to maintain the reform momentum, with a view to strengthening the economy's underpinnings for sustained and balanced growth, and meeting the challenges posed by EU harmonization.

- The implementation of the proposed fiscal reform package, which seeks to rein in the public deficit, would send a strong signal of the authorities' commitment to fiscal prudence. However, it is unfortunate that it appears to have taken a sharp deterioration in the fiscal accounts to bring home the need for a fiscal adjustment.

- While conditions in the financial system are broadly favorable, efforts to strengthen supervision have continued.

The Czech Republic's economy has performed solidly over the past few years, and this owes in no small measure to the authorities' commitment to macroeconomic discipline as well as to institutional and structural reforms. The medium-term outlook is also expected to continue to be broadly positive, provided that the government tackles decisively the weakening fiscal position that threatens to complicate economic management and undermine investor interest.

Growth is moderate, with household demand driving overall economic performance. The surge in household demand can be traced in part to real wage gains that, as the staff point out, were estimated to be matched by productivity increases. Growth has also been supported by the very large fiscal stimulus. However, the composition of growth is narrowly based and while the export sector has held up remarkably well, a more robust economic recovery will ultimately depend on a strengthening in the euro area. It is unfortunate that a gloomier outlook for Europe has led staff to revise down its growth projections for the Czech Republic.

Monetary Policy Responses Have Been Appropriate

With inflationary pressures expected to continue to be well-contained in the near term, monetary policy has considerable scope to provide the all-important support to growth. The availability of this policy stimulus should help balance the tough fiscal adjustments that the government plans to undertake over the medium term.

We commend the authorities for their careful handling of monetary policy in the past. We similarly support their prudent approach in keeping monetary policy on an even keel moving forward. This is evident in their development of a timetable for euro adoption that would be based on solid progress toward a medium-term fiscal adjustment program and more general indications of the country's readiness for monetary union. At the same time, the authorities are undoubtedly aware that any significant lapses in progress toward satisfying the Maastricht criteria could dent investor confidence and affect financial markets. It is for this reason that we believe that the planned harmonization with the EU will serve as a disciplining force that will help ensure prudent economic policy formulation.

We join the staff in endorsing the monetary authorities' intention to continue with the familiar and tested inflation targeting framework at least until ERM2 entry. In this regard, we appreciate the information provided by Mr. Kiekens and Mr. Jonas in their helpful preliminary statement regarding the CNB's recommendations on the Czech Republic's strategy for euro adoption.

The expected surge in inflation as a result of indirect tax changes before EU accession should be a one-off influence and as such should not require a policy response. However, it will be important for the CNB to make it clear that policy will respond should the increase in prices lead to a rise in inflationary expectations and a wage response.

On page 12 of the staff report, the staff observe that measures of business cycle synchronization and integration with the euro area are not as strong as in other Central European countries. It would be helpful if staff can elaborate on why this may be the case.

Underlying fiscal trends are a source of concern but the fiscal reform package aims to put public finances on a sounder footing.

The fiscal accounts have weakened considerably, with the general government deficit projected to widen to about 7¼ percent of GDP in 2003. It would have been desirable if the staff report provided more information on the background for the rise in the general government deficit by 4¼ percent over two years. The report says that the increase reflected mainly expenditure increases, about one-third on subsidies and the rest on goods and services related to the establishment of a new layer of regional government. In addition, there were flood-related payments and restitution to a foreign investor. While some of this increase in expenditure was clearly one-off, an understanding of the driving forces behind this large increase in public expenditure would have been helpful in order to assess the prospects of the authorities' proposed strategy to implement fiscal adjustments that would reduce this deficit by about 2¼ percentage points over the 2004-06 period. On the surface, the proposed reduction in the deficit appears rather gradual, given the magnitude and speed of its increase in the past.

While we support the authorities' intention to consider indirect tax increases consistent with EU harmonization, it is appropriate that the weight of the consolidation measures rest on restraining expenditures, given that spending pressures were responsible for the large part of the weakening of the public finances. It would be useful to know whether the measures contemplated in the fiscal reform package will be directed at the areas that had produced the bulk of the recent increase in expenditures.

We are also pleased with the authorities' commitment to strengthened budgetary procedures including through the introduction of a medium-term fiscal framework with binding expenditures targets, the incorporation of spending by extrabudgetary funds in the responsible ministries' expenditures ceiling and the budget procedure, and the establishment of limits in the issuance of new public guarantees.

While we note the staff's comment that their discussions with the authorities indicated a strengthened political will to achieve fiscal sustainability, public support, especially for the more difficult adjustment measures (such as the proposed reform of the pension system, streamlining of the bureaucracy and changes in sickness benefits), appears to be less clear cut. The authorities need to take every opportunity to explain to the public the need for reform and the adjustment costs that this will entail. It is to be hoped that the publication of the staff report will help with this task, and perhaps some further analysis on fiscal sustainability would have been suitable for inclusion in the selected issues paper.

Supervisory Reform — Work in Progress

Going forward, the authorities face the challenge of ensuring banking system soundness and efficient financial intermediation. We are pleased that the authorities intend to respond proactively to potential financial sector risks even as current financial indicators provide a favorable view on the strength of the financial system. In particular, with lending to the household sector continuing to rise sharply, it is well-advised that the authorities have been strengthening their supervisory capabilities, including by putting in place appropriate prudential norms and closely monitoring relevant key indicators on the credit exposure of households, in particular, and—along the lines identified in the 2001 FSSA—improving banks' risk management and facilitating consolidated supervision.

Institutional and Structural Reforms Continue

Continuing institutional and structural reforms have enhanced the Czech Republic's attractiveness to foreign investments, which have, among other things, helped in the economy's modernization and provided a comfortable and stable source of financing for the current account. In this regard, we encourage the authorities to continue their efforts to strengthen the institutional and legal framework, including by remedying the weaknesses in the existing bankruptcy law (specifically those concerning the protection of creditors) and completing the privatization of state enterprises, as well as to increase labor market flexibility in order to maintain the country's external competitiveness.

Mr. Padoan and Ms. Rizzotti submitted the following statement:

Introduction

We wish to commend the Czech authorities for their success in completing the negotiations for accession to the European Union and congratulate them for a successful referendum favoring membership in the EU. We also thank staff for the well-written papers and Mr. Kiekens and Mr. Jonas for their insightful and candid preliminary statement.

More broadly, we commend the authorities for the comprehensive reform efforts they have undertaken to transform their economy into an efficient market economy. The Czech economy has achieved macroeconomic stabilization early on in the transition process and the implementation of structural reforms has been strengthened in the last few years.

The Czech Republic has been a frontrunner for EU accession since the beginning of the negotiations. The European Commission in its last annual report on Czech Republic's progress toward accession, confirmed that transition is essentially complete and affirmed that the continuation of its current reform path should enable the country to cope with competitive pressure and market forces in the Union.

However, important challenges remain. Especially, more needs to be done to ensure the sustainability of the fiscal position. Improvement in the management of the public finances, focusing on addressing the high mandatory expenditures, will be crucial in order to adjust to the macroeconomic conditions of EU membership.

Recent Performance and Outlook

In 2002 the Czech economy demonstrated a considerable resilience, coping fairly well with sluggish external demand and the koruna appreciation . These factors were counteracted by the increase in export capacity and competitiveness associated with large FDI flows, which resulted in an increase in exports. The performance in 2003 is encouraging, in the face of a gloomier outlook for Europe. However, in the medium term the challenge will be to raise economic growth to rates more in line with the potential of the Czech economy, in order to sustain real convergence and reduce the gap in GDP per capita with the EU average.

The recent rise in unemployment can be read as a necessary step in economic transformation and it is less concerning if it represents a temporary effect of enterprise restructuring. However, given the degree of regional concentration in unemployment rates and the increasing share of long-term unemployment, we encourage the authorities to reduce the impediments to labor mobility and to provide retraining opportunities in order to prevent the emergence of a long-term problem. In this regard, and also in light of the EU funds that will be available upon accession, it would be interesting to know whether the authorities are already elaborating a strategy for regional development policies. Staff comments are welcome.

Fiscal Policy

The fiscal policy stance loosened considerably last year and the increase in subsidies is a particularly worrying trend.

In this light, we are encouraged by the authorities' awareness of the need for fiscal consolidation and their strengthened commitment to address this issue, as demonstrated by the recent government proposal which aims to markedly reduce the fiscal deficit by 2006. In particular, we welcome the fact that the proposal aims also to make room for EU related spending and that the bulk of the adjustment is on the expenditure side. We agree with staff that the challenge ahead will be to ensure the actual implementation of the proposal, and we urge the authorities not to water it down.

We welcome the Czech authorities focus on fiscal adjustment, which represents the priority over the medium term, also in light of the EU requirements for fiscal discipline.

Monetary Policy and ERM2

The recent relaxation of interest rates by the CNB was in our view appropriate and timely, given the negative output gap, the weak external environment, continued low inflation and pressures towards exchange rate appreciation. We also agree with the strategy of not responding to the impact of the tax changes on inflation, while being ready to react promptly to any second round wage effects.

Regarding foreign exchange market intervention, taking into account the potential costs involved, we support the view that intervention, even if not completely ruled out, should be limited to exceptional circumstances.

We welcome the steps that the authorities have already taken to develop a strategy for ERM2 participation and euro adoption, as outlined in Mr. Kiekens's and Mr. Jonas's preliminary statement, and their intention to finalize this strategy by the end of next month . We welcome, in particular, the fact that the recommendations of the CNB for participating in ERM2 and euro adoption have been formulated after consultations with representatives of the European Commission and the European Central Bank. In this regard, it is also very encouraging that the authorities emphasize that the pace of fiscal consolidation is a crucial factor in setting the time for adopting the euro. In this light, we would note that it is not advisable to seek entry into ERM2 until there are sufficient assurances that all the relevant conditions are being met. On the other hand, we believe that if sufficient progress is made on fiscal consolidation and structural reform, participation in ERM2 is likely to prove compatible both with the retention of the inflation targeting framework and the attainment of the degree of exchange rate stability needed for eventual adoption of the euro.

Structural Issues

We agree with the staff that strengthening the institutional and legal framework is critical for improving the business climate and maintaining a strong record on FDI. In particular, we welcome the authorities' effort in preparing amendments to the bankruptcy law, especially in order to improve creditors' rights. This should be helpful also in strengthening the role of the banking sector in financing economic development, given the low level of credit to enterprises, especially to SMEs.

We welcome the fact that the banking sector has stabilized since the transfer of bad loans to the state Consolidation Agency and the completion of banking privatization. In this respect, given the cost that bank restructuring entailed on public finances, it is reassuring to know that progress is being made in working out the Consolidation Agency's impaired assets. Given the magnitude of these assets, a decisive approach in selling them off is relevant in order to free the economy of misallocated resources.

The lack of a proper regulatory and legal framework, especially in the financial sector, became apparent as a crucial weakness in the 1997 crisis. Commendably, however, the authorities have made much progress in strengthening banking supervision, although there is still room for improvement, namely in the field of corrective action, licensing practices and connected parties' lending.

With these remarks we wish the authorities every success and smooth progress toward full EU membership.

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

The Czech Republic has consistently experienced healthy per capita GDP growth rates for the last ten years, with the exception of a two year period during the currency crisis episode. This performance, which was accompanied by declining inflation and until recently sound fiscal accounts, is a testimony to the Czech authorities' commitment to reforms and to the transformation of the economy to an effectively functioning market economy. Alongside the deep structural reforms undertaken so far, prudent macroeconomic policies have strengthened the economy's resilience. Enhanced investors' confidence has rendered the Czech Republic a prime destination for foreign direct investment, especially from Europe, which has had a considerable positive effect on economic performance. In fact, in spite of the appreciation of the koruna, the export sector has been an important driving force behind the continuing growth.

Looking forward, we share the staff's assessment of the challenges facing the authorities and the proposed policy responses. A key issue that needs to be accorded the highest priority is the recent loss of discipline in the conduct of fiscal policy, which is clearly noted in Mr. Kiekens' and Mr. Jonas' very helpful and candid preliminary statement. In this regard, the authorities should initiate a fiscal consolidation as soon as possible. The current environment of improved growth prospects for Europe, notwithstanding the attendant risks, presents an opportune time to undertake strong adjustments.

For the short term, while the growth outlook is generally positive, the balance of risks, as the staff report points out, is on the downside. In this regard, it is essential that the authorities reduce reliance on fiscal policy in their efforts to temper any slowdown in growth. Given the tame inflation outlook, there seems to be reasonable room to further ease monetary policy in the face of weaker external demand, which would at least partly compensate for the expected reduction in the fiscal stimulus. Clearly, in the event that growth in Europe turns out to be lower than foreseen, the authorities would perhaps have to accept a slower pace of economic growth in order to avoid further amplifying the fiscal problem. The extent of the fiscal consolidation in 2004 should be calibrated in line with the cyclical position of the economy. In particular, while tightening the fiscal stance is essential in the period ahead, it is also important that the authorities do no attempt to implement an unduly restrictive policy in an environment of weak growth outlook. This would also help to limit the adverse impact on income levels and thus enhance the attractiveness of the reform program to the public.

While the level of public debt is still relatively low and manageable, it is a matter of concern that it has been rising steadily, and that the medium-term projections reveal its vulnerability to a further sharp increase. The currently rising fiscal deficit, the rigid structure of expenditures, and the potential for a significant increase in pressures on the budget as the population ages underscore the entrenched weaknesses. The extension of government guarantees, which are rather large, risks clouding further the fiscal outlook. These factors call for a speedy adoption of a deficit reduction plan that focuses on reducing expenditures in non-priority areas. The need to reduce the high tax burden and to allocate resources for EU-related spending in the period ahead adds to the urgency of undertaking such a plan. In this regard, we welcome the authorities' proposal for reducing the deficit to 4 percent of GDP by 2006. However, like the staff, we have some reservations regarding the nature of some of the contemplated measures, namely compressing operating expenditures and delaying civil service reforms. It is critical that the actions taken end up generating sustainable savings, and that they address fundamental weaknesses in the budget. In particular, the staff is right in pointing out the lack of specific measures to reverse the increase in subsidies and transfers to non-financial enterprises and the need to further reform the pension system. In addition, we are encouraged by the authorities' efforts to support specific expenditure reducing measures by strengthening budgetary procedures, including through the adoption of a medium-term fiscal framework with binding expenditure targets, incorporation of extrabudgetary funds into the budget, and limiting the issuance of public guarantees.

With regard to monetary policy, we are of the view that a prudently accommodative stance is appropriate given the current circumstances. In spite of the recent rise in food prices and the moderating effect of the appreciation of the currency, it appears that inflationary pressures are broadly under control. In this light and given the concern over a further appreciation in the currency, some relaxation of monetary conditions would be called for if demand conditions remain weak. With regard to the expected tax-induced increase in inflation in 2004, it should be noted that a policy reaction would be warranted only to the extent that this increase seeps into wages.

On the monetary policy framework, it seems only reasonable to continue with the inflation targeting framework until otherwise suggested by the requirements for the adoption of the euro. More importantly, as we stressed above, the authorities should have a clear medium-term fiscal adjustment plan, which is essential not only for maintaining stability in the economy, but also for reducing the uncertainty with regard to meeting the Maastricht criteria and adopting the euro. Clearly, there are other issues pertinent to the economy's readiness to participate in the monetary union, including inter alia the synchronization of the business cycle and flexibility of the labor market. We welcome the authorities' close examination of these issues which should influence the decision on the timing for entering ERM2.

On the financial sector, we are encouraged by the recent strengthening in soundness indicators, particularly the improvement in profitability and capital adequacy ratios and the decline in non-performing loans. The continued reluctance of banks in extending credit to small and medium-sized enterprises seems to be related to the lingering effect of the recent troubles associated with bad loans, and is therefore understandable. However, it is important for the authorities to make every effort to promptly strengthen the legal infrastructure to increase protection for creditors, and hence prevent this reluctance from becoming embedded in the credit culture for too long. With regard to credit to the household sector, while the level is still relatively low, a continuation of the recent expansion, which seems likely given the high demand for such credit and what staff refers to as anecdotal evidence on negligible default ratios for mortgages, calls for vigilance in supervision. The authorities should move quickly to adopt prudential norms in line with best international practices to minimize potential vulnerabilities.

With these remarks, we wish the Czech authorities success in tackling the challenges facing the economy.

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

The economy of the Czech Republic has shown a good performance over the last year. Despite weak global conditions and serious floods, the country is experiencing a small but positive growth rate, and inflation has remained subdued. However, some risks, mainly related with fiscal sustainability, are becoming more visible, underscoring the urgent need to address them.

Staff note that the adjusted general government deficit widened in 2002 and is expected to further increase this year to a record of 7.25 percent of GDP. Even though the public debt is low (27 percent of GDP), the public sector debt sustainability analysis shows that in a non-reform scenario, it would increase to above 55 percent of GDP by 2008, entering into a dangerous zone where unfavorable shocks may generate conditions for a crisis, clearly reinforcing arguments in favor of a prompt adjustment.

Box 1 of the main report depicts the Czech Republic having the highest corporate income tax rate among selected accession countries. This and the already large tax to GDP ratio justify the government proposal for fiscal adjustment in 2004–06, with the weight of the measures on the expenditure side. Maybe the staff could elaborate more on the likelihood and eventual timeliness of civil service reforms that seem key to accomplish permanent savings.

Given the expected population aging, proposed changes to the current pay-as-you go pension system, such as increasing the retirement age, are welcome. However, keeping in mind some figures from a recent OECD Economic Survey, we should conclude that much remains to be done in this area to restore the medium and long-term sustainability. The above-referred survey warned that annual deficits related to the current pension system are projected to double from 1 to 2 percent of GDP within the coming few years, while the present value of the contingent pension liabilities is well above 100 percent of GDP.

Fiscal reforms appear even more imperative after taking into account the risk that privatization sales might be delayed. While privatization receipts in 2002 allowed a moderate increase in the general government debt, the staff stress that broad support is not assured. Perhaps the staff could expand upon the current state of the public support to the reforms and privatization prospects. At the same time, we would like comments on the progress of having strong regulatory agencies in key sectors, so as to avoid that privatized enterprises end up being transformed in private monopolies. In particular, vertical mergers in energy industries might be a threat to competition in these markets. In this regard, we would like to have staff comments on the evolution of competition and of prices of public utilities.

The Central Bank has followed commendable and prudent monetary policies, which are mirrored in a subdued inflation. At the same time, as a result, in a large part, to the remarkable success in attracting foreign direct investment, the local currency has shown a persistent real appreciation. The real appreciation has not significantly weaken exports performance and strong FDI inflows have been mostly directed to expand export capacity.

The study about the monetary policy transmission mechanism in the Czech Republic, included in the Selected Issues paper, finds that the interest rate channel is the most prominent one in the country. Keeping in mind the limited prospective inflationary pressures, we welcome the authorities' decisions to cut the policy interest rate, and share the staff's position on the need to continue reducing rates as inflationary conditions allow for it. Moreover, continuing inflation targeting until the country enters ERM2 seems to be a right decision, and we also concur that foreign exchange market intervention should until then continue to be exceptional. Nonetheless, we have some reservations regarding the continuation of the IT system after joining the ERM2. In this regard, as the authorities recognize, the existence of two nominal targets potentially in conflict, may end-up affecting the clarity of monetary policy intentions and the credibility of the inflation target. A specially careful policy management and communications policy will then be needed.

The large amount of FDI that the Czech Republic has attracted over the last decade has been of key importance to sustain economic growth. Going forward, the authorities should take further steps to improve the business environment and continue to attract FDI. Strengthening the institutional and legal framework should be considered a top priority, and in particular, better defining creditors' rights through a new bankruptcy law will be critical. With these remarks, we wish the authorities every success in their future endeavors.

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

We thank the staff for the helpful set of papers and Mr. Kiekens and Mr. Jonas for their helpful and candid preliminary statement.

Despite the serious floods that affected the country and the global slowdown last year, Czech economic growth outpaced the OECD's average. The Czech Republic remains the leading destination of foreign direct investment in central Europe, taking advantage of its geographical location and the growing cross-border integration of production processes. Inflation is under control and the balance of payments position remains comfortable owing to strong capital inflows. The trade deficit has declined in the last few years, partially due to enhanced competitiveness resulting from the persistent high levels of FDI. In addition, the current account deficit, while recently widening to 6½ percent of GDP, has been fully covered by FDI and is expected to narrow in the coming years. Nonetheless, several important challenges stand out, in particular, the worsening fiscal imbalances and the increasing unemployment rates. It should be noted, however, that the authorities have already begun to push for concrete measures to address the burgeoning budget imbalances, consistently with EU harmonization.

The current scenario of low inflation and strong koruna creates the conditions for maintaining the supportive stance of monetary policy. Although there was an anticipation that the scheduled tax increase would push up inflation significantly in 2004, the primary impact was recently reassessed downwards. Higher household consumption and the expectation of global economic recovery in the second half of 2003 should improve Czech growth prospects later in the year and in 2004.

As expressed in Messrs. Kiekens and Jonas's statement, the fiscal situation is clearly unsustainable, albeit manageable in the short run due to low interest rates and ample liquidity. In this connection, we are encouraged by the growing political consensus on the need to address this worrying imbalance, and share staff's view that the authorities should appropriately focus the fiscal adjustment on the expenditure side, given the comparably high tax burden already in place. We are also encouraged by the fact that many of the actions being proposed may bring permanent results, as in the case of the reforms of pensions and sickness benefits.

The Czech Republic is in good position to benefit from the European Union membership. Currency risk elimination, lower interest rates, and faster economic growth are all key components of a promising accession scenario.

Notwithstanding the clear impending gains, participation in ERM2 and the fulfillment of the exchange rate convergence criterion have a number of implications that deserve the authorities' attention. Adoption of ERM2 places high pressure on economic policy consistency and there are significant potential costs involved, inasmuch as financial markets may "test" the willingness of the authorities to maintain the exchange rate within the fluctuation band. Here, again, the importance of bringing public finances on a sound footing cannot be overly emphasized. Similarly, other structural reforms, as the institutional and legal framework strengthening, are fundamental to enhance the country's resilience to shocks. The authorities' approach towards ERM2 seems sensible, by "buying" additional flexibility in the timing of adherence to allow for substantial fiscal consolidation.

The rise in the unemployment rate in the Czech Republic, which increased from 4 percent in 1995 to 8.8 percent in 2001, is a matter of concern. A closer examination of this figure shows that most of it is due to the ongoing shift in the economic structure, as well as to changes associated with demands for different skills. Although great part of the unemployment is concentrated on the young population, increasing enrollment in secondary and tertiary schools bodes well for future labor market developments, as the younger are preparing themselves to fill the more skilled positions where demand is stronger.

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

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

Key issues

- While the Czech economy has demonstrated considerable resilience against the global slowdown, stronger and sustained fiscal consolidation together with further economic restructuring is needed to promote real and nominal convergence after the accession to the European Union.

- Strong and frontloaded fiscal consolidation focusing on spending restraint will be essential in the coming years and should be sustained over the political cycle, respecting the requirement of the EU Treaty and the Stability and Growth Pact. It would also seem useful to develop a full-fledged medium-term framework, consistent with the SGP as this would make policy more transparent and predictable.

- We are pleased to see that significant progress with regard to fiscal consolidation is seen as a crucial factor in setting the appropriate time for ERM2 membership and euro adoption. Participation in the ERM2 should help to achieve the necessary convergence and should not be seen as a mere waiting room for the adoption of the euro. The current inflation targeting framework has served Czech Republic well and could remain in place after 2005.

- Redressing shortcomings of the judicial and legal systems should be a priority on the structural front, and the authorities should proceed further with privatization. Further reforms of the labor market are needed to support the reallocation of labor to more productive sectors.

We thank the staff for a well-written set of papers and Mr. Kiekens and Mr. Jonas for their thorough and candid preliminary statement. We are in broad agreement with the staff appraisal and we can also associate ourselves with the thrust of the statement by Mr. Padoan and Ms. Rizzotti. We congratulate the Czech authorities for a successful referendum favoring membership in the European Union. EU membership buttresses the significant successes that have been achieved during the last decade, and provides support and incentives for achieving further real and nominal convergence.

General Remarks

The Czech economy has demonstrated considerable resilience against the global slowdown. However, significant macroeconomic and structural challenges remain. Recent developments are partly attributable to renewed restructuring efforts as large foreign direct investment inflows and several structural measures have resulted in a pick-up of the trend productivity. However, massive public spending has brought about a dramatic deterioration of fiscal position that is clearly not sustainable. Decisive fiscal consolidation and reform and further economic restructuring are needed to sustain the current pace of real convergence and to achieve higher growth after the accession to the European Union.

Fiscal Policy

We join staff in welcoming the government's resolve to address the significant deterioration in the fiscal situation and are pleased to note the increasing domestic support, although its sustainability is still to be tested. We join Mr. Padoan and Ms. Rizzotti in urging the authorities not to water down their ambitions. Indeed, strong, frontloaded, and sustained fiscal consolidation will support sustainable growth over the medium term and is also essential for preparing the Czech Republic for the requirements of the EU policy framework, including the 3 percent deficit limit in the Treaty and the Stability and Growth Pact's requirement of a fiscal situation close to balance or in surplus in the medium term.

It would also seem useful to develop a full-fledged medium-term framework, consistent with the SGP as this would make policy more transparent and predictable. We agree that putting emphasis on spending restraint is appropriate in view of the already high taxation and the high share of mandatory and quasi-mandatory expenditures. We also note with concern the increase in subsidies and the complexity of the fiscal accounts, resulting from extra-budgetary funds and an additional layer of local government. A Civil Service reform should be commenced, but it seems that the bulk of initial savings will come from a freeze on wages and other costs that, as staff points out, would restrain the spending only temporarily. The current system of social and health care benefits is not sustainable in the long term. OECD predicts that the deficit of present PAYG pension and health care systems, already over 1 percent of GDP, would rise to 4 percent of GDP by 2010 and would continue to increase thereafter.

Monetary and Exchange Rate Policies

The authorities should be commended for their conduct of monetary policy. Interest rate decisions have been appropriate and timely. We concur with staff and Mr. Padoan and Ms. Rizzotti that interventions on foreign exchange market should be kept for exceptional cases only and be used extremely sparingly.

We look forward to a further articulation of the authorities' strategy for euro adoption, to be submitted by end-September and can associate ourselves with remarks made by Mr. Padoan and Ms. Rizotti on ERM2. In particular, we are pleased to see that significant progress with regard to fiscal consolidation is seen as a crucial factor in setting the appropriate time for euro adoption. This is fully consistent with the requirement that the authorities should ensure that a general economic policy framework is in place consistent with the objectives of the ERM2 before entering the mechanism. Moreover, it should be borne in mind that the objective of ERM2 is exchange rate stability, despite the wide fluctuation bands. While a minimum stay of two years in the ERM2 prior to the convergence assessment without severe tensions is expected, it is also part of the agreed framework that the assessment of exchange rate stability against the euro will focus on the exchange rate being close to the central rate while taking into account factors that may have led to an appreciation, in line with what was done in the past. Thus, upon entry in the mechanism interest rates will have to be set with the aim of keeping the exchange rate stable. While ERM2 participation can be fully consistent with the retention of the inflation targeting framework, the fact that interest rates are reserved for this purpose, in turn, requires a stability-oriented framework for fiscal policy and sufficient progress on structural reform. Needless to say, participation in the ERM2 should help to achieve the necessary convergence and should not be seen as a mere waiting room for the adoption of the euro.

Banking System and Structural Reforms

We welcome that the Czech banking system and banking supervision have been strengthened further, including by introducing legislative changes and developing supervisory practices. The authorities seem to be much better positioned to face the challenges stemming from a successful banking reform, such as a further rapid increase of credit to households. This year's update of ROSC provides an impressive list of measures that will, inter alia, reinforce supervision on a consolidated basis and improve monitoring and the regulation of banks' risk control systems. It is also clear that there remains room for improvement in certain areas as noted by staff, including further attention to banks' management of operational risks.

We agree with staff that redressing shortcomings of the judicial and legal systems should be a top priority on the structural front, and we urge the authorities to proceed further with privatizations. A major challenge will be to spread efficiency gains beyond the FDI sector. That can be achieved by sticking to market-oriented approaches in enterprise restructuring, further liberalization of network industries, and strengthening of market regulatory bodies.

While the Czech unemployment rate is rather low compared to most other acceding countries, the recent increase is a concern together with the high female unemployment and important geographical disparities. Further reforms to improve mobility and flexibility will be essential to tackle the persistent problems in the Czech labor market.

Mr. Reddy submitted the following statement:

We thank staff for the set of well-focused documents as well as Mr. Kiekens and Mr. Jonas for their helpful preliminary statement. Since the last consultation, growth has slowed but remains robust despite the sluggish external environment and domestic challenges. The commitment of the authorities to maintain an investor friendly environment as well as their progress in structural reform has resulted in significant FDI inflows. Inflation remains low. With the demands of EU accession continuing to drive policy, the authorities will need to focus on improving the fiscal framework as well as accelerate structural reform. We broadly agree with the thrust of the staff report and would therefore focus on a few issues only.

The fiscal situation, which has accentuated over the past three years continues to dominate the policy agenda and complicates the prospects for early euro area entry. While admittedly, about one-third of the three percent increase in the general government deficit during the current year can be attributed to one off factors, the residual increase in expenditure remains a cause for concern. As staff points out, further stress on the fiscal issues from demographic considerations and contingent liabilities needs to be factored in. We therefore welcome the commitment of the authorities to directly address these issues over the next three years through the proposed fiscal adjustment package. This is a good start even if it is seen in some quarters as not being ambitious enough. With the proposed adjustment projections in Para 19 being based upon the assumption of a deficit of 6.2 percent in 2003, the actual fiscal compression for 2004, may be significantly higher than the corresponding figure for the next two years. We hope this relative unevenness of the effort will not constrain its acceptability. In the present environment, to ensure the implementation of this fiscal initiative, the authorities need to actively generate widespread consensus for the proposed measures. Given the limited headroom available on the revenue side, the focus on containing expenditures is appropriate. Within this category, the reform of the social benefit and pension systems is an attractive option, given its long-term impact. Staff concerns about the sustainability of some of the measures in the package also needs careful consideration.

The intention of the authorities to adopt a monetary policy stance supportive of the fiscal consolidation program in case the down side risks to growth and inflation materialize, is appropriate. Operating within the inflation targeting framework, restraining the impact of the appreciation of the koruna continues to be a policy challenge for the authorities. While the relative roles of the recent interest rate cuts and the intervention on halting the appreciation remain unclear, we note the intention of the authorities to intervene in the foreign exchange market only in exceptional circumstances.

The improvements in the financial soundness indicators, after the restructuring of the banking sector, is reassuring. Staff have pointed to the need for the authorities to remain vigilant to unfolding scenarios in the credit sector and in this context urged that the prudential implications of the rapid increase of credit to the household sector be examined carefully. This suggestion has merit, and we therefore welcome the intention of the authorities, described in the statement of Mr. Kiekens and Mr. Jonas, to monitor the growth of household debt carefully.

The deterioration in the labor market and the need for the authorities to undertake proactive measures to improve its flexibility had been raised during last year's consultation also. Issues relating to the need for enhancing labor mobility, motivating job searches and improving the efficiency of the process of matching vacancies with job seekers, had been discussed. The viewpoint of the authorities that, with the labor participation rates being the highest among the CECs, the increase in unemployment is merely a temporary manifestation of restructuring; provides some reassurance. We also welcome the candid comments of Mr. Kiekens and Mr. Jonas in their preliminary statement in this regard.

We wish the authorities all success in their policy endeavors.

Mr. O'Loghlin submitted the following statement:

While the Czech Republic has been buffeted by the ongoing slowdown in global and European economic growth, it has sustained at least a moderate pace of advance over the past couple of years. Key contributors to that outcome, one suspects, were its relatively restrained inflation and commendable progress on structural reform, leading to strong FDI—doubtless a reflection of positive views among the international business community of the country's potential as an about-to-be member of an enlarged European Union.

However, it is important not to overrate recent performance, lest it lead to undue expectations. The growing gap between GDP and GNP is noteworthy in this context. If forecasts for this year are on the mark, GDP will have expanded by about 2¼ percent annually over 2001–2003. During this period, however, the share of net factor outflows in GDP will have risen by about three percentage points. In effect, a large part—not far short of half—of recent growth reflects returns to international investment rather than added output attributable to the domestic economy. The same pattern has held since the mid-1990s, albeit with a lesser differential. I do agree with the staff that TFP, reflecting cumulating benefits of FDI and structural reforms, should be higher going forward than hitherto. But the question arises whether GDP-based measures of recent Czech productivity growth give a somewhat inflated pointer to potential for future growth the fruits of which will accrue to the domestic Czech economy.

Whatever the outlook for productivity improvement, the authorities face a difficult challenge of arresting the recent fiscal deterioration and sufficiently reversing it to sustain confidence that the Republic's goal of euro-adoption will not be unduly delayed. Discounting the adverse effects of once-off events on the 2003 budget, the goal of cutting the deficit to 4 percent of GDP by 2006 implies an average annual net fiscal consolidation of 0.75 percent of GDP. Achieving this at the same time as: (i) creating room for the net budgetary costs accompanying EU membership; (ii) bearing the higher interest costs which a large, if declining, fiscal deficit implies, and (iii) reducing corporate taxes will not be easy. The authorities' commitment to consolidation, implicit in their bringing forward the proposals now before parliament (and moving to improve spending discipline by introducing medium-term expenditure ceilings, as noted by Messrs. Kiekens and Jonas), is very welcome. In view of its already high level, the authorities are right to seek adjustment primarily on the expenditure side—with the focus on current spending and avoiding any diminution of public investment effort.

While wishing the authorities every success in meeting the fiscal consolidation challenge, given its scale I strongly support Mr. Padoan's observation about the inadvisability of seeking entry to ERM2 in advance of assurance of sufficient progress in all the relevant respects. In this instance, that means assurance in the form of adoption and implementation of measures of a character which will deliver sustained budgetary improvement.

The fiscal adjustment proposals also involve significant revenue-raising through increases in indirect taxation equivalent to about 2½ percent of personal consumption—leading to a temporary up-tick in inflation. In this context, I join with Mr. Callaghan's commendation of the Czech National Bank for their careful handling of monetary policy in the past, and with his caution to the CNB that it make clear it will act if the temporary "spike" should lead to a wage or like response.

As to structural issues, I endorse the staff call to redress remaining key lacunae in the judicial and legal systems which would further improve the business environment. The authorities are to be commended for a labor market environment which has delivered labor force participation and an employment rate above the European average. But, as noted by Mr. Kiekens, significant shortcomings remain. I agree with the staff that steps to improve flexibility are crucial to maintaining external competitiveness and the capacity to adapt to the shocks which will inevitably arise, and would encourage the authorities to move in that direction.

With these remarks we wish the Czech authorities well in their future endeavors on behalf of the Czech people.

Mr. Usman submitted the following statement:

We thank the staff for a well prepared set of documents and Mr. Kiekens and Mr. Jonas for their comprehensive and detailed preliminary statement. As stated in Mr. Kiekens's statement, the Czech economy has more or less completed the transitional process from a central planning to a market economy. The fiscal position has been sound, external and public debt has been low and the stabilization process consolidated. The prospects for entry into the European Union and the eventual adaptation of the euro attest to the economic achievements made by the Czech Republic. We commend the authorities for their effort in ensuring a smooth transition. Since we are in broad agreement with the thrust of the staff report, we will limit our brief comments of selected issues for emphasis.

The performance of the Czech economy has been solid over the past few years and indications for medium-term prospects are good. But the recent deterioration of the public finances, in particular the widening of the general government deficit resulting largely from increasing expenditures, clouds the public finance picture. However, we note in the staff report the authorities' strengthened political will to address the risks to fiscal sustainability demonstrated during policy discussions and the preparedness to take the necessary measures to address the problems, as outlined in Mr. Kiekens and Mr. Jonas's statement. There is need to be vigilant in fiscal reforms and fiscal consolidation in order to meet the Maastricht criteria.

On the structural front, the completion of privatization of the banking sector, and the large-scale transfer of non-performing assets from banks balance sheets has helped strengthen the banking sector. This has in turn led to improvement in financial indicators including profitability. Bank holdings of liquid government and Czech National Bank's paper has continued to rise reflecting bank's reluctance in taking risks. Lending to enterprises has declined, but lending to households has increased. While broad indicators of banking system soundness are reassuring, the increasing exposure to household could become a source of vulnerability. To this end, we urge the authorities to monitor the lending expansion to households, and are encouraged by Mr. Kiekens and Mr. Jonas's statement that the authorities are following this development closely.

The authorities have accorded top priority to addressing shortcomings of the judicial and legal systems in order to strengthen the institutional and legal framework. In this regard, we welcome the forthcoming amendments to the bankruptcy law to strengthen creditors rights and enhance capacity of administrators for bankrupt firms. Moreover, we concur with staff that more transparent legal procedures, timely court decisions, and better-functioning Commercial Registries are also necessary to enhance business environment and help attract private foreign and domestic investment.

With these remarks, we wish the Czech authorities success.

The Deputy Director of the European I Department (Ms. Schadler), in response to questions posed by Directors, made the following statement:

Mr. Callaghan requested more information on the rise in the general government deficit in the past few years and on debt sustainability. The increase in spending in the last couple of years reflects mainly increases in subsidies, transfers, and capital spending, as mentioned in the staff report. Also, in 2003, one-off spending on flood repair and a restitution payment added some ¾ percent of GDP to spending.

The staff encountered some difficulty in going deeper into the sources of spending increases. We discussed at some length with the authorities what was behind the spending increase, particularly in connection with our concern that the spending restraint that is being proposed for the next few years should be focused in a forward-looking way on areas where spending had risen in the past. More precision in identifying the exact source of spending increases proved very difficult, for several reasons. First, there were no big-ticket items or changes in legislation or regulations that precipitated this increase in spending. Rather this was an across-the-board drift in a lot of different kinds of spending categories, but mainly in the areas of transfers, subsidies and capital spending.

Second, on capital spending, there was certainly an increase in spending by the transportation fund, which is mainly concerned with road infrastructure. On the transfers and subsidies, however, it was much more difficult to get a handle on precisely what was involved. We see that most of it appears to be in the area of social spending but, again, it is a drift over a large number of categories of social spending.

Third, there was also difficulty in identifying spending increases clearly in our classification, which differs from the authorities' budgetary classifications. Some of the spending for example was in extrabudgetary funds, where it was not always completely clear what the precise nature of the spending was. There were transfers that were for education purposes, for building hospitals, or for current spending in hospitals. The authorities pointed out that it was difficult to pinpoint specific items on which the spending had taken place.

Another problem is that, even in the authorities' categories of spending, there have been changes in classification, owing to, for example, devolution, where specific spending items are shifted from one category to another. Overall, where we ended up was to point out that it was important that the authorities assess the increases in spending that had taken place over the last few years, to what extent these had been drifts of an undesirable nature and how looking ahead, to ensure that spending cuts were focused on areas where excesses existed.

Another question concerned civil service reform. The proposal is to delay it as part of the fiscal adjustment program, because it does entail costs. The staff has supported and continues to support civil service reform,, which is also part of a required reform for the European Union and eventually will be required in order to attract and retain high quality staff in the government. It will probably also, however, need to be accompanied by more reductions in employment than are now foreseen. We definitely see the delay as a temporary measure, as the authorities do, and are fully supportive of proceeding with it without too much delay.

Another question concerned the current support for reforms and privatization, and we do not have much to add to the staff report on this question. The mission discussed the fiscal proposals, which were just proposals at that stage and had not been discussed by the Cabinet, with major labor unions during the mission. I will say that in my experience of talking about these things with labor unions, they certainly did not appear to be unduly negative. They had some hesitations about aspects of the proposals but, in general, they recognized that fiscal adjustment was necessary and it was more a question of determining where the burden was going to be borne than whether it should happen at all. But, since then, predictably, there has been more noise from labor unions and other segments of the population, and there are some plans now for various sorts of demonstrations, possibly even a strike in September. It remains to be seen whether this actually comes to pass.

Another question was related to regulation of utilities, which is largely an area that is dealt with by the World Bank and the OECD, so we do not cover it in any depth or detail in the staff report. I will just briefly summarize that the energy and telecoms are regulated and have been regulated for the past several years by an independent regulatory body. The OECD having assessed prices in the energy and telecom sectors, feels that prices are probably on the high side. They have expressed, rather obliquely, concern about whether the regulatory authorities are as disciplined as they might be in resisting price increases, which is probably something that one observes in many countries.

There has been some criticism from both the OECD and the World Bank on the process of privatization of the gas sector as a vertically integrated bloc, with restrictions on selling off parts of it. Similarly, in the electricity sector, there are also plans to sell generator transmission and distribution components and these were challenged by the Czech Competition Office. Changes in plans are now being made.

A question was raised about why the Czech Republic might be showing lower business cycle correlations than other Central European countries vis-à-vis the European Union. The staff has done some work on this recently in preparation for the paper that we will send to the Board shortly on euro adoption in the Central European countries. We have found, and others have found, that business cycle correlations in the Czech Republic tend to be somewhat lower than they have been in the other Central European countries. The main reason for this, however, is that these correlations are run over a period that typically spans from the early to mid-1990s until now. The Czech exchange rate crisis and banking crisis in 1997 significantly throws off the correlations because it was quite an idiosyncratic shock that was not felt by the other countries, and certainly not by the European Union. As time goes by, though, we were looking at data that are showing closer correlations so that when we can get a data series long enough to run a correlation since the 1997 crisis, we expect to see that the correlations are as strong in the Czech Republic as they are in any of the other countries.

Mr. Calderón-Colín made the following statement:

With an amazing pace of economic and structural reforms, the Czech Republic is well on its way to be one of the countries that will achieve successfully the goal of completing the transition of its economy from a centrally-planned regime to one that is market oriented in a reasonable period of time. As if this test were not enough, the Czech Republic has imposed itself another enormous challenge attempting to join the EU and eventually, the monetary union. We have no doubt that both objectives will be accomplished. As we agree with the thrust of the report I will only make some brief remarks for emphasis.

While it has been integrating into the world economy, the Czech Republic has already suffered the effects of the current global slowdown. However, the economy seems to be proving its resilience quite well, although with a rather modest growth outlook. Inflation is very low and the current account deficit is expected to narrow to 5–6 percent of GDP.

We are concerned about the expansion of the general government deficit of 1¼ points of the GDP in 2002 and a further widening during this year, which will lead to a 8.6 percent of the GDP deficit in this year, according to the last figures provided by Mr. Kiekens and Mr. Jonas. Some relief is provided by the assurance of the staff, and also of Mr. Kiekens and Mr. Jonas, that the proposal to the Parliament—we hear recently approved—includes a plan to reduce the deficit to 4 percent by 2006, improve the efficiency of government spending and strengthen longer term budgetary discipline by introducing medium term expenditure ceilings, reduce corporate taxes and harmonize the Czech taxation system with the EU and increase the transparency of the public finances. However, we cannot understand the motives that lead the authorities to such an increase of the deficit in this year, given that their next objective—the incorporation to the EU—requires significant fiscal consolidation.

In this sense, we consider that given most of the increase in the deficit of this year was due to higher expenditures, more efforts can be made in order to bring the public finances into order in a more rapid manner. We notice that Staff has doubts whether the measures targeted the areas that had produced most of the recent increase in expenditures. We also agree with Mr. Le Fort and Mr. Vogel's comment with respect to the public sector debt sustainability in the case a non-reform scenario, particularly given the effect that an increase in the level of the debt and a failure to meet the Maastricht criteria would have on investor's confidence, exchange markets and interest rates.

On monetary policy, we commend the authorities for their swift management. The inflation target regime has proved to be useful, lowering the inflation already to levels similar to those required to access the EU.

Additionally, the reduction of interest rates has helped to counteract the appreciation of the koruna due to the large capital inflows attracted by the economy.

Although we acknowledge the difficulty of attempting to meet two objectives—price and exchange rate—once in the ERM2, we are in accord with Mr. Padoan on the importance of an adequate fiscal consolidation and structural reform process. In our opinion, if the public finances are not in order or if they show increased difficulty to reach the levels consistent with the convergence, these events will be taken into account by market participants and the exchange rate will depreciate, with or without inflation targeting, complicating the integration to the EU.

We welcome the continuation of the privatization process including Czech Telecom and Unipetrol and the notice that privatization of other state companies might be accelerated. The structural reform process has advanced noticeably, but has still a way to go, as evidenced by the high unemployment registered. We share Mr. O'Loghlin's comments regarding the progress in labor market environment, but coincide with his opinion and Mr. Kiekens that significant shortcomings remain and that much has to be done in this area.

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

Mr. Abbing made the following statement:

Before saying anything else, I would like to join Ms. Rizotti and Mr. Padoan in congratulating the Czech authorities in passing the last remaining hurdles for EU membership. I generally agree with staff's assessment of the Czech economy: the performance over the past few years has been sound and medium-term prospects appear good. That is, if the authorities succeed in tackling a variety of medium-term challenges. I will focus on a few of these.

The most important one, obviously—and as stressed by all other Directors—is fiscal consolidation. This has become all the more pressing in view of the recent substantial fiscal loosening, leading to a ballooning budget deficit. Although admittedly the Czech Republic's public finances do not look unfavorable in comparison with neighboring Poland and Hungary—especially with regard to the level of public indebtedness—future challenges including demographic pressures, cofinancing of EU projects and high structural unemployment rates should prompt timely corrective policies. The unfortunate downgrading of local currency debt by one of the international ratings agencies earlier this year, underlines the concern about the government's spending agenda, and should be considered as an early warning call; while currently low, the government's lending costs may rise substantially in the near future if the government shows no credible plans for expenditure cutbacks over its term in office. This would of course also have an adverse impact on public debt dynamics.

Against this background, I strongly welcome recent efforts to establish a medium-term fiscal framework. The Czech authorities have set their own agenda for gradual and thereby sustainable fiscal adjustment and we strongly welcome this as a sign of strength and realism. The consequence is that it will take a number of years before Czech Republic will meet the Maastricht Criteria—and will be in accordance with the demands of the stability pact—but in our view the Czech authorities' strategy is appropriate—and certainly preferable to trying to meet the nominal Maastricht criteria as soon as possible, without paying attention to the underlying real convergence. That said, Czech's own agenda for fiscal adjustment could have been somewhat more ambitious. Here I note that vigorous and decisive expenditure reforms—for instance in social services—have not yet been announced, partly due to the lack of public support.

As to monetary policy, I feel that the CNB's policy of gradual interest rate cuts in response to easing inflationary pressures is appropriate. Notwithstanding this aggressive policy response, this year's inflation target band will probably be undershot as inflation has entered into negative territory in the course of 2003. I note that staff expects an upswing in headline inflation to materialize by the end of this year, but would have welcomed somewhat more attention for the backgrounds of the current deflation, as prices have been falling for several months this year. I was glad to learn from Mr. Kiekens and Mr. Jonas that the falling prices were mainly due to one-off exchange rate effects, but perhaps staff could discuss the risks of continued deflation in some more detail.

The Czech Republic is probably one of the few acceding countries not to aspire immediate participation in ERM2 after EU-entry next year. Provided that the Czech authorities continue to press on with fiscal and structural reforms, I feel that this is a sensible strategy. I agree with the CNB that sustainable fiscal and structural policies should precede the introduction of an exchange rate band, rather than the other way around. Adopting the ERM2 for the sake of pressing on fiscal reforms is a risky bet, considering the amount of adjustment the Czech Republic, like most other acceding countries, still needs to make in this area.

At an earlier stage in the transition process, major strides have been made in cleaning up the financial sector. I particularly welcome the strengthening of banks' balance sheets, increasing capital adequacy ratios and the declining stock of nonperforming loans. Nevertheless, the aftermath of the Czech banking crisis still makes itself felt in the form of banks' reluctance to lend to small and medium-sized enterprises. This suggests that financial intermediaries—through increasing the stock of capital available for investment and picking the most profitable investment projects—are not yet delivering their potential contribution to economic development in a free market environment. I feel that the Czech authorities can continue the process of financial development by critically reviewing the existing bankruptcy law, and improving creditor rights.

Finally, I also agree with the staff that the Czech supervisory authorities should respond to buoyant credit growth to households with more vigor. As the financial sector's exposure to households increases, a better understanding of the associated macroeconomic risks -including developments in the real estate markets—is essential to detect vulnerabilities at an early stage. I suggest that the Czech supervisory authorities, in line with a broader global trend, develop the relevant skills to assume their financial stability responsibilities, and establish prudential norms accordingly.

Mr. Yu made the following statement:

We thank the staff for the candid paper and Mr. Kiekens and Mr. Jonas for their helpful statement. The Czech economy has shown strong resilience against a weak external environment. Smooth economic growth has been accompanied by low inflation, a declining trade deficit and financial strengthening. The impressive performance id due mainly to the authorities' efforts in promoting sound macroeconomic policies and structural reforms. The moderate growth is mainly underpinned by buoyant household consumption and a narrowing current account deficit. Investment, however, has been weak due to the uncertain external environment. On policy issues, the authorities have ably managed the macroeconomy. Nevertheless, the problems in the fiscal area are building up and prompt actions are needed in fiscal consolidation. Meanwhile, a number of structural impediments have yet to be removed. We can generally go along with the staff appraisal and raise the following issues for emphasis.

Monetary Policy

The authorities deserve to be commended for their prompt and appropriate response to market speculation and slowing economic growth. With inflation slightly below zero, there is considerable room to stimulate the economy with monetary policy tools while keeping an eye on the likely increase in inflation due to the recovery in food prices and indirect tax changes.

On adoption of the euro, the authorities' cautious attitude is appreciated. It is appropriate for them to set a timetable on the basis of the medium-term fiscal adjustment program and the more general indication of readiness. In this vein, synchronization of the business cycle and integration with the euro area should be further promoted.

The exchange rate has been under upward pressures due to the significant capital inflow and the Balassa-Samuelson effect. As part of the appreciation is reflected in the fundamentals, intervention should be limited to smoothing exchange rate fluctuation.

Fiscal Policy

Fiscal performance has an important bearing on the economy's integration with the euro area and eventual EU entry. While fiscal stimulus has helped maintain activities, the fiscal position has continued to weaken. Thanks to privatization receipts, the rapid fiscal deterioration has not resulted in large public debt. However, receipts from privatization are declining and hardly provide as much cushion as before. In addition, contingent liability could rise dramatically in the period ahead under the status quo policy path. Hence, fiscal consolidation is not only necessary, but also urgent. We are pleased to learn of the authorities' initiative to reduce the deficit by mobilizing revenue and reining in spending. Giving greater weight to the latter is appropriate as it has been the root cause of fiscal weakness. We also welcome the proposals to reform the social security system and downsize public employment.

Structural Reform

The authorities have made extensive efforts to promote effective structural reforms. However, there remains the daunting task of removing the structural impediments to long-term sustainable growth.

The privatization of the financial system has helped improve financial soundness. However, the current situation points to a lack of bank financing enterprises, particularly for small and medium enterprises and this situation, undoubtedly, smothers economic prosperity. We encourage the authorities to improve the legislative and institutional frameworks and facilitate enterprise lending.

Also on the banking issue, we are somewhat concerned with the rapidly rising household exposure. We concur with the staff that the ability of the banking system to monitor the household debt status and the implication of changes in interest rates and house prices should be expanded.

The rising unemployment rate is a concern. There is no evidence of strong labor market rigidity. Rather, the cause is the restructuring of the economy. In this sense, efforts in education, retraining and reducing impediments to labor mobility might be helpful.

Conclusion

The authorities deserve to be commended for their positive performance, particularly when the external environment has been so gloomy. While there remain daunting tasks to further improve economic performance and eliminate underlying risks, the authorities have shown substantial ownership and due diligence. We wish them continued success.

Mr. Alazzaz made the following statement:

The Czech economy's growth moderated again last year with a further slowdown projected for 2003. This has been accompanied by a decline in the already low inflation rate and another rise in unemployment. While the external reserves have continued to rise, the fiscal deficit has widened sharply with a further marked widening likely in 2003. The outlook is also mixed, given the fiscal deterioration and the downside risks to recovery prospects.

Against that background, I find the staff appraisal somewhat strongly upbeat. That said, I share the staff's view that the medium-term outlook can be strong with responsible monetary policy, strong fiscal policy resolve, and further institutional reforms. Here, I welcome the interest easing and the progress of the fiscal reform bill reported in the staff update. I also welcome the authorities' cognizance of the challenges that remain, as further confirmed in the helpful statement of Mr. Kiekens and Mr. Jones.

The short-term outlook is clearly dominated by recovery prospects in the European Union. In the event of the downside risks becoming dominant, falling investments and exports could indeed spill over to depress domestic demand, which has been a major prop to growth. Given the aggravated fiscal conditions, growth support should indeed come from the considerable scope for monetary easing. I therefore welcome the authorities' monetary policy efforts to help offset effects of the weakening prospects for recovery in the EU. I also agree with the staff that the authorities should stay with the inflation-targeting framework that has served the economy well.

As the economy heads for entry into the euro area, an expedited reversal of the recent fiscal deterioration is particularly important. Indeed, convincing progress in fiscal adjustments is essential for euro participation. Here, the staff has rightly stressed the dangers from rising public debt and falling market confidence. I therefore welcome the envisaged reduction in the deficit by over two percent of GDP by 2006. The stress on spending cuts and improved budgetary management rather than revenue growth is also appropriate. Reversal of the rising share of mandatory spending in the widening deficits is critical. Clearly, while the proposals under the public sector reform strategy are reasonable, their implementation will be a test of the authorities' policy resolve.

I welcome the authorities' continued focus on strengthening the banking systems' supervision and regulation. The importance of this effort is underscored by the sharp rise in household credit at a time of continued decline in bank loans to the nonfinancial enterprises. Here, I am encouraged by the progress already made in line with the recommendations of the 2001 FSAP/FSSA report. The authorities' proactive stance in this area is also evident from the Union Banka de-licensing episode detailed in paragraph 27 of the staff report. Finally, speedy progress with the ongoing broader reforms toward a dependable and efficient judicial and legal system is a priority.

With these remarks, I wish the authorities further success.

Mr. Szczuka made the following statement:

The assessment of the recent economic developments in the Czech Republic appears to be straightforward and uncontroversial, given that the well-written staff report does not indicate any significant disagreements between the staff and the authorities. This would allow me to keep my statement reasonably short.

I join the staff and the previous speakers in recognizing the solid growth record, low inflation, successes in attracting foreign investment, and other achievements that made the Czech Republic well prepared for its forthcoming EU membership. However, this broadly positive picture has been clouded by the recent serious deterioration of the fiscal accounts. On this front, strong and timely action is clearly warranted.

Some other areas that require careful attention include the relatively fast growing unemployment, the expansion of credit to households, and the sizable—but, for the time being, still relatively safely financed by FDI—current account deficit. The need to decisively address the problem of the growing fiscal imbalances results not only from the medium-term unsustainability of the current deficit levels, in particular in view of the other unfavorable demographic trends, but also reflects the aspirations of the Czech Republic to join the euro area without excessive delays, and the country's future obligations under the Stability and Growth Pact.

The cushion provided by the relatively low level of public debt is also probably thinner than it appears, if one includes the debt of the Czech Consolidation Agency and the very sizable contingent liabilities resulting from the large stock of public guarantees. I believe that it would be worthwhile if the staff and the authorities attempted to thoroughly assess the probability and the possible timing of converting the contingent liabilities into direct state obligations.

I welcome the fact that the Czech authorities not only recognized the seriousness of the fiscal problem, but also prepared a concrete plan of addressing this issue. The real challenge, however, will be to ensure enough political and public support to implement this plan in its entirety. I would appreciate the staff's—even though Ms. Schadler already indicated that there is not much to be said about it—and Mr. Jonas's comments on the risks of significantly watering down the plan during the parliamentary debate and on the availability of any contingency measures.

I find the proposed fiscal targets broadly appropriate, but I consider them realistic rather than very ambitious. Clearly, much more would need to be done to sustain and meet the relevant Maastricht criteria, and still more to completely eliminate the fiscal imbalance. This latter objective would be difficult to achieve without further reforms in the areas of pension, health sector, and social assistance spending. The pension reform in its currently envisaged form certainly appears to be too timid. The report is not offering much information on the situation of the health sector, and perhaps the staff could add a few comments on the scope for savings there, and also in better targeting social assistance. I was also somewhat puzzled by the notion of semi-budgetary organizations in the health and education sectors, and I would welcome some clarification of their treatment within the general government sector.

Monetary policy has been successful in reducing inflation and stemming the appreciation pressures. I agree with Mr. Kiekens and Mr. Jonas that it is difficult to disentangle the effects of interest rate reductions and effects of interventions in achieving this result. I also agree with the staff that monetary policy may need to remain supportive, as the risks of a significant increase in core inflation are not apparent. I would welcome, however, the staff's comments on how much room for a further easing of monetary conditions they would see, given the already very low level of nominal rates and the recommended policy of nonintervention on the foreign exchange market.

The staff may also wish to comment on the similarities or differences of the current Czech situation when interest rates are already at or even, at times, below the ECB levels, with the situation of the countries that benefited from a significant interest reduction after joining or in the run-up to joining the EMU. As opposed to some such countries, in the Czech case we do not see a broad-based credit boom. Given that fiscal benefits are also limited due to a relatively low level of public debt, one could say that the Czech Republic is being punished by being prudent on the fiscal side.

Like other accession countries, the Czech authorities are now confronted with a difficult decision on the selection of the monetary and exchange rate framework in the run-up to EMU membership, and on the timing of joining ERM2 and the euro area. I find the authorities' approach of delaying ERM2 entry until a sufficient improvement in the fiscal position has been secured very prudent. At the same time, however, I would caution them not to use this decision to delay the entry as an excuse for reducing the speed of fiscal consolidation.

I support the continuation of the current direct inflation-targeting regime, at least until ERM2 entry. However, like Mr. Le Fort and Mr. Vogel, I am not entirely convinced about the feasibility of combining a narrow fluctuation band within the ERM2 with a direct inflation-targeting framework. The staff's comments on this issue would be welcome. This issue also underscores the importance of fully understanding the rules of the game with regard to the assessment of the Maastricht criterion on exchange rate stability.

I broadly share the staff's assessment of developments in the banking sector, and support their calls to further strengthen supervision and to carefully watch the rapid increase in lending to households. I wonder if the staff and/or Mr. Jonas could assess the probability that the Czech—but by now already mostly foreign-owned—banks could indeed be requested to repay part of the received state assistance if the EU were to take such a decision. I would also appreciate a clarification of the difference between classified and nonperforming loans in the statistics. We have on pages 29 and 30 of the report, the figures of 16 and 8 percent of bad loans. I wonder which measure of these bad loans better reflects international standards.

The Czech Republic made great progress in advancing structural reform and reducing state ownership. However, I agree with the staff that improvements in the Bankruptcy Law and increased efficiency of judiciary and commercial registries would contribute to strengthen creditor rights and maintain a favorable investment climate. I also support the plans to conclude the privatization of strategic companies in 2004/05.

With regard to privatization, I would welcome the staff's comments, or perhaps also from Mr. Jonas, on what happened to the Czech mass privatization scheme. As I recall, at some stage this scheme was criticized for not contributing enough to the restructuring of the enterprise sector, because of the de facto concentration of control in the state-owned banks. I assume that this situation must have changed with the almost completed privatization of the financial sector.

Finally, I would appreciate the staff's remarks on the comment made by Mr. O'Loghlin concerning the differences in measuring growth on a GDP and GNP basis. I also wonder whether the increasing current account deficit caused by the repatriation or reinvestment of profits by direct investors is a more favorable sort of deterioration of the current account deficit than any other form of deterioration. With these comments, I wish the Czech authorities success in their further endeavors.

Ms. Wolff-Hamacher made the following statement:

I thank the staff for the well-written reports and Mr. Kiekens and Mr. Jonas for their informative and frank preliminary statement.

Like other chairs, we congratulate the Czech authorities for the successful EU accession referendum held in June. We also commend the authorities for their economic achievements since the start of the transition process. The economy also performed well over the past years despite an adverse economic environment helped by very high FDI. However, as staff put it, the picture is marred by the steady deterioration of the fiscal stance over the last years with an expected general government deficit of 8½ percent of GDP for 2003. Therefore, reducing the fiscal deficit is the main policy challenge. This needs to be accompanied by further structural reforms.

We are in broad agreement with staff's analysis and recommendations. In addition, I can broadly associate myself with Mr. Padoan and Ms. Rizzotti. I will, therefore, limit my comments to four points: fiscal consolidation, monetary policy, the banking sector, and structural reforms.

First, on fiscal consolidation, we welcome the authorities' commitment to fiscal consolidation and the proposed measures to limit the fiscal deficit outlined by the staff as well as Mr. Kiekens and Mr. Jonas. One of the main challenges now is to implement these measures quickly and fully. It will be important to ensure broad-based support for the measures, as also Mr. Szczuka mentioned. Another challenge is to go beyond these measures in the medium term and to address concerns raised by staff in paragraph 21 of their report. Mr. Calderón-Colín also raised that point. Like Mr. Andersen and Mr. Ross, we encourage the Czech authorities to implement a medium-term framework for fiscal policy in line with the EU Treaty and the Stability and Growth Pact. In this context we also urge the authorities to incorporate the extrabudgetary funds in the responsible ministries' expenditure ceilings and to limit the issuance of new public guarantees.

Second, we congratulate the Czech Central Bank for the quite skillful handling of monetary policy. We concur with the staff and other chairs that the Central Bank is right in its intention to not immediately respond to the expected price increase from adjustments in indirect taxes, but to be ready to react promptly to second round wage effects. We also welcome the authorities' intention to keep foreign exchange market interventions exceptional. We share the view of other Directors that the inflation targeting regime seems to have served the Czech republic well. We also believe that targeting a point in the

2½-3 percent range is appropriate to accommodate the Balassa-Samuelson-effect and the goal of price stability.

We welcome the authorities' initiatives to develop a strategy for ERM2 entry and euro adoption. Looking at the recommendations of the Czech Central Bank, we are greatly encouraged that it is emphasized that progress on sustained fiscal consolidation should be a crucial factor in determining the timing of ERM2 entry. However, as we have stressed in other cases, it is important that the authorities ensure that a general economic policy framework, including fiscal policy, is in place consistent with the objectives of ERM2 before entering the mechanism. As regards the duration of membership in ERM2, we continue to believe that membership in ERM2 need not necessarily be limited to the minimum of two years.

Third, on the banking sector, against the background of rapidly increasing credit to private households, we agree with the staff that supervision of the banking sector, including through collection of the relevant data by the Central Bank, should be further strengthened. My preceding speakers Mr. Abbing, Mr. Yu, and Mr. Alazzaz also mentioned this. In this context we would also like to ask the staff for some further information on the impact on banks if the European Commission decided that government funds provided to the banking sector did not comply with EU guidelines on state aid.

Finally, on structural reforms, we fully share the staff and other chairs' recommendation to address the shortcomings of the judicial and legal system to improve the business climate. Changes in the bankruptcy law would be particularly important to raise lending to small and medium-sized enterprises. We also share the view that privatization should resume and that the mobility and flexibility of the labor market should be further improved. Together with fiscal consolidation these structural reforms are important to sustain real convergence and for smooth entry into ERM2.

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

Mr. Lissovolik made the following statement:

Given that we broadly share the overall thrust of the staff appraisal, we would like to focus on just a few points for emphasis.

The main vulnerability facing the Czech economy is the very high budget deficit, which is expected to exceed 7 percent of GDP in the course of this year. Alongside the sheer need for a very sizeable fiscal correction, its composition should target subsidies, while accompanying measures need to concentrate on promoting greater transparency in the budget process (including via acting on the recommendations of the fiscal ROSC update) and ensuring an orderly process of fiscal devolution to the regions.

The need for expediting the onset of fiscal adjustment is reinforced by two factors. Firstly, the implementation of the reform measures will not be easy given the frailness that the ruling majority holds in the Parliament, threats of strikes and protests over the proposed fiscal measures on the part of the labor unions, and the fact that broad support for fiscal reforms in the populace is still not assured. Secondly, in assessing the urgency for fiscal adjustment, the Czech authorities will need to take into account possible fiscal costs arising from the implementation of structural reforms (such as the reform of the labor market and pension reform).

Another issue that should be very much on the radar screen of Czech policymakers is competitiveness. The weakening of cost competitiveness in comparison with non-European emerging markets should not be dismissed as inconsequential due to what the staff report refers to as a “considerable geographic advantage vis-à-vis the European market”. Firstly, in a globalized world, the importance of distance is increasingly undermined by forces of outsourcing, fragmentation and technological advances—the recent WEO amply showed the decreasing importance of distance for East Asian emerging markets’ trade patterns in the context of a gravity model exercise. Secondly, in such an open global environment, it is advisable to diversify the country’s trade links rather than put all eggs into one basket.

Finally, on monetary policy and structural reform issues we broadly share the views expressed by Mr. Kanaan and Mr. Bakhache.

Mr. Basdevant made the following statement:

We would first like to thank the staff for their interesting set of papers, as well as Mr. Kiekens and Mr. Jonas for their informative preliminary statement. As we broadly agree with the staff appraisal and Mr. Padoan’s and Ms. Rizzotti’s statement, we will limit our intervention to a few points.

Real convergence toward EU standards is a major issue. There are several positive signs rightly underlined in the staff report such as the economy has had in penetrating the EU market and the role of FDI. Looking forward, we support the staff’s view that strengthening the institutional and legal framework remains critical for maintaining a strong record on FDI.

As stated by Mr. Kanaan and Ms. Rizzotti, the rising unemployment is not a concern as long as it is a temporary effect of enterprise restructuring, and we concur with the analysis that improving labor market mobility should bring substantial help in fighting unemployment. We also call for higher investment in human capital, as newly created jobs will be more skill-intensive than former ones.

The fiscal deficit is worrisome and has deteriorated over the last three years. At the same time, we see that many questions have been raised regarding the inflation-targeting framework on the eve of the euro adoption. It is worth noting that most of the Eastern European countries who adopted an inflation-targeting framework have also encountered huge public deficits while those who adopted a currency board are more in line with the Maastricht criteria. This highlights the fact that when a credible exit strategy exists—in this case, the adoption of the euro—a fixed exchange rate system might strongly dominate the flexible one, because it imparts fiscal discipline. We thus call for more transparent and credible fiscal rules so as to reduce the exposure of the economy to slippages. It is commendable that the authorities are planning to reduce the deficit substantially in the coming years, and we encourage them to continue their efforts in light of the EU requirements for fiscal discipline.

Regarding euro adoption, we strongly support the idea that the authorities should first consolidate the fiscal position before entering ERM2. More generally, we would like to underline that the adoption of the euro should not occur at the cost of real convergence. We thus welcome the steps taken by the authorities, as mentioned in Mr. Kiekens's and Mr. Jonas's preliminary statement.

Finally, we urge the authorities to build a large consensus on the reforms and, like Mr. Padoan and Ms. Rizzotti, we encourage the authorities to improve their regulatory and legal framework, especially in the financial sector, and to strengthen creditor rights. With these comments, we wish the authorities all the best.

Mr. Epstein made the following statement:

At this stage of the discussion, since we agree with the thrust of the staff appraisal, I will be very brief. First, fundamental indicators in the Czech Republic remain generally sound, with modest but sustainable real GDP growth, low inflation, a moderate unemployment rate—at least in European terms—and even the relatively large current account deficit, which continues to be largely financed by strong FDI flows. Indeed, we note the comment made earlier today during the GFSR discussion, in which Mr. Kiekens alluded to the strong flows of FDI in the Czech Republic as perhaps helping to mitigate the recent widening in bond spreads seen in neighboring countries. However, we do share the concern regarding the deterioration in the public finances, as raised by other Directors, and in that context we welcome the medium-term fiscal framework currently put in place.

On monetary policy, we welcome the authorities' restraint from intervening in the exchange rate and commend them for a generally sound implementation of the inflation targeting regime. Finally, we commend the authorities for their consent to the publication of the staff report, and wish them success in their policy endeavors.

Mr. Miyoshi made the following statement:

The Czech economy has shown great performance over the past two years, and I commend the authorities for the successful early and smooth transition to a market economy. As Mr. Kiekens and Mr. Jonas note in their helpful statement, the next milestone is entry into the European Union and the adoption of the euro. Regarding the latter, I concur with the authorities that options on the timing of joining a single currency should be kept open provided that the authorities have a strong will to achieve this objective. This would help them to choose the best timing for adopting the euro, taking into account the changing economic conditions, without inviting unnecessary pressure and speculation in setting the target. I wish the authorities every success in this challenging endeavor.

I agree with the staff that, while the short-term outlook is positive, the downside risks are significant. As the staff notes, much depends on the strength and pick-up of the European economy, and it is important for the authorities to be vigilant against potential risks, given that the Czech economy is an open and relatively small economy. In light of the need for fiscal adjustment, monetary policy should play a greater role in supporting the economy. In this context, the current low underlying inflation is welcome. This is also favorable from the standpoint of preventing the koruna from appreciating further.

With regard to the issue of whether interest rate policy or foreign exchange intervention was most effective in reversing the appreciation of the koruna in 2002, I tend to agree with Mr. Kiekens and Mr. Jonas. Although we cannot rely on interventions too heavily, their effectiveness in correcting overshooting cannot be ruled out. The authorities' determination to address the fiscal deterioration is welcome. Like the staff, I agree that the authorities' emphasis on expenditure restraint is appropriate, and I encourage them to formulate a medium-term framework. Obviously, steady implementation of various strong measures are needed. However, with regard to the staff's concern about public support for this reform, I am somewhat more optimistic, given the authorities' strong resolve.

In any case, it is not appropriate to regard every backward step in the short term as a failure or a watering down. For example, a Japanese proverb says, you are doomed to fail when trying to do things too hastily or, if you are in a hurry, it is sometimes better to go around. I am not trying to justify the so-called go-slow or muddle-through approach, but it is the authorities who know best about how to implement difficult measures in the political process in their own countries. I hope that they will be able to achieve long-term gains in the end.

Finally, I welcome the further strengthening of the banking sector, and broadly agree with the staff assessment. While not posing an immediate threat, acceleration of lending to households is a cause for concern and warrants close monitoring. The authorities should take appropriate action to strengthen prudential supervision to counter vulnerabilities. In addition, I wonder whether greater indebtedness of the household sector could also have significant macroeconomic implications in the form of an adverse wealth effect if housing prices start to decline. The staff's view on the possible magnitude of this effect would be appreciated.

The representative of the European Central Bank (Mr. Wijnholds), made the following statement:

The European Central Bank broadly agrees with the comprehensive and concise analysis conducted by the staff and I will, therefore, confine my remarks to a few observations.

First, let me stress that a too expansionary fiscal policy is the main risk for sustained macroeconomic stabilization in the Czech Republic, and this view has been echoed here today. Without further fiscal measures, inflationary pressures could arise and the twin deficit problem may worsen. Moreover, as privatization is coming to an end, public deficits will increasingly be financed through public debt rather than privatization receipts, which may lead to a crowding out of private sector investment and higher exchange rate volatility. In this context, the recent proposal presented by the government to the National Parliament for fiscal adjustment in the years 2004–2006 is a first step in the right direction. It would be of the utmost importance that the whole package be passed in the fall of this year and implemented without further compromises. In fact, even under this scenario, the speed of consolidation would remain slow and additional measures in due course appear to be warranted to reduce the fiscal deficit more quickly from current levels, which are not in line with the EU fiscal rules.

Second, let me briefly comment on monetary and exchange rate policy matters. Mr. Kiekens and Mr. Jonas mentioned in their preliminary statement that, after consultations with representatives of the European Commission and the European Central Bank (ECB), the Czech National Bank (CNB) has made a number of recommendations. In order to avoid any misunderstanding, it should be noted that these are recommendations of the CNB and do not necessarily reflect the views of the ECB. We think that it is too early to come to grounded conclusions on all aspects of ERM2 participation and euro adoption. Having said this, we certainly share the CNB's view that progress with fiscal consolidation is crucial as regards the timing of euro adoption, and that in that light it is not desirable for the Czech Republic to join ERM2 immediately after EU entry.

Concerning the conduct of monetary policy in the period immediately following EU entry, there is no apparent need for a change in direction, provided that the present monetary policy framework continues to function smoothly as it certainly does currently. As to the conduct of monetary policy in the context of ERM2, it should be noted that the Czech authorities will have to adapt their monetary policy strategy at some point in time. In particular, maintaining the current inflation-targeting regime after entry into ERM2 would imply a switch from a purely domestic anchor—namely, an inflation target—to a combination of both a domestic and external anchor.

Finally, as concerns the Maastricht criterion of exchange rate stability, let me stress that equal treatment between future European Union member states and the current participants in the euro area will be ensured. It is clear that a minimum stay of two years in the ERM mechanism prior to the convergence assessment without severe tensions is expected. Moreover, the assessment of exchange rate stability against the euro will focus on the exchange rate being close to the central rate, while taking into account factors that may have led to an appreciation in line with what was done in the past.

The Deputy Director of the European I Department (Ms. Schadler), in response to questions posed by Directors, made the following statement:

There were a number of questions raised. First, on the risk of deflation, I would consider it quite small. As you know, the staff is projecting a fairly sizable increase in inflation, still to relatively low levels, but definitely not in the direction of deflation. The staff report, together with Mr. Kiekens's and Mr. Jonas's statement, all pointed to the same factors—the likely increase in food prices, the weighing in of the effects of the depreciation of the exchange rate, and the implementation of indirect tax increases. I would note that right now most estimates of core inflation are coming in at around 1 percent, so there is no reason to think that that would become weaker, particularly in light of the fact that we, as well as most others, are projecting recovery in demand and output.

Mr. Szczuka raised several interesting questions. On the risks of watering down the fiscal program, I will leave this to Mr. Jonas to answer. I will say, though, from the staff's perspective of having discussed this with the authorities and following the progress since the mission, it appears that there is quite a bit of determination to see this through. Will there be any changes? I would be astounded if there were not, and some of that will probably be seen as a watering down. The political commitment is there so that the risks of a serious watering down are probably relatively small.

Mr. Szczuka asked about the scope for savings in the health sector and also extrabudgetary funds. Let me take extrabudgetary funds first. The new framework that is being proposed for medium-term fiscal consolidation and procedures will make closer control of these extrabudgetary funds more feasible. For the two largest funds, in particular, the authorities are aware of the problems and they are certainly taking steps to rein in spending there. The housing fund now plans to operate on a revolving basis, so that should certainly contain any increase in spending there.

On the transportation fund, the plan is to include it in the transport ministry's expenditure ceiling and to cap each expenditure at about 2 percent of GDP, so there are certainly in train measures to be sure that those extrabudgetary funds which were the most important will be part of the overall expenditure restraint. Also, it is important to note that many of these extrabudgetary funds were created to spread the privatization revenues. As privatization is completed, these funds are going to find themselves under a great deal more pressure and scrutiny.

On health spending, it is rather high and growth has been strong. We expect that the pressures on health spending will rise with the aging of the population, and we have discussed with the authorities steps that could be taken in that area. There is nothing particularly new or out of the ordinary in these proposals, and better cost control, of course, is one of the most important. Possibly charging user fees or other partial payment for services is always under discussion, but extremely unpopular. There may also be some possibilities, for example, in reforming health insurance or private sector involvement in the health sector.

I should just say a quick word about guarantees. Since the staff report was issued, we do have more information on guarantees and feedback from the authorities. There has not been a framework for formally assessing the risk-adjusted increase in government debt caused by these guarantees. The chart in the staff report that shows a fairly substantial potential cost of the guarantees in some 40-50 years is an upper bound in the sense that it looks at what would happen if all guarantees were called. Of course, all guarantees will never be called.

In the Czech case it is important to realize that a good portion of these guarantees is for export credits and for other types of guarantees we have discussed with the authorities that are unlikely to be called. But, I understand that in connection with the preparation of the PEP for the Commission this year, they had done a more focused assessment of the potential risks of the guarantees, and the conclusion was that by 2008 a reasonable upper band on the estimate of the potential increase in debt from the calling of guarantees would be about 5 percent of GDP.

There was also a question about classified loans. As Mr. Szczuka pointed out, there are two measures in this area: loans under watch and nonperforming loans. Both of these are completely consistent with international standards. Nonperforming loans are, of course, actual problems, and the loans under watch are the potential problems.

Another question concerned the effect on banks if the Commission finds the compensation was not consistent with its guidelines. These are early days yet in this whole dispute. I do not think there is any reason to conclude or to be too concerned that a really radical conclusion will be drawn from this assessment. I can say that the FSAP review and the subsequent staff analysis certainly sees the state aid as having been made in order to make banks solvent, and a reversal of them would obviously raise questions about banks' solvencies. There is nothing more that could be said about that until the actual assessment is done and something more concrete by way of conclusions is available for us.

Mr. Szczuka raised several questions about the Czech Republic adopting the euro. Would the benefits of adopting the euro be as great for the Czech Republic as some of the other transition countries, because interest rates are already quite low? The elimination of the exchange rate risk premium is one of the main tangible advantages for the countries that are considering adopting the euro or considering the timing of adopting the euro. So, in that sense, to the extent that Czech interest rates across the maturity spectrum are broadly similar to those in the European Union, the advantages or the benefits from that source are likely to be smaller.

I would put two caveats on this, however. Just because Czech interest rates are now at around European Union levels does not in any sense guarantee that three, four, or five years from now, or whenever the decisions about the timing of euro adoption are being made, they would still be at European Union levels. In fact, I think there are many people who would consider this a real aberration and suggest that interest rates could well be considerably higher. Second, the benefits of joining the euro area certainly go beyond just eliminating the exchange rate risk premium. Certainly, some of the calculations that have been done on the benefits are emphasizing the gains to trade, the gains from loss of transaction costs, among others, which the Czech Republic would still enjoy.

There was a question related to inflation targeting with a narrow band; as there is more emphasis placed on the narrow band being strictly observed, would inflation targeting still be viable? That is an important question that all these countries are going to have to come to grips with. I guess most observers at this stage would say it would be difficult to envisage an inflation-targeting regime with adherence to very narrow bands. What Mr. Wijnholds in fact has just said that there would need to be a shift to at least some sort of domestic and external objective if the narrow bands are going to be adhered to.

Mr. Szczuka raised one more question on differences between GNP and GDP and, in particular, whether the increase in the current account deficit that has occurred in recent years, which is largely mirrored in an increase in profit remittances, is better than the deterioration from some other sources. Here, all I can say is that there is no way to advocate foreign direct investment unless you are willing to accept this general process. Successful FDI should generate profits; profits are recorded as outflows through the current account and, if they are reinvested in the country, inflows to the capital account. Successful large-scale foreign direct investment is going to have to generate this pattern. Does this make a country vulnerable? Well, I suppose potentially, in the sense that companies could decide not to reinvest the profits or there could even be outflows of foreign direct investment. That is part and parcel of the process of foreign direct investment that all of us are happy to see in a country like the Czech Republic.

Finally, I will comment briefly on the privatization investment funds. I will leave this for Mr. Jonas in substance, but note that these funds have become very small players in the financial sector in the Czech Republic, in part because the regulatory setup was initially limiting. At their strongest point, they were probably not playing a terribly large role, in part because there is also the demise of some of the underlying companies whose assets these privatization investment funds held. Right now, though, the data suggest that the assets of investment funds, and that is not only the privatization investment funds but all investment funds, account for well under 10 percent of total financial sector assets, and that demonstrates that these are no longer a significant influence in the financial sector.

Mr. Jonas made the following concluding statement:

During the months ahead, there will be an intensive discussion in the Czech National Bank what monetary policy framework is best during the period leading to euro adoption. And though we cannot yet know the outcome of this debate, it is my sense that the CNB will prefer to continue its regime of inflation targeting, not only after the Czech Republic joins the EU, but also after it joins the ERM-2 system. Of course this raises the question whether inflation targeting can be compatible with the criterion of exchange rate stability. Mr. Le Fort rightly observes that a central bank cannot successfully pursue two nominal targets with one instrument. But is the Maastricht criterion of exchange rate stability a full-fledged second nominal target? I think the answer to this question is no--at least not in the usual sense. Although this criterion contains one element of a nominal target namely the central parity and a narrow fluctuation band it is nonetheless possible for the actual exchange rate to be allowed to deviate from that band. The extent of permissible deviation cannot be known ex ante. It can only be known ex post, when the European authorities come to assess whether exchange rate stability has been observed. Moreover, the flexibility of the exchange rate is unconstrained in the direction of appreciation. I would therefore argue that under certain circumstances, inflation targeting can be compatible with this interpretation of the exchange rate stability.

Nonetheless several requirements must be met to make inflation targeting compatible with the existing rules for assessing exchange rate stability.

For their part, the accession countries must ensure that (1) their fiscal policy comply with both the SGP requirements and the Maastricht criteria, and that this compliance is credible and sustainable; (2) that rapid progress is made with the remaining structural and institutional reforms needed to ensure sufficient flexibility and strong productivity growth.

For their part, the European authorities have to take account of a country's progress in these areas when evaluating the stability of its exchange rate. It is equally important to take account of the new reality of the global financial markets, which are characterized by large and potentially volatile capital flows. These flows can sometimes lead to large exchange rate fluctuations which are not related to the economic fundamentals of the affected countries. The European authorities must recognize the possibility of circumstances such that it would not be optimal for monetary policy to respond to exchange rate deviations exceeding the limits of the fluctuation band, and neither these fluctuations, nor the absence of policy responses to them, should be automatically seen as breaching the exchange rate stability criterion.

Of course, one of the reasons for a sudden large downward pressure on the currency of an accession country that threatens its observance of the exchange rate stability criterion could be a worsening expectations about the country's future economic policies and outlook. EU candidate countries can minimize this risk in several ways.

First, such a country should enter the ERM-2 system only after it makes a clear and credible commitment to meet the policy requirements of euro adoption. Here I particularly emphasize the word credible, because the behavior of exchange rates in influenced less by the authorities' opinion of their policies, and more by how the markets see them.

Second, once a candidate country joins ERM-2, it must make sure that market participants have no reason to change their expectations regarding euro adoption. In this situation, it is likely that exchange rate fluctuations will be limited sufficiently to allow the candidate country to pass the exchange rate stability test with or without an inflation targeting framework.

The Acting Chair made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for the Czech economy's solid performance, attested to by healthy growth, low inflation, moderate (albeit growing) unemployment, successful economic restructuring, and approaching EU membership. They welcomed the recent referendum results in favor of EU accession. Directors regretted the deterioration of the public finances in the past few years, but welcomed plans to correct it. They emphasized that, in addition to responsible monetary policy and continuing institutional reforms, tackling the fiscal deficit is a precondition for a strong medium-term outlook, meeting the Maastricht criteria, and keeping options on the timing of euro adoption open.

Directors noted that the prospects for a strong recovery of the Czech economy were linked to those for Europe as a whole. The current account deficit was substantial, but needed to be seen against the backdrop of sizable reinvested profits from foreign direct investment. In light of the sizable output gap and the lagged effects of the koruna appreciation on prices, Directors expected inflation to remain low.

In these circumstances, Directors supported the decision to lower the policy interest rate in response to expectations of slower growth in Europe and softening inflation expectations at home. More generally, they commended the authorities on their proactive interest rate cuts since early 2002, which had contributed appropriately to halting and then reversing the appreciation of the koruna.

Directors recommended continuing the successful policy of inflation targeting when decisions on the post-2005 framework are made early next year. They recommended that the target be chosen with a view to providing room for low inflation and a broadly stable nominal exchange rate as the effects of real convergence on relative prices take place. Directors supported the authorities' intention to intervene in the foreign exchange market only in exceptional circumstances.

Directors welcomed the government's commitment to address the deterioration in the fiscal accounts by reducing the general government deficit to 4 percent of GDP by 2006, while cutting corporate income tax rates and reprioritizing spending to accommodate EU-related demands. Directors supported the emphasis on expenditure restraint, particularly on measures that yield permanent savings, as well as the intention to formulate fiscal policy plans and annual budgets within a forward-looking medium-term framework. Directors considered that other proposed institutional reforms—such as incorporating spending by extrabudgetary funds in the ministries' expenditure ceilings, and internalizing the budgetary impact of new public guarantees—

would help reduce policy implementation risk. They urged the authorities to act on the recommendations of the fiscal Report on the Observance of Standards and Codes (ROSC) to complement these changes.

Directors emphasized that the challenge now will be to implement the fiscal adjustment proposals and to strengthen consolidation efforts. In this context, additional scope for permanent savings, particularly on mandatory and quasi-mandatory spending, will need to be identified to replace temporary measures, prepare for population aging, and move toward the Maastricht deficit limit.

While the broad indicators of banking system soundness are reassuring, Directors encouraged bank supervisors to respond proactively to new potential risks so as to maintain that soundness. Rapidly increasing exposures to households could become a source of vulnerability. To evaluate the prudential implications of this trend, bank supervisors should give priority to collecting information on household indebtedness, housing and property prices, and banks' aggregate and individual exposure to households. They should also monitor banks' ability to assess the risks of this dynamic class of credit and adopt appropriate prudential norms for loan-to-value ratios for real estate lending. Directors welcomed efforts to continue to strengthen supervisory policies and practices. Directors also urged the authorities to press ahead with institutional and legal changes, especially with respect to creditor rights. This should help stimulate bank lending to enterprises, which remains sluggish.

Directors emphasized that continued progress with structural reforms remains essential for strong medium-term prospects; and redressing shortcomings in the judicial and legal system should be given top priority. Legal procedures should be more transparent and decisions more timely, and the functioning of the Commercial Registries needs to be improved. Directors urged the authorities to renew their commitment to measures that would promote mobility and flexibility in the labor market, which would complement their intention to press ahead with privatization and restructuring. They noted that a strong regulatory structure could help ensure that public monopolies would not be replaced in the privatization process by de facto private monopolies.

Directors commended the authorities' efforts to comply with international standards on AML/CFT and looked forward to the issuance of the ROSC AML module.

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

4. NEPAL—2003 ARTICLE IV CONSULTATION

Documents: Staff Report for the 2003 Article IV Consutlation (SM/03/275, 8/6/03; and Cor. 1, 8/20/03); and Statistical Appendix (SM/03/277, 8/7/03)

Staff: Shishido, APD; Fisher, PDR

Length: 1 hour, 25 minutes

Ms. Indrawati and Mr. Karki submitted the following statement:

We, on behalf of our Nepalese authorities, would like to thank the staff for preparing a comprehensive and analytical report on Nepal's recent economic situation. The overall observations and suggestions put forth by the staff are commendable and should certainly be useful in the authorities' endeavors aimed at tackling the current socioeconomic problems and addressing the structural development challenges of Nepal.

Development Challenges

As Nepal's past development outcomes are modest, the development challenges are hence daunting. The Ninth Development Plan (1997–2002) achieved an annual average GDP growth of 3.2 percent against the targeted growth of 6 percent, with the respective growth of agricultural and non-agricultural sectors at 3.9 percent and 3.6 percent compared to the Plan targets of 4.0 percent and 7.3 percent respectively. Accordingly, the per capita GDP during the Plan period increased by an annual average of 0.9 percent, and the ratio of the population below the poverty line could fall only by 4 percentage points to 38 percent compared to the target of reducing it by 10 percentage points. Total investment as percent of GDP during the Plan period averaged 23.6 percent vis-à-vis the Plan target of 25.0 percent. Inflation averaged 5.7 percent vis-à-vis the Plan estimate of 6.5 percent. Macroeconomic stability in terms of the containment of inflation, balance of payments (BOP) surplus, exchange rate stability and competitive interest rate levels clearly depicted a mixed economic scenario during the Plan period.

Expediting economic development and reducing poverty through employment generation in the productive pursuit of the economy and providing access to productive resources for the poverty-stricken and marginalized sections of the population as well as the underdeveloped geographical regions have thus become major challenges for the Nepalese authorities. The insurgency intensified as the situation of development outcomes falling below the expectations provided the insurgency the fertile ground and the fillip for its growth. Against such a backdrop, the Tenth Development Plan (2002–2007) is now being implemented. The Plan targets poverty reduction by 8 percentage points to 30 percent. The economic growth target is 6.2 percent with a goal of

4.1 percent growth in the agriculture sector and 7.5 percent growth in the non-agriculture sector. Total investment/GDP ratio is targeted at 25.9 percent. A total of 57.5 percent of the development expenditure would be financed through the foreign assistance (grants 23 percent and loans 34.5 percent).

Macroeconomic Developments

Despite the insurgency, macroeconomic developments in Nepal remained broadly satisfactory until 2000/01 as a result of the adoption of liberal economic policies. However, the Nepalese economy, for the first time in the last two decades, declined by 0.5 percent in 2001/02 due to the intense internal security problem emanating from the escalation of the insurgency together with the adverse external developments. The first year of the 10th Plan, 2002/03, witnessed some positive outcomes, though quite modest from the perspective of the Plan targets. A positive growth in non-agriculture sector of 2.5 percent and agricultural growth of 2.2 percent contributed to the overall growth rate of 2.4 percent in 2002/03. Though consumer price index (CPI) inflation increased by 4.8 percent in 2002/03 following the hike in administered prices of petroleum products, supply shortfalls, and price developments attributed to contraction in agricultural output in India, and the inflation rate remained within the 5 percent target of the 10th Plan.

The external sector too recorded some improvements in 2002/03. Exports increased by 4.9 percent in 2002/03 against a decline of 15.6 percent in 2001/02. Despite a decline of exports to India following the quantitative restrictions in the renewed trade treaty in 2002, a strong acceleration in garment exports contributed to the growth of overall exports in 2002/03. The import demand for both consumer and capital goods resulted in a 16.9 percent increase in imports in 2002/03 against a decline of 7.2 percent in the preceding year. A significant increase in remittances resulted in a BOP surplus of US$66.7 million in 2002/03 from a deficit of US$42.7 million in the preceding year. As a result, the existing gross official international reserves at US$1.5 billion are sufficient to finance 11 months of merchandise imports.

The fiscal deficit narrowed down due mainly to the decline in development expenditure in conjunction with the satisfactory performance of revenue collection. In 2002/03, revenue grew by 11.5 percent compared to the 3.2 percent growth in 2001/02. As such, the budget deficit narrowed down to 4.7 percent of GDP in 2002/03 from 5.4 percent of GDP in 2001/02. Foreign assistance (grants and loans) rose by 20.4 percent in 2002/03 compared to 23.5 percent decline in 2001/02. Domestic loans, which had increased by 14.4 percent in 2001/02 declined by 46.6 percent in 2002/03. The treasury position at the end of 2002/03 showed the cash balance of His Majesty's Government (HMG) at US$17.7 million in sharp contrast to the overdraft of US$75.3 million at the end of the previous fiscal year.

Monetary Policy

The broad objectives of monetary policy in Nepal are to attain domestic price stability, maintain comfortable level of international reserves and make a provision of an adequate level of liquidity to facilitate the sustained level of economic growth. In the face of economic contraction, an accommodative policy stance was adopted for 2002/03. Accordingly, the CRR was cut by one percentage point. Monetary authorities sterilized foreign inflows by selling HMG securities nearly to the extent at which foreign exchange accretion took place at the Nepal Rastra Bank (NRB). As a result of this, reserve money increased by less than one percent in 2002/03 compared to the significant rise of 11.9 percent in the preceding year. Similarly, narrow money growth was estimated at 7.5 percent in 2002/03 compared to the 9.3 percent rise in the preceding year. The major contributory factors for monetary growth were net foreign assets and the bank credit to the private sector with the negligible role of the banking sector's loans to HMG.

NRB unveiled its new monetary policy for 2003/04 on July 24, 2003. The new monetary policy has supported the current exchange rate peg regime with the Indian currency as the nominal anchor to ensure domestic price stability and, at the same time, to prevent real appreciation or depreciation of the Nepalese rupee. The new monetary policy has abolished the vault cash CRR of 2 percent and also simplified the CRR into a uniform rate of 6 percent. The policy is directed at domestic stability as well as reducing the external vulnerability by avoiding the unnecessary depletion of the nation's international reserves.

Financial Sector Reform

Under the World Bank-supported financial sector reform, the management of the two largest public sector commercial banks and the reengineering work of NRB have been contracted out to internationally recognized management groups: the management of Nepal Bank Limited (NBL) to the Bank of Scotland (Ireland) ICC consulting group, while that of Rastriya Banijya Bank (RBB), following the unilateral breach of agreement by the Deloitte Touche Tohmatsu, to a group of experts led by an American consultant. Similarly, the reengineering process of NRB has been entrusted to the IOS Partners, an American consultancy agency. In order to reduce the overstaffing especially at the non-officer level, NRB also launched a voluntary retirement scheme (VRS), which reduced 17 percent staff mostly from the non-officer layers. The Debt Recovery Tribunal under the Debt Recovery Act has been constituted. HMG has reiterated its commitment to legal reforms including enacting the proposed legislation on Secured Transaction, Insolvency and Anti-money Laundering. In addition, with the view to reducing the non-performing assets (NPA) of the banking sector, HMG is going to introduce an ordinance to set up an Assets Management Company (AMC) within the first six months of the current fiscal year, and has earmarked US$ 2 million in the 2003/04 budget for this purpose. Credit Information Center with legal entity, in the form of public limited company, is also being established to cater the credit information needs of all the commercial banks and financial institutions. The structural reform of the rural development banks and the transfer to the private sector of the NRB-held shares in one of these banks are under implementation. The supervision system is being improved through the implementation of international standards of supervision. The central bank is committed to discharge its duties and responsibilities for the implementation of all the measures required toward loan recovery and reducing the ratio of NPA.

Since Nepal has accepted the obligations of Article VIII, it has not yet pursued capital account convertibility. Accordingly, commercial banks are not permitted to invest in Indian T-Bills. Moreover, trade deficit with India during 2002/03 has risen by 80.7 percent, resulting in the substantial decline in the Indian currency reserve to US$1.3 million in mid-July 2003 from US$3.2 million in mid-July 2002. In such a situation also, it would not be desirable to allow commercial banks invest in Indian T-Bills. The provisions with respect to the interest rates and foreign exchange rates are also aimed at stabilizing the financial markets. NRB directives for commercial banks, one of the focal points of the financial sector reform strategy, have been instrumental in improving the financial condition of the commercial banks besides enhancing the confidence of the public in the financial system. In the process of phasing out the priority sector credit requirement other than the deprived sector credit requirement of 3 percent of the total outstanding credit by 2007/08, the ratio for 2003/04 has been brought down to 6 percent. These directives and measures have also enhanced commercial banks' ability to price credit risk and expand profit opportunities even in the prevailing difficult economic situation of the country.

Fiscal Reform

In line with the Tenth Plan with single objective of poverty reduction, the budget for the current fiscal year has clearly visualized the multi-dimensions of the nature of poverty in terms of income poverty, human poverty and social exclusion as the cause of social conflict and unrest. The budget has also addressed programs and policies for poverty reduction and economic reform. They include regional balance, employment promotion, social justice within the framework of the Tenth Plan's growth target, fiscal balance, collaboration and partnership among the public and private sectors, transfer of ownership of state-owned enterprises through stock market, performance evaluation based on the prescribed criteria of the top management in public sector enterprises, strict financial discipline, anti-corruption drive, and transparency in the financial decisions. Efforts are also being made to reorganize programs within the framework of the PRSP/Tenth Plan.

Expenditure and Revenue Reform

Though the recurrent expenditure comprising the debt servicing, salaries and allowances is not amenable to reduction at a single go, the authorities have expressed their long-term commitments to its reduction. On the development expenditure front, programs and projects are being prioritized and fund availability to higher priority projects has been ensured in conformity with the Medium-Term Expenditure Framework (MTEF). To avoid the possibility of construction work turning out to be substandard and financial misappropriation due to the bulk expenditure incurred at the end of the fiscal year, the budget will be released only for the contracts awarded by the second week of February. Similarly, budget transfer or additional budget release for development programs would not be allowed after the second week of May in order to discourage the demand for development budget toward the end of the fiscal year. The authorities have continued to encourage higher community participation in the areas of education and health services through transferring these services to the Local Management Committees. An arrangement has also been made to launch special program to reconstruct infrastructures destroyed by the insurgents.

The thrust of the tax policy as spelt out in the budget is to enhance effectiveness and elasticity of the tax system by broadening the tax base with the reduction and adjustment in the tax rates. Efforts are underway to make the Income Tax Act, 2002 simple and understandable to tax payers. Similarly, broadening the VAT base, increasing the tax payers' awareness, auditing, improvement in customs valuation, tax payer registration campaign, Gift Lottery Program in Kathmandu Valley for encouraging billing practices, etc., have been initiated. In order to make Revenue Investigation Department more effective, additional legal provisions have been introduced. A cut in the personal income tax burden at lower income level has helped this group in easing their livelihood.

Corruption Control

To control the corruption at political level and to make donations more transparent, an arrangement has been made for providing the nationally recognized political parties grants at a rate of Rs 20 for each vote polled in the immediately preceding election for the House of Representatives. Based on the report of Property Investigation Commission as well as its own investigation, the Commission for the Investigation of the Abuse of Authority (CIAA) has been taking actions against civil service officials and politicians.

External Reforms

In the context of phasing-out of the MFA quotas in the near future and the WTO Working Party's recent recommendation to the Ministerial

Conference to be held in Cancun, Mexico, during September 10–14, 2003 for Nepal's accession to WTO, it is natural that Nepal pursue and be supported to expand access to overseas markets. Nepal has fulfilled the obligations under Article VIII and has further liberalized foreign exchange facility through the current fiscal year's monetary policy. As Nepal has an open border and free convertibility of the Indian rupee into the Nepalese rupee, it would be more feasible and practical to move ahead a bit cautiously towards extending unlimited foreign exchange facility for personal travel even for bona fide reasons. As a step towards this, the recently announced monetary policy has unified and upgraded the foreign exchange passport facility at US$2000 for all countries, and NRB has also made arrangements to provide exchange facility exceeding the above amount based on the reasonable ground.

Additional items will be included in the list that can be imported from India through the payment of convertible currency. The provision of making exports through the cash against document (CAD) mechanism has been further liberalized up to US$100,000 by maintaining 10 percent bank guarantee replacing the existing amount of US$50,000 at 25 percent bank guarantee. The amount of imports from third countries through the draft/TT has been raised from the existing US$3,000 to US$30,000. The facility of opening usance letter of credit, which has so far been extended to the industrial importers, has also been allowed for other importers. Commercial banks are allowed to make inter-bank transactions of the Indian currency among themselves.

Statistical Issues

Our authorities would like to acknowledge the technical assistance in the areas of monetary and banking, foreign exchange and BOP, multi-sector data dissemination and management. Nepal has benefited greatly from such technical assistance and has implemented a number of recommendations in different statistical areas. The NRB is to incorporate the major deposit-taking institutions through the compilation of the banking survey within the current fiscal year. The multi-sector statistics mission has been very useful and Nepal has been participating in the GDDS framework for compiling and disseminating macroeconomic and socio-demographic data. The authorities are looking forward to receiving further support in the future.

PRGF Issues

As a result of positive impact of policy reform measures in various sectors of the economy, the World Bank upgraded Nepal's status in its funding program from that of the low case to the base case level. The financial sector reform program is being implemented with the highest priority. The MTEF and the Tenth Plan are also under implementation. Macroeconomic indicators are broadly on the right track. The successful conclusion of the ongoing dialogue with the insurgents along with the macroeconomic policies and developments as outlined above are expected to pave the way for a conducive environment to give a big push to the Nepalese economy. Against this backdrop, the Nepalese authorities would like to enter into a PRGF arrangement with the IMF.

Conclusion

The current challenge facing Nepal is the restoration of peace and security towards which HMG has been committed and is also ushering in a positive environment for this purpose. Since some normalcy has returned following the announcement of the ceasefire for the last 6–7 months, a rebound of economic activities is in the offing. The third-round of talks between HMG and the insurgents was held during August 17–20, 2003. With the ongoing peace talks, the implementation of some of the key reform programs and the sustenance of the overall macroeconomic stability, the Nepalese authorities are eagerly looking forward to entering into the PRGF-supported program. The program would go a long way in assisting Nepal in its task of expediting the much-needed economic development by building on the intensified economic reform endeavors and the improvements in the overall macroeconomic management. Obviously, domestic efforts alone would not be adequate to provide the necessary wherewithal for Nepal to spur economic growth and combat poverty. Hence, Nepal seeks and looks forward to financial and technical support from the international community.

Mr. Reddy submitted the following statement:

We thank the staff for the useful set of documents and Ms. Indrawati and Mr. Karki for their comprehensive preliminary statement. The developments which have taken place since the last consultation have intensified the policy challenges being faced by the Nepalese authorities who are already facing a sluggish external environment. The delicate security situation and the present uncertain political environment have made an adequate policy response from the authorities increasingly difficult. It is therefore heartening to note that growth during 2002 has recovered from the previous year's setback, albeit at a modest pace. The authorities are to be commended for this. As has been brought out in the staff documents, much more needs to be done to put in place a framework for sustainable poverty reducing growth. We are in broad agreement with the staff appraisal and will therefore focus on a few issues only.

The acceleration of growth required to reduce poverty from its present level and reach the MDGs, may require considerable structural changes. While we welcome the significant stepping up in Fund technical assistance to Nepal this year, the country's ambitious reform program can be best managed through the framework of a PRGF arrangement. We therefore support the request of Ms. Indrawati and Mr. Karki in their preliminary statement that the PRGF-supported program be put in place as early as possible.

We support the four-pronged thrust of the PRSP with its emphasis on the enhanced and extended delivery of social sector services and providing targeted programs for the poor while facilitating growth through improvements in the institutional environment. Determined implementation of the reform agenda, as well as improvement in the security situation would enable the authorities to achieve their target of reducing poverty levels by about eight percentage points over the next five years of the Tenth Development Plan. With the level of rural poverty being almost double than that in urban areas, and given the role of the agricultural sector in the economy, we also welcome the wide ranging initiatives incorporated in the Agricultural Perspective Plan aimed at boosting agricultural growth.

The fiscal strategy to strengthen revenue while reprioritizing expenditure in favor of infrastructure and the social sector will lay a strong foundation for the implementation of the PRSP. Considering that development expenditure as a percentage of GDP is targeted to reach 2000/01 levels only in 2004/05, it is essential that such expenditure is not crowded out by other expenditure. We hope that the authorities have contingency plans in place in case the revenue and external aid levels do not match projections. As a substantial part of the present multilateral commitments remain undisbursed, perhaps the authorities could also focus on enhancement in project implementation structures as well as procedures. Parallel action by the multilaterals to support this objective would also be essential. Considering that remittances form nearly eight times the gross official disbursements, the authorities could also consider the useful staff suggestions made in the box in paragraph 13 to ensure sustainability of such flows.

We are in agreement with the staff that the monetary and exchange rate policies adopted by the authorities have served the country well. The reform of the NRB through downsizing and enhancing supervision capabilities, as well as the steps proposed for improved loan recovery by the commercial banks and the loosening of restrictions on commercial bank operations will assist in strengthening the financial sector.

We support the authorities in their efforts to implement their critical structural reform agenda. The proposed reform in the civil services, including the elimination of vacant positions, the introduction of merit based recruitments/ promotions, the decompression of the wage scale, as well as the improvements in the public procurement process will reduce the level of government expenditure while enhancing its quality. The reform of public sector enterprises is an equally urgent priority, given the pressure they exert on the budget.

Nepal's trade restrictiveness index of 2 seems to point at the limited scope available for further tariff reforms. The authorities could thus consider the other staff suggestions to improve competitiveness through accelerating the pace of structural reform and enhancing productivity by addressing the impediments outlined in paragraph 7. In this connection, we would like to clarify the statement in paragraph 13 of the staff paper that "Recorded exports to India declined reflecting the revised more restrictive trade treaty with India in March 2002." As we had pointed out in our preliminary statement last year, the previous trade arrangement had allowed Nepal to export goods duty free to India, without a value addition norm; while permitting Nepal to impose tariffs on Indian exports. Such a provision led to some third country goods finding unrestricted access to the Indian market, which was totally unintended. This also resulted in the anomalous situation, whereby some segments of domestic industry in India were adversely affected unjustifiably. Under the present trade treaty, this position has been rectified. Non-reciprocal zero duty access to India is still available to Nepalese exports with a stipulated value addition norm and quantitative limits to ensure the origin of the exports. All exports from Nepal to India above these ceilings are fully permitted under MFN terms.

We wish the authorities all success in their challenging policy endeavors.

Mr. Kremers and Mr. Litman submitted the following statement:

PRSP

Despite decades of development efforts supported by substantial foreign aid, Nepal remains among the poorest countries in the world. The population living in poverty not only increased from 5.7 million to 9.2 million during last 20 years, but also income disparities between different areas are large and widening. 38 percent of the population is living below $1 a day and 83 percent of the population is living below $2 a day. The Human Development Index (HDI), which measures average achievements in basic human development in one simple composite index, while having been growing during the last 20 years is, nevertheless, 8 ranks lower than may be expected, even from a country with such low GDP per capita. In our view, the staff has correctly identified the reasons responsible for Nepal's pervasive poverty—insufficient growth and inadequate targeting of the poor. The poverty is among the key causes of the seven-year old insurgency.

Nepal remains politically unstable, and although clashes between insurgents and governmental forces continue to occur, a truce of sorts remains in force. It is important to continue efforts to sustain the reform momentum. We believe that economic as well as political stability in the country is best achieved by the continued involvement of the international financial institutions as well as of donor countries. The authorities have prepared the PRSP following extensive discussions with a wide range of stakeholders. This extensive consultation process should ensure wide and strong ownership of

PRSP policies aimed at generating high and sustainable growth and poverty alleviation. We note with satisfaction that the authorities believe that the growth strategy should be rooted in macroeconomic stability. The existing macroeconomic stability and manageable fiscal position provide a good basis to begin the program. We also note that the PRSP addresses key weaknesses, including those of the financial and public sectors, and poor governance. The PRSP rightly places special emphasis on health and education. The School Leaving Certificate examination results published in June 2003 highlight the state of education: only 25 percent of students who took the test passed, and less than 25 percent of those who passed the test went to state-run schools. Therefore, the wide spread lack of satisfaction with the existing education system is well understandable, and challenges ahead are enormous. The Nepalese government has decided to devolve a significant part of spending especially in social areas to improve service delivery. While this plan, if successful, could improve delivery of education and health to the poorest areas, it would add an additional level of bureaucracy increasing inefficiency and corruption, if this were not the case. Because the elected local government's term ended in July 2002 and election is being postponed, it seems that the bodies that were to deliver education and health to rural areas, where 88 percent of Nepal's population live, are in disarray.

We welcome the resumption of PRGF negotiations and urge the staff to promptly complete its assessment of the PRSP in order to bring it for endorsement by the Executive Board as the basis for a PRGF arrangement.

Financial Sector

We agree with the staff that financial sector weakness was among the key constraints of GDP growth. The staff does not provide appropriate data – NPLs ratios, provisions against NPLs, banks' negative net worth as percentage of GDP - to illuminate the problem. However, the financial sector, which includes two insolvent commercial banks which account for more than 50 percent on the banking sector, can not serve the economy well. These banks are run by foreign management consultants. As more than 50 percent of their loan portfolio consists of NPLs, the managers urgently need the committed authorities' support for their efforts to recover loans from well-connected defaulters, retire a large number of employees, close branches, improve management and update accounts. Establishing the Debt Recovery Tribunals is a step in the right direction, and we urge the authorities to put them to work without any delay. Prompt and even handing cases of well connected defaulters will send an important signal of the authorities' seriousness to deal with corruption-tinted lending.

Exchange Rate Policy

We agree with the staff that, given Nepal's close ties to India, the exchange rate peg to the Indian rupee served Nepal well. However phasing out the MFA by 2005, the decline of Nepal's exports to India due to the new trading rules agreed in March 2002, and the recent free access of Nepalese garments to Canada, may change the composition of the Nepalese trade. Therefore, we encourage the staff to prepare in the next report a list of pros and cons that compares the pegging of the Nepalese rupee to the Indian currency with pegging to a basket of currencies, which reflects more correctly the composition of the Nepalese trade. A paper on whether the exchange rate of the Nepalese rupee is appropriate would also be welcome.

Governance

We join the staff in commending the authorities for their anticorruption efforts. The work of the Commission for the Investigation of Abuse of Authority (CIAA) seems to be evenhanded and with appropriately wide coverage. We hope that the prominent politician's challenge of the CIAA summons at High Court will be proved baseless, and that the Court decision will send a clear signal that CIAA is not used to settling political scores. Such a signal is urgently needed, especially in the politically unstable environment.

Mr. Rutayisire submitted the following statement:

Nepal's economic and financial situation remains difficult, with the country being among the poorest in the world, despite the development efforts of the authorities. While more recently, political uncertainties, a deteriorating security situation and other domestic and external shocks have combined to worsen the situation, the staff paper also indicates that growth prospects and the reduction of poverty are severely constrained by deep-seated structural impediments, poor governance, and a lack of institutions. We therefore welcome the preparation of a PRSP and the strategy to alleviate poverty. We also welcome the commitment of the authorities to pursue economic reforms. While the return of domestic political stability will be critical to the success of the authorities' efforts, it is also important that the authorities maintain the thrust of their reform efforts. In this context, we look forward to the start of discussions between the staff and the authorities on a medium-term program of adjustment that could be supported by a PRGF arrangement based on the PRSP.

Despite the challenges faced by the authorities, it is encouraging to note that a relative macroeconomic stability has been maintained, and that the debt-to-GDP and the debt service ratios are manageable. These provide the authorities with a good basis on which to build their economic reform program. The PRSP strategy as outlined in the staff report appears to address the basic challenges facing the economy, and places appropriate emphasis on macroeconomic stability as the basis for sustainable growth and poverty reduction.

Improving fiscal performance will be critical to the achievement of the other macroeconomic objectives. In that respect, we welcome the intention of the authorities to take measures that will boost revenue over the medium term. Broadening the tax base and increasing some taxes may be needed, and in this context, we note the intention to increase the VAT rate. The implementation of the tax reform recommended by the Fund T/A mission will also help to streamline the tax system, but we note that these measures will be revenue neutral. It will be important that other sources of revenue be found, and we wonder if the staff could give us some indications as to whether other reforms are envisaged with a view to raising revenue. These measures will also have to be complemented by better control and monitoring of expenditure, although there will be a need to raise social and capital spending. Prudent debt management will also have to be followed to maintain fiscal sustainability.

Monetary policy has been geared towards supporting the peg to the Indian rupee, and has been broadly appropriate. However, with changes in the external sector, in particular, in the context of the phasing out of the MFA quotas, Nepal needs to keep the level of the peg under review and to follow policies that will maintain competitiveness. In this regard, we welcome the approach being followed by the authorities, and we would emphasize the need to pursue reforms in the labor market and the restructuring of the public enterprise sector.

As regards structural reforms, we agree with the recommendations of the staff on the improvements needed. However, it is clear that the program of reforms is extensive and will take time. It will be important that a realistic timetable be put in place and that reforms be appropriately timed and sequenced. Attention will also have to be given to the social impact of these reforms, and an adequate social safety net should be put in place. The decision to start the process of downsizing the civil service is welcomed. The measures that have been approved by the cabinet go in the right direction. Decentralization can also help to reduce budgetary pressures, while at the same time improving important government services to the population, but it has to be well planned. We also welcome the progress that is being made in the reform of the banking sector. However, we would encourage the authorities to accelerate the reform of the NRB and to enhance its supervisory and regulatory functions. The restructuring of the banking sector should also be accelerated so that it can play its role in financial intermediation and contribute more positively to the development of the economy.

In conclusion, we commend the Nepalese authorities for their efforts at reforms, and we hope that they can complete negotiations soon with the staff on a PRGF-supported program.

Mr. Daïri submitted the following statement:

We thank the staff for their informative report on Nepal and Ms. Indrawati and Mr. Karki for their comprehensive statement. Nepal continues to be among the poorest and least-developed countries with some 40 percent of its population living below the poverty line. Deterioration in the security situation, combined with financial sector weakness, inefficient resource allocation, weak public sector management, low productivity in agriculture, and adverse external development has seriously affected the economy, especially in 2001/02 when GDP declined by 0.5 percent. Against this background and as reflected in some macroeconomic indicators in 2002/03, there is considerable scope for accelerating the pace of economic growth. This calls for a lasting return of peace and security, prudent macroeconomic policies, strengthened structural reforms, and accelerated and effective implementation of social and poverty reduction programs under the recently issued PRSP. As rightly noted by the staff, the effects of a ceasefire, agreed with the insurgents in early-2003, are already evident in higher economic activity, and efforts should aim at maintaining peace and eliminating remaining policy uncertainties in order to help sustain the economic recovery.

While the security situation, political uncertainties, and weak administrative capacity have hindered the reform process, the authorities have generally followed a prudent macroeconomic stance and have responded favorably to Fund tax policy recommendations. The domestically financed government deficit has remained low, notwithstanding a decline in concessional assistance and, following the lower economic activity in the first part of the year, the authorities have undertaken measures, in consultation with the Fund, to reduce spending in 2002/03 so as to offset the weaker revenue performance.

Progress in structural reforms has been achieved on several fronts. Financial sector reform has proceeded with IFIs advice and financial assistance, including in streamlining the staffing of the NRB, restructuring the troubled NBL and RBB, and improving loan recovery, which should be boosted by the establishment of the Debt Recovery Tribunal. We welcome the measures taken to improve the financial position of the Nepal Oil Corporation and restructure or liquidate other enterprises. A well-defined social safety net, however, should be established to ensure a smooth implementation of the public enterprise reform program. The authorities are also to be commended for their efforts in governance reform and fighting corruption, including the adoption of the Anti-Corruption Strategy.

We broadly concur with the main objectives and policies of the PRSP and with the medium-term fiscal strategy. It is important to ensure that higher growth translates into improved social conditions and reduced inequalities. It is indeed troubling that the prevalence of poverty did not decline over the past decade (paragraph 1 of the staff report) despite average real growth of 5 percent, with improvement in GDP per capita of 2.5 percent. The staff may wish to comment.

On fiscal issues, the authorities should redouble their efforts at revenue mobilization and expenditure control and limit domestic borrowing. The tax reform package, prepared with Fund technical assistance, seems appropriately geared at expanding the base and enhancing efficiency. In the longer term, increasing VAT rate, broadening the VAT base, and limiting tax exemption are essential. In addition, auditing the large taxpayers should be strengthened. Moreover, given the resource constraints, spending should be prioritized to poverty reduction and social programs, in line with the MTEF, which will not only improve long-term macroeconomic performance, but also alleviate the population's concerns about social inequalities.

We share the staff and the authorities' view that the exchange rate peg to the Indian rupee continues to be appropriate and has served the economy well. The authorities' intention to carry out preparation for accession to WTO is welcome. As Nepal is largely dependent on trade with India, accession, together with the phasing out of MFA quotas, will expose Nepali goods to serious competition. However, it could also increase credibility and predictability of the trade regime, which may eventually lead to improved access to foreign markets as well as diversification of the economy. We welcome the authorities' intention to keep the exchange rate peg under review.

Structural reforms will be key to improving efficiency and protecting competitiveness. In this connection, the authorities' intention to consolidate all import levies into a single customs duty to enhance transparency and to reduce administrative barriers to trade is commendable. Attention should be paid to further strengthening of the financial sector, including improved regulation and supervision and restructuring of the development banks, elimination of directed credit and restoration of the credit culture, reforming state-owned enterprises and the civil service, and strengthening governance which are key to promoting sustained growth and social development.

Nepal is faced with formidable challenges, and its land-locked situation creates additional burden on its competitiveness. We are pleased that the authorities are engaged in a wide range of reforms and that they attach high priority to macroeconomic stability and poverty eradication. However, capacity constraints will continue to hinder policy formulation and implementation and extensive technical assistance will be needed. In view of the authorities' good track record in implementing Fund technical assistance, as indicated by

Ms. Indrawati and Mr. Karki, further Fund support in this area is recommended. Moreover, we believe that it is time to extend Fund support under the PRGF to a well-articulated program that could push forward the authorities' reform and stabilization efforts, and, like Mr. Reddy, we support the authorities' request to this end. We also call on the international community to strengthen its assistance to Nepal so as to lay the foundation for a durable peace, sustainable growth, and lasting poverty reduction.

Mr. Usman submitted the following statement:

Introduction

We thank the staff for very analytical report and Ms. Indrawati and Mr. Karki for their detailed preliminary statement. Since we agree with the thrust of the staff's recommendations, we will limit our comments to only a few issues for emphasis.

It is evident from the staff report and the preliminary statement that the success of Nepal's economic development and poverty reduction efforts lies in the ability of the authorities to sustain the current peace agreement with the insurgents, as well as the political will to conscientiously implement the current development plan and reforms. Nonetheless, we commend the authorities for the substantial reforms that have been undertaken so far, and for those that are being proposed. In particular, we note that the Tenth Development Plan (2002–2007) was prepared, bearing in mind the mistakes and the over-optimistic benchmarks of the preceding plan, so that this time around, more realistic and achievable targets now form the basis of the implementation and measurement of the current programs.

Recent Developments

In spite of the political and other social challenges that Nepal faced in the implementation of the last development plan, and which constrained the achievement of some program objectives, it is noteworthy that some solid foundations have nonetheless been laid to support the current plan. These include a high total investment averaging 23.6 percent of GDP and a low inflation averaging 5.7 per cent. In the first year of the current plan, some modest results have also been recorded, including maintaining the inflation rate within the plan target of 5 percent, and recording positive growth rates of 2.2 and 2.5 percent in both the agricultural and the non-agricultural sectors, respectively. The fiscal deficit narrowed to 4.7 percent of GDP from 5.4 percent, due to the growth in revenue by 11.5 per cent, while domestic loans declined by 46.6 percent. Exports also increased by 4.9 percent, and significant increases were recorded in remittances, resulting in a balance of payments surplus of $66.7 million as against a deficit of $42.7 million in the preceding year, and raising the gross international reserves level to 11 months of imports.

In the area of reforms, we note that some commendable steps that will enhance performance of the current plan have been taken. In this regard, the Nepalese authorities are commended for undertaking a structural reform of rural development banks and for the ongoing transfer of the shares of the NRB in one of the banks to the private sector, as this will facilitate the private sector-led growth that is needed to emancipate the poor masses and support poverty reduction. Closely tied to this, to achieve the same objective, is the identification by the authorities, of the multi-dimensional nature of poverty in Nepal and the prioritization of the issues relating to them in the implementation of the current plan program, as well as the steps taken to transfer education and health services to local management committees in order to encourage higher community participation.

Remaining Challenges

The major challenge facing the Nepalese authorities remains the ability to sustain the current peace and keep the momentum of the reform efforts to achieve the medium-term projected higher growth rate of 5.0 per cent. In particular, reform measures remain outstanding largely in the financial sector, in streamlining the tax system, as well as in policies to raise allocations for poverty-related expenditures and further reduce domestic borrowing, as well as improve Nepal's competitiveness. We urge the authorities to give these areas priority attention in order to accelerate the process of achieving the objectives of enhanced real growth and poverty reduction in Nepal, at which the current development plan aims.

With these remarks, we wish the authorities the very best in their efforts to sustain the current peace and in implementing their current economic development programs

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

We start by thanking the staff for the concise and focused paper and Ms. Indrawati and Mr. Karki for their helpful preliminary statement. In terms of recent economic developments, the Nepalese authorities have achieved a great deal with the help of the World Bank and the Fund, among others. A modest recovery is under way, with macroeconomic policies broadly in line with targets. The manageable fiscal position and accommodative monetary policy have facilitated economic growth. Balance of payments developments turned favorable around mid-2002/03 while large and increasing remittances reflect adequate international reserves. Significant progress has been made with financial sector reform as well as in with budgetary spending, and public enterprise, governance and anti-corruption reforms.

Nevertheless, poverty in Nepal remains pervasive with 40 percent of the population living below the poverty line—putting it amongst the poorest countries in the world. In our view, the priority for the authorities is poverty alleviation. To reach this end, broad-based economic growth, social sector development, targeted programs for the poor and deprived groups, and improved governance must be put place. Encouragingly, these strategies have been included in the government's recently issued Poverty Reduction Strategy Paper, and we look forward to their implementation. For every country—including Nepal—social stability is a key precondition for nascent economic recovery and healthy development.

On fiscal policy, we agree with the medium-term strategy to boost revenue performance, reorient and reprioritize social and infrastructure spending and reduce domestic borrowing. To broaden the revenue base, we welcome the measures listed in paragraph 22 of the report to further streamline the tax system, promote exports, and reduce the personal income tax burden at the lower income levels. With these prudent policies, macroeconomic stability should be maintained.

On monetary and exchange rate policy, we support a stable currency for the long run. Currently, the authorities' policy that the exchange rate peg the Indian rupee continues to be appropriate, given Nepal's close ties with India. The authorities will need to review the level of the peg in light of prospective external sector developments and to keep inflation in check in line with price movements in India.

Significant progress has been made with financial sector reforms, while further actions are needed to strengthen both the central bank and commercial banks. The central bank needs to downsize further and supervision of the financial sector needs strengthening. On commercial bank restructuring, it is suggested that the central bank initiates a voluntary retirement scheme at major banks, thereby reducing overstaffing and facilitating banks' loan recovery based on the measures endorsed by the government, such as the blacklisting mechanism.

We broadly agree with the staff on other issues, including (i) public enterprise and governance reforms, (ii) legal and trade policy reforms; and (iii) data improvement. The first will help improve the allocation of public sector resources, the second will improve the business climate, and the third should facilitate policy formulation and monitoring. We wish to stress the importance of further legislation to enhance economic administration.

Lastly, we hope that the PRGF-supported program, initiated in 2001, will be finalized very soon.

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

The staff representative from the Asia and Pacific Department (Mr. Shishido) informed Directors that the authorities had taken action to remove foreign exchange restrictions related to payments on foreign travel, as suggested in the staff report.

Mr. Cho made the following statement:

We welcome the emerging signs of economic recovery with the newly agreed cease-fire early this year. We also welcome the resumption of negotiations for a PRGF arrangement with the issuance of a PRSP, as well as the meeting of some of the prior conditions that have hindered the progress of previous program negotiations. With the other international financial institutions and donors working closely to assist the implementation of the PRSP, the negotiations for the PRSP and PRGF-supported program appears to be on track.

However, we note that the foundation for a lasting peace, which is the key element in ensuring effective implementation of a PRSP, is still not secure. The authorities themselves list political and security uncertainties as one of the four downside risks the economy faces in achieving sustainable growth. We would like join other Directors in emphasizing that security uncertainties are the most critical threat to sustainable growth and urge the authorities to come up with a peaceful resolution.

Political turbulence has been the single worst hindrance to the economy's growth in the past few years and the authorities have tried to address the various structural issues behind slow growth. The authorities appear to be fully cognizant of the urgency of the issues identified in section 2 of the staff report and have been receptive to the staff's policy recommendations, as acknowledged in the report. Nevertheless, security and political conditions have not been stable enough to expect accelerated progress in the implementation of structural reforms under sound macroeconomic management. We sincerely hope that lasting peace will be a stepping stone to enable the authorities to double their endeavors in fighting poverty reduction under the assistance of the Fund-supported program.

With these general remarks, I will focus on some specific issues raised in the staff report.

While it is a relief that fiscal sustainability appears not to be in danger, debt service already accounts for a quarter of the country's revenue. In addition, wage, benefits, and retirement provisions account for approximately the remaining two thirds of the country's revenue. This leaves little room for development expenditure, although the reality is that the bulk of development projects have been donor-financed.

The scarcity of fiscal resources for development expenditure is worrisome since strong agricultural growth, which is a prerequisite for broad-based growth, hinges upon continued public investment as outlined in the Agricultural Prospective Plan. Donor-financed projects also often require matching domestic investment. It is paramount to maintain current expenditure under firm control. In this respect, we welcome the progress in civil service reform, and encourage even stronger efforts to reduce the wage bill and pension payments. We also welcome the authorities' plan to extend their multiyear expenditure framework to regular expenditures.

Revenue-raising efforts should also be intensified. We note that the tax reform measures reflected in next fiscal year's budget focus on the rationalization of the tax structure rather than on increasing revenue. Correcting distortions in the economy and simplifying the tax structure will certainly contribute to raising revenue, but it should be followed by strengthening tax administration. We also encourage the authorities to remain vigilant to find other revenue-raising measures, such as a timely increase in VAT rates, as other Directors have also mentioned in their preliminary statements.

Regarding monetary and exchange rate policy, we share the staff's assessment that the country's pegged exchange rate regime with the Indian rupee has served the economy well. We also concur that monetary policy has been broadly well conducted, with inflation remaining subdued. Nevertheless, we are not comfortable about the macroeconomic implications of the sizable remittances, which could endanger macroeconomic stability if they are not well managed. This possibility appears to loom at large given the unsterilized informal remittance inflows to the economy and highlights the urgent need to accommodate these flows into a formal channel along with managing the reserve money to support the peg.

Financial sector reform is also essential. While full-fledged financial liberalization is still premature for the Nepalese economy, we note that capital controls have already been weakened substantially, as evidenced by the sizable informal capital flows. This has caused some serious anomalies, such as a positive growth rate differential in exchange rates. It would be better to bring capital flows under proper oversight rather than allowing them to continue to bypass the loosely controlled network. In this respect, I welcome the staff's earlier remarks about the recent progress in lifting some exchange controls. Like Mr. Reddy, we encourage the authorities to consider the staff's recommendation in the box in paragraph 13 of the staff report.

Regarding financial reform and restructuring, we thank Ms. Indrawati and Mr. Karki for the update on these issues in their preliminary statement.

Nevertheless, we note that financial restructuring eventually requires sizable public resources as government contingency liabilities become clear. Therefore, we would like to emphasize the need for sound fiscal management. As for the lifting of lending requirements on commercial banks, we welcome the faster elimination of priority sector lending requirements and encourage the equally rapid removal of requirements on private sector lending.

Finally, we agree with the staff's emphasis on public sector and governance reform. This includes not only public enterprise reform through better accounting, accountability, restructuring and privatization, but also more direct efforts to fight corruption. Particularly in regard to anti-corruption efforts, we would like to stress the importance of procurement reform, and encourage the authorities to follow the recommendations of the World Bank-sponsored Country Procurement Assessment report. With these remarks, we wish the authorities every success.

Mr. Robert made the following statement:

I would like to thank the staff for their insightful set of papers, which presents a clear and comprehensive view of the situation faced by Nepal. I would also like to thank Ms. Indrawati and Mr. Karki for their helpful preliminary statement.

Nepal faces several crucial challenges, including the normalization of the political situation which is the central issue that the authorities have to deal with since it affects the country's economic development in the coming years. The consolidation of peace is a prerequisite for economic growth and poverty alleviation, and should therefore be a priority for the country. We pledge our strong support to the authorities in their efforts to solve political disputes in a conciliatory manner.

Lasting peace should help restore confidence, permit investment to develop, and allow tourism to return to its previous levels. Moreover, the reduction in security expenditures could be used to raise capital expenditures. All these factors should contribute to strengthening the nascent economic recovery and should provide the country with more resources to implement poverty alleviation programs, which must be the authorities' economic priority as many Directors have indicated. However, the impact of higher resources on poverty reduction will be stronger if they are allocated in an efficient way. In this respect, we join the staff in urging the authorities to increase their anti-corruption efforts.

We look forward to the implementation of the first practical measures of the recently issued PRSP and welcome the fact that the conditions for the resumption of the PRGF arrangement discussions are being met, since such a program could significantly help Nepal implement its PRSP strategy.

As stated by the staff and emphasized by Mr. Reddy, fiscal consolidation is a crucial issue. We welcome the authorities' willingness to rationalize the tax system, and we encourage them to prioritize their spending in the key sectors of agriculture, health, and education. With respect to the cuts in the current revised budget, we would like to ask the staff which sectors have been mainly affected and whether the repercussion from the budget cuts have been felt on social programs.

We encourage the authorities to pursue structural reforms initiated in the financial and public sectors. In particular, we welcome the NRB's decision to implement measures aimed at facilitating loan recovery by commercial banks. I would like to stress the importance of quickly restructuring commercial banks to improve financial intermediation and provide the country with a sound financial system that will favor growth. We welcome the authorities' announced decisions in this domain and look forward to the implementation of these measures in the near future.

Finally, the exchange rate peg to the Indian rupee seems to be advantageous for the Nepalese economy due to its close ties to the Indian economy. However, we share Mr. Kremers and Mr. Litman's concerns regarding the impact of changes in Nepal's external trade composition and we support their request for a report to examine the appropriate exchange rate regime for Nepal. The current account's strong and increasing dependence on expatriate remittances may be a concern. Therefore, I would like to ask the staff how volatile the remittance inflows are and what the staff's assessment is of the country's vulnerability in this respect.

I conclude by wishing the authorities full success in their efforts.

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

In his preliminary statement, Mr. Rutayisire asked whether there are tax measures that the staff would recommend in addition to the existing Fund technical assistance recommendations. Given that Nepal's tax system is fairly robust for its income level of US$250 per capita, with a functioning VAT system, an appropriately designed income tax, and generally low tariff levels, we do not currently propose any major change in the tax system. As stated in the staff report, we recommend the authorities reduce exemptions in both the VAT and the customs tariff and consider raising the VAT rate if necessary. Currently the VAT rate is relatively low at 10 percent; raising this rate would be the most efficient way to raise revenues.

However, the tax administration system in Nepal needs improvement in both the inland revenue and customs areas. As the Fiscal Affairs Department recommended, we will be focusing in the medium term on administration improvements. In the immediate future, the plan is to establish a large, fully-fledged taxpayer unit in the inland revenue area and start a comprehensive review and reform of customs administration. We foresee the potential to significantly increase revenues this way.

There was a question in Mr. Daïri's preliminary statement on why after 10 years of 5 percent average real growth and over 2.5 percent per capita income growth, Nepal's poverty level has remained stagnant at approximately 40 percent of the population. A key reason is that, although growth occurred, it was relatively urban-based and biased in favor of the nonagricultural sector. Within the agriculture sector, the plains and hill regions benefited more from the growth than the mountain area where the bulk of the poor live. Furthermore, the targeting of the social and poverty programs was not good, which also contributed to the continued high incidence of poverty. Under the PRSP, the authorities are proposing to address these issues.

Mr. Robert asked whether spending cuts in the budget affected social programs, these programs. Although there were some difficult times last year when development spending had to be suppressed due to the security situation and the unfortunate absence of local government authorities, the authorities were determined to maintain their investment in the priority sectors. Therefore, the spending on education, health, and other social sectors remained constant at 6 percent of GDP. The reduction in spending appears to have been made in rural development projects, particularly in agriculture and irrigation projects. As we expressed in the staff paper, we hope that the government's efforts to fully fund priority activities will improve their implementation significantly given the ongoing cease-fire and the peace process.

Mr. Robert also raised a fairly difficult issue on the volatility of remittances and our assessment of the country's vulnerability from that volatility. We have not seen volatility in remittances since they have been steadily increasing, now exceeding merchandise exports, and the authorities expect this trend to continue. Migrant workers are moving out of Nepal, unfortunately due partly to the lack of good job opportunities in the country. At the same time, the number of countries that officially accept Nepalese workers is increasing and currently stands at proximately 33 countries. That said, although we have not seen volatility in remittances so far and the authorities do not expected volatility, remittance flows can be affected by changes in economic and political situations in host countries as well as other external factors. This volatility can be factored into our vulnerability assessment in a fairly crude manner. Together with other vulnerabilities Nepal faces in the external area, this highlights how much a PRGF-supported program, which could catalyze other donor support, is needed.

Mr. Marques made the following statement:

Nepal remains mired in political chaos. Despite the ceasefire agreed in January, confusion persists and unless there is a dramatic increase in political transparency and accountability, the situation will become more and more unmanageable.

A failure of the peace talks and resumption of violence would prolong Nepal's suffering from low growth and pervasive poverty. The economic recovery just getting under way cannot be sustained without a lasting peace and effective implementation of essential social and infrastructure projects.

I welcome Nepal's recently issued PRSP, which must now be implemented. The budget for 2003/04 was tailored to the medium term fiscal strategy current at the time, but the erosion of growth prospects may force the authorities to reduce their development expenditures. Have appropriate contingency measures been identified?

The development expenditure program has already been significantly altered by dropping or combining low priority projects and prioritizing the remaining projects based on their poverty reducing potential, but it must now be further streamlined to maximize its developmental impact and minimize the fiscal burden.

Domestic revenue estimates seem optimistic, as do the projected grant disbursements, and it will require determined effort to reach the budget's revenue target and keep spending within the stipulated limits. The optimistic estimates of revenues and grants make it important to keep the central bank's financing of the deficit within the limits of the monetary program.

Revenue mobilization should be strengthened by broadening the tax base and thinning the large number of tax exemptions. To contain expenditures the government must disengage itself from public enterprises, though past experience points to the complexity of this process and the need for a multi-pronged approach.

Could the staff elaborate on the possible effects of possible large contingent liabilities in the financial sector and stemming from public enterprise reforms in the present environment of persistent low growth?

The authorities are to be commended for recognizing that good governance is critical for realizing the poverty reduction targets. I urge them to strengthen their civil service reforms and anticorruption measures by trimming redundant staff, decentralizing public services, improving the transparency and accountability of the civil service, and strengthening auditing and accounting standards. The strong investigative efforts of the CIAA are a step in the right direction, but must be followed by prompt court rulings against violators of the law.

In the financial sector, I welcome the greater autonomy granted to the NRB, the expansion of its duties, and the issuance of new banking regulations. The NRB must now reorganize itself to cope with its expanded responsibilities, and especially the improvement of its supervision capabilities.

After considerable delay, we are encouraged to see that external contracts have been completed for developing plans and managing the restructuring of the two largest commercial banks, which are technically insolvent. It is also noteworthy that external audit and operational reviews of the development banks are under way to address similar issues.

We are also pleased by the government's intention of recalling its representatives from the boards of banks that it does not own and in which it does not have a majority stake. The decision to set up a loan recovery tribunal is another positive step, and I hope that its rulings against well connected defaulters will be effectively enforced.

The daunting challenges already facing Nepal have been seriously worsened by the insurgency. The ceasefire is a good omen for social and economic development, but there is not certainty that it will lead to a credible peace process. But addressing the insurgency—which is largely the result of continued rural poverty and failure to spread the benefits of development more widely—will be critical for Nepal's further development.

With these comments, I wish the authorities every success.

Ms. Zubkova made the following statement:

Let me first thank the staff for its paper which provides a comprehensive look at the key economic issues, and Mrs. Indrawati and Mr. Karki for their revealing preliminary statement. When the Board discussed the Nepalese economy about a year ago, most chairs were not optimistic about the Nepalese growth prospects because of the global slowdown and the deteriorating domestic security situation. Therefore, I am encouraged by the fact that the ceasefire which was announced earlier this year helped to sustain the speed of reforms and renew hopes for a vigorous recovery.

Against the background of persistent political uncertainties, the authorities deserve recognition for keeping the economy on a stable path and for adherence to sustainable fiscal policies. The most notable progress since the last Article IV consultations is in prioritization of budgetary spending and public enterprise reforms, as well as the financial sector reforms focused on reorganization and a reduction of overstaffing of the lower-level servants.

However, on a broader scale, weak governance and grave socio-economic imbalances, which are hard to solve even with very good governance, remain the main sources of concern. As is already emphasized in the previous preliminary statements, the economy slowed down considerably during the last two years, and key sectors of the Nepalese economy, like food and textile industries, and tourism were most adversely affected.

I welcome the government's poverty reduction strategy as embodied in the adopted 10th 5-year plan and its commitment to raise GDP growth to 5–6 percent over the medium-term. However, these projections seem to be too optimistic, basically for two reasons:

1) A major upturn in the service sector, including tourism, is unlikely unless the ceasefire leads to a significant improvement in the security situation;

2) The extent of the recovery and the medium-term outlook will be largely determined by agricultural and industrial exports. While the steep decline of exports in 2002, according to the staff paper, reflects quantitative restrictions in the new trade treaty with India, the future export outlook remains mixed due to a prolonged global slowdown and the continued high dependency on the Indian market. I was pleased to notice in the preliminary statement that a strong acceleration in garment exports contributed to the 4.9 percent growth of the overall exports in 2003, which seems to be a better performance than estimated by the staff. Without doubts, the forthcoming WTO accession will open access to new markets, but I join the staff and Mr. Daïri in stressing the necessity for the authorities to proceed more vigorously and explicitly to implement the measures which would help to improve competitiveness in the major export sectors. These measures must be addressed as a consolidated reform package, which would eliminate all structural impediments to export growth with a particular emphasis on the current labor legislation and customs procedures.

Like many other chairs, I am encouraged by the fact that the designing of the PRSP that could be supported by under the PRGF has been finalized, and I welcome the resumption of the respective PRGF negotiations as soon as possible. However, I am concerned with the fact that, as mentioned in the staff paper, uncertainties still exist on how the specific needs of the insurgents will be incorporated into future policies. Moreover, it is still unclear how the economic development will be affected by getting the insurgents into the mainstream of the Nepalese society and economy.

Taking into account the ubiquitous nature of the economic and social problems faced by the country, I urge the authorities to be as focused as possible in targeting the factors most critical to restoring growth and reducing poverty. It would facilitate better focusing to consolidate and align the PRSP with the Tenth Development plan and with the Medium-term Expenditure Framework.

I wish the authorities every success in transforming the ceasefire into a permanent peace. This is not an easy process but hardly any economic reform is going to move forward without peace and social stability. At the same time, the success in such areas as civil service reform and anticorruption measures would contribute to the resolution of the civil conflict.

Ms. Sekine made the following statement:

At the outset, I wish to thank the staff for an insightful report and Ms. Indrawati and Mr. Karki for their helpful statement.

I am glad to note the Nepalese economy's modest recovery in 2002/03, with signs of a rebound in exports, manufacturing production, and tourism. The ceasefire brought expectations toward social stability as well as economic recovery. However, as the staff indicates, the situation is still fragile and uncertainty clouds the outlook. It is necessary to bear in mind that the pervasive poverty and the perception of unfairness are the root causes of the recent insurgency. Tackling this issue by achieving sustainable poverty-reducing growth remains dauntingly challenging. Formulation of the PRSP is a welcome step, as it outlines an important strategy toward achieving higher growth and poverty alleviation. I commend the authorities' commitment as well as the efforts made by relevant participants, including the Fund staff, in supporting the authorities finalizing the PRSP under difficult circumstances.

The authorities have made several initial steps toward the implementation of the PRSP, but achieving its objectives requires significant and continuing efforts on their part as well as of the international community. In this vein, I support the authorities' request for the PRGF-supported program, in order to facilitate and strengthen the implementation of reforms, and I encourage the staff and the authorities to continue their discussions regarding a viable program. I also expect the joint staff assessment of the PRSP to be put forward for Board endorsement. But as the authorities are aware, the restoration of peace and security is paramount for bringing these processes forward and for promoting reforms. The political stability and the authorities' increased ownership as well as strong ownership are also critical to the successful implementation of the program.

I agree with the thrust of the staff appraisal, but will comment briefly on four issues; namely fiscal policy, financial sector reform, the external sector, and public sector reforms.

First, on fiscal policy, I welcome the 2003/04 budget that adheres to the medium term framework, incorporating tax reform and prioritizing expenditures. It is important to safeguard social and capital spending in order to achieve the PRSP objectives. In this regard, I join Mr. Reddy in calling for more effective enhancement of project implementation supported by external assistance. I also hope that the restoration of peace will reduce military spending.

Second, I welcome the progress made in financial sector reform and encourage the authorities to continue their efforts in this vein. I broadly support the measures outlined in the staff report but have two questions. First, while streamlining of the staffs of the NRB and the two largest commercial banks is a necessary step, I am concerned about whether retired people could be absorbed by the private sector, and whether an adequate social safety net is in place. Second, I noted in footnote 4 of the staff report that the number of financial institutions is too large for the size of the Nepalese economy and wonder if any reduction of this number has been considered in order to enhance effectiveness and better supervision of the financial sector. I would appreciate the staff's comments on these issues.

Third, on the external sector, the movement to liberalize and to increase access to various countries through WTO accession is important. However, this will expose Nepalese goods to serious competition, along with the phasing out of the Multi-Fiber Agreement by 2005. The current account deficit is projected to widen in the medium term, and the staff points out that increasing remittances and international aid will keep foreign reserves at a sustainable level. However, despite Mr. Shishido's previous comments, I agree with Mr. Robert that remittances are vulnerable to the external environment, and international assistance could wind down along with economic development. Therefore, I join the staff, Mr. Zubkova and other Directors in emphasizing the need to strengthen the domestic industry and diversify export products through promotion of structural reforms in order to increase international competitiveness. In addition, recovery of tourism is important, which again calls for security and social stability.

Finally, on public sector reform, I welcome the authorities' efforts to streamline the public sector under civil service reform as well as the movement to combat corruption and improve governance. Restructuring and privatization of state-owned enterprises is essential to development of the private sector, but as noted by Mr. Rutayisire and Mr. Daïri, it should be promoted with adequate pace and sequencing, along with a well-defined social safety net.

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

Mr. Skurzewski made the following statement:

We share the assessment of the macroeconomic situation and the appreciation for the fiscal and monetary policies that have been conducted in a very difficult political environment. It is true however, that the moderate growth achieved in the last decade was insufficient for reducing the extreme poverty. It has been constrained by various weaknesses in the macroeconomic management, especially in financial sector, budgetary policy and corporate governance, which are well identified in the report, and had been raised by the Board on past occasions. In addition, there are some deeply rooted causes of poverty in the country, such as the geographical and social exclusion; concentration of power in the hands of a small Katmandu elite, ethnic and gender discriminations. Therefore social programs face enormous challenges because their implementation is not decentralized and the poor do not have enough voice in shaping and running them. At the same time, poverty reduction in Nepal requires deep social and political changes, and will not be achieved with assistance programs alone. In this context, one should notice that many donor-funded operations that are expected to finance the budget, will be conducted successfully and be sustained only if the decentralization process recovers momentum, and the local bodies are led again by the elected authorities.

Continued support of the international community will be very important for Nepal and the Fund's PRGF-supported program would be a key element. I therefore welcome that the prior actions, which precluded an earlier start of the 2001 initiated program, were finally taken. The one emphasized by the staff, installation of foreign managers at the troubled banks, should help to improve the condition of the banking system. However, in view of the significant and not even fully recognized non-performing loans, the loan recovery process and the work of newly established Debt Recovery Tribunal must be effectively and timely implemented and enforced. I fully concur with the staff and other speakers on this point.

Fiscal area is another target on which the authorities must focus. While the fiscal position was manageable and broadly stable during the 1990s, it was achieved with the help of massive cuts in development spending to offset the decline in external loans and higher security expenditures. Public debt remains sustainable but with unchanged policies, and the potentially large contingent liabilities from the financial sector and restructured public enterprises, it could significantly rise over the medium term. Several tax reform measures to streamline the tax system, promote exports and reduce the burden for the less wealthy persons are welcome, but since they are broadly revenue neutral, more effort might be needed. At the same time, the measures on the expenditures side should continue in the context of public expenditures review and prioritization within the Medium-Term Framework.

Finally, the open trade regime maintained by Nepal is welcome, and will benefit further from the WTO accession related changes. These should include addressing the structural barriers to export growth identified by the staff, such as cumbersome procedures, export taxation and inefficient duty drawback. Future developments in the Nepalese foreign trade, its structure and directions, may warrant however some changes to the peg to the Indian rupee, which has worked well until now. Like Messrs. Kremers and Litman, I encourage the staff to give this issue some consideration in the next consultation.

Mr. Epstein made the following statement:

At the outset, we thank the staff for its insightful report and Ms. Indrawati for her helpful statement.

There are encouraging signs that Nepal may be on the path toward recovery after a period of upheaval. However, we note that this Article IV consultation demonstrates that there is much fundamental work to be done. We urge the authorities to take advantage of the current cease fire to lay the groundwork for more consistent strong growth and poverty reduction.

Fiscal

In the fiscal area, reorienting and reprioritizing government expenditure under a medium-term expenditure framework is a positive step. However, we note that it will be a challenge, given that the contingent liabilities of financial sector and public enterprise reform are not yet fully known. It is interesting to note that external debt is over 2.5 times greater than domestic debt, yet it is domestic debt that accounts for the higher portion of debt service. If expenditure is to be diverted to priority items the authorities must limit domestic finance in order to avoid this expensive drain on resources over the longer term. The staff's focus on this issue and the need to mobilize revenues is appropriate.

Financial Sector

Directed lending policies and a culture of non-payment have resulted in disturbing NPL ratios at the two largest commercial banks. Bringing in external management teams at these two banks is a significant development that will hopefully result in lasting reform. However, these teams will need support from the authorities. Full political backing to loan recovery efforts is crucial. The alternative is an eroded rule of law that provides a weak foundation for moving forward. Reconsideration of NRB's directed lending guidelines is also important. Commercial banks should be allowed more freedom to respond to market signals when making their lending decision, and this includes being able to properly assess credit risks.

Other Structural Issues/External

With the expiration of the Multi Fiber Agreement in 2005 and Nepal's recent acceptance to the WTO, the economy will have to become more competitive as it enjoys access to other markets. In that regard, diversification of exports will help as will privatization of viable but inefficient public firms.

As the bulk of Nepal's international trade takes place with India, we understand the rationale behind the exchange-rate peg. However, we wonder whether Nepal could benefit in the medium-long term if it were to move to a more freely floating exchange rate regime.

PRGF-Supported Program

The staff report mentions negotiations for a PRGF-supported program having begun in April. What is the status of these negotiations, and how will the staff be evaluating a track record of performance when considering a funding program for Nepal? We also believe that an assessment of the risks associated with the security situation ought to be reflected under such consideration.

Finally, we commend the authorities for their consent to publication of the staff report and wish them success with their policy endeavors.

Mr. Droop made the following statement:

We support the staff's analysis of the current macroeconomic situation and the assessment of the challenges facing the country. Nepal is certainly making progress on implementing the challenging agenda of economic and social modernization required if the medium-term growth rates of 5-6 percent envisaged in the PRSP are to be achieved and poverty is to be reduced. Macroeconomic policy has been generally sound, some deep-seated structural constraints in the public and financial sector are being tackled, and the government has renewed its commitment to reforming enterprises through privatization or liquidation in the recent budget statement.

On the public finance side, we welcome the fact that the recent budget is fully in line with the medium-term strategy and is aligned with PRSP objectives. We also welcome the ongoing progress on the institutionalization of the medium-term expenditure framework. However, as the staff note, longer-term fiscal sustainability will require a systematic expansion of the revenue base, supported by modernization of the tax system and revenue administration. We encourage the staff to continue their support for this agenda, including the use of technical assistance.

On the structural side, we again concur with the staff analysis that the financial sector is a priority. We are encouraged by the steady progress that has been made in the two big banks, NBL and RBB, although significant challenges remain. However, the financial sector modernization agenda is broader than simply addressing the problems of the two largest commercial banks. A range of systemic reforms is required and we support the staff's recommendations for strengthening this area, including many of their recommendations which aim to instill good governance in this sector. We note that a broad and sustained commitment to good governance on the part of the authorities, and to anti-corruption efforts in particular, is not only essential for success in the financial sector, but is also central to Nepal's overall development effort. Particularly important will be measures that address shortcomings in public enterprises, the civil service, and the business climate. Therefore, we feel that corruption and governance issues should be given their appropriate weight in the design of a PRGF-supported program.

It is a significant achievement that the terms of accession for the WTO have been agreed upon, and that Nepal's membership is now a formality. Accession offers great opportunities, and there will clearly be a great deal of work ahead to bring legislation into conformity with WTO agreements. Technical assistance will be required in this area as well. We encourage the authorities to view this process as more than simply a WTO compliance exercise: it is also an opportunity to systematically modernize and improve governance throughout the legislative and administrative framework.

While the previously mentioned reforms are all necessary conditions to attain higher growth rates, these reforms will not be sufficient without a lasting solution to the conflict and to political uncertainties. We note that the staff report recognizes the fragility of the cease-fire and the risks to the economy of a return to full-blown conflict. Nevertheless, we feel that the extent of the downside risks are downplayed slightly, particularly in the stress tests which underpin the debt sustainability framework.

Nepal has faced a range of internal and external shocks in recent years. We believe the overall macroeconomic framework and adjustment effort demonstrated by the country merit support through a PRGF-supported program. We also believe that increased Fund engagement through a PRGF arrangement at this stage would significantly enhance the prospects of the reform effort leading to a positive outcome. Therefore, we encourage the staff to work to move forward with the PRGF arrangement as quickly as possible. Although we understand that final negotiations are awaiting the conclusion of the current Article IV consultation process, it is not clear to us why this should be the case. We felt that the September 2002 Article IV consultation discussion had already given a very clear mandate for a PRGF arrangement, as reflected in the summing up of that discussion.

Finally, we would encourage that prior actions and performance criteria for the PRGF arrangement be well aligned with the second Immediate Action Plan (IAP) that the authorities are finalizing with broad donor support. The IAP draws out key reform actions and priorities from the PRSP and is an extremely important tool to facilitate the implementation of PRSP priorities, to cement ownership of the PRSP, and to harmonize and coordinate the overall donor effort. By aligning the PRGF arrangement behind the IAP priorities and, by extension, the PRSP, the Fund would not only support the objectives I mentioned, but would also significantly raise the prospects of successful program implementation by ensuring that conditionality was locally-owned and in line with national priorities, was politically sustainable, and most importantly, was sensitive to the dynamics of the peace process.

With these comments, we wish the staff and the authorities well on the forthcoming PRGF discussions, and look forward to reviewing a proposed program in the coming weeks.

Ms. Indrawati made the following statement:

It is very encouraging to have so much support from many Directors this afternoon. I would like to confirm the interest and the commitment of my authorities, His Majesty's Government of Nepal, in pursuing the PRGF-supported program. Being among the poorest countries with one of the lowest per capita incomes in the world, Nepal's main development challenge is to reduce poverty through income and employment generation and by pursuing broad-based and pro-poor growth.

As the staff mentioned in their report, the main constraint to growth in Nepal is due to financial weaknesses, weak public sector management, governance problems, and low agricultural productivity. Given the Fund has expertise in most of these areas, we sincerely expect that major progress can be achieved with a PRGF arrangement to overcome these obstacles to growth. Although the past efforts by the Nepalese authorities were not sufficient to address these challenges, some progress has been achieved. For some years, the country was facing peace and security problems that affected the performance of the economy, specifically through the impact on the growth rate and the fiscal structure. However, in the current difficult period, His Majesty's Government of Nepal is making best efforts to undertake a structural reform program in a steady manner and implement prudent macroeconomic policies.

I would like to give assurances of my authorities' good intentions in response to Directors' concerns about fiscal and financial restructuring. The authorities have always cooperated with the Fund and have been receptive to the Fund's suggestions and recommendations in the last three years. Most recently, they have implemented prior actions and fulfilled most of the conditions to be eligible for a PRGF-supported program. The result of the authorities' actions is that the macroeconomic policy performance has been generally sound and economic recovery is under way, while inflation is moderate and the balance of payments is manageable.

As many Directors mentioned, the current 2003/04 budget has been formulated in line with the medium-term fiscal strategy. Monetary and exchange rate developments are appropriate, and the authorities will continue to examine the best policy options. The structural reform program is being implemented and is having a positive impact on the economy. Recently, the World Bank upgraded Nepal's status in its funding program from a low case to a base case level. The financial sector reform project, which is an important initiative and has been widely supported by many Directors, is being implemented with World Bank assistance. The medium-term expenditure framework has been prepared and the current budget has been formulated accordingly to rationalize resources and programs.

Many Directors noted Nepal's fulfillment of the conditions to enter the WTO and the WTO Working Party's recommendation for Nepal's accession. Nepal, along with Cambodia, which is another of my constituents, will be the first least developed countries to join the WTO since its inception in 1995.

I want to express my appreciation to all the Directors for their concern for Nepal. At this stage, I sincerely hope that the Board can endorse a PRGF-supported program.

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

Mr. Marques questioned the impact of possible large contingent liabilities if growth is persistently low. Let me turn the argument around and say that current growth projection is based on implementation of PRSP reforms. With reforms, higher growth can be sustained and this allows accommodation of contingent liabilities. If reforms were not implemented adequately, growth would be lower making it more difficult to accommodate contingent liabilities. This also underlines the importance of serious reform implementation.

Ms. Sekine asked about the social safety net and whether those who participate in the voluntary retirement schemes (VRS) in the central bank and the two largest banks could be absorbed by the private sector. The public sector in Nepal enjoys a fairly generous severance package due to the rules and regulations of the government. Those who participate in the VRS are also entitled to other outsourcing jobs after they leave their job. Therefore, in the immediate future, these three VRS schemes do not present a social problem. Of course, Ms. Sekine is correct in stating that Nepal needs private sector growth and the expansion of job opportunities in the private sector. PRSP reforms are needed to maintain macroeconomic sustainability, enhance financial sector intermediation, improve human capital through social sector development, promote agricultural and private sector growth and labor market flexibility. I hope the authorities will continue to implement PRSP reforms and that we can support them in order for this development to take place.

Ms. Sekine also mentioned that there maybe too many banks in Nepal. Although it is a matter of judgment, there is perception among some professionals working on Nepal that over banking might exist. The solution for the Nepalese authorities is to improve supervision of the financial institutions, enforce prudential regulations, and appropriately deal with the institutions that cannot comply with prudential regulations. The authorities can also establish a high bar for entry and enforce appropriate fit and proper criteria for the new banks that want to enter the Nepalese market.

Mr. Epstein asked where we stand on the PRGF arrangement negotiations and how we are evaluating the track record of the implementation, which has not been very good in Nepal in the past. We resumed negotiations on a PRGF-supported program during the Article IV consultation mission in April. These discussions have been continuing for a long time, as Mr. Droop mentioned. Although we cannot prejudge the negotiation outcome, with the Board's endorsement, we would like to return to Nepal in the near future with a view to concluding a PRGF-supported program discussions. We hope to come back to the Board as soon as negotiations and the prior actions are completed.

Implementation risks are part of the reason why the previous Article IV consultation in September 2002 had similar conclusions compared to the current Board discussion. Nepal had a fairly weak reform implementation track record and we waited until some key actions were undertaken before proceeding further with a PRGF arrangement. For example, as many Directors noted, the installment of external managers in the two largest commercial banks was completed in March 2003. We also waited until the full introduction of the medium-term expenditure framework to prioritize spending development was completed. Nonetheless, implementation capacity remains a risk in Nepal.

The authorities are putting in place mechanisms to endogenously address implementation risk, including using the medium-term expenditure framework to prioritize spending and ensure priority activities can be implemented. Another way to improve implementation of key activities, given the limited implementation capacity of the central government, is decentralization of critical services like basic education and health to communities. We will continue to take the risk of implementation into account in our discussions with the authorities and will also make sure implementation can be monitored well, under the prospective PRGF-supported program.

Mr. Droop mentioned that we have not taken adequate account of the security risks involved in low growth in our analysis. We believe we have and we can discuss this issue bilaterally. Various low-case scenarios have been incorporated into our analysis and we are very much aware of the serious consequences of peace talks unraveling and violence returning.

Ms. Indrawati made the following concluding statement:

I would like to make some clarifications and address some concerns. First, the growth scenario in the PRSP was lowered to 4.3 percent growth instead of 6.2 percent, which was viewed as optimistic based on security and other considerations. Regarding the concern of some Directors on priority sector lending, the NRB has already announced that aid would be phased out by 2007/2008 and the ratio has already declined from 9 percent to 6 percent in the current fiscal year. I would like also to inform the Board that Nepal has already published the PRSP and the staff report on the IMF website and His Majesty's Government website.

In conclusion, I would like thank all the Directors who are in favor of the authorities pursuing the negotiations for the PRGF-supported program. I certainly hope that, as the staff representative mentioned, these discussions will be begin soon and will be conducted on an abbreviated timetable. I assure the Board that I will convey the Directors' messages, concerns, as well as their many valuable suggestions and advice to my authorities. The current discussion will hopefully help Nepal achieve a higher growth rate and conduct a successful poverty alleviation effort. I would like to thank the staff for their hard work and management for their support. I also thank the Board for supporting Nepal's goals of poverty alleviation and improving the growth performance.

The Acting Chair made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They stressed that to address the pervasive level of poverty in Nepal, growth needs to be raised significantly over the medium term through vigorous implementation of structural reforms, particularly in the financial and public sectors. In this regard, Directors welcomed the authorities' Poverty Reduction Strategy Paper (PRSP), which is founded on broad-based growth, social sector development, targeted programs for the poor and deprived groups, and improved governance. Directors looked forward to considering a Joint Staff Assessment of the PRSP in the near future. They encouraged the authorities to reach early agreement on a program that could be supported by the Poverty Reduction and Growth Facility to help achieve PRSP goals.

Directors welcomed the ceasefire agreement with the insurgents reached in January 2003. They underlined that continued peace was essential to help sustain the economic recovery currently under way. Directors also noted that progress in the peace talks and the build-up of confidence should help relieve budgetary pressures for security spending.

Directors commended the authorities' for maintaining broad fiscal stability to create conditions to support economic growth. Looking forward, Directors endorsed the authorities' fiscal strategy based on revenue mobilization, expenditure prioritization, and a reduction in domestic borrowing. They welcomed the 2003/04 budget as the first step in implementing this strategy. However, Directors called for a determined effort to meet the revenue targets and to resist spending pressures. To raise revenue over the medium term, Directors suggested cuts in exemptions, improvements in tax and customs administration, and increases in the VAT rate. Directors welcomed the steps taken to prioritize development spending to help achieve poverty reduction goals, including the introduction of a medium-term expenditure framework, and encouraged the extension of such efforts to all expenditures. Directors noted that the envisaged reductions in domestic borrowing would help maintain fiscal sustainability over the medium term, especially in view of potentially large contingent liabilities from financial sector and public enterprise reforms. Continued technical assistance in the fiscal area will help address capacity constraints.

Directors agreed that monetary and exchange rate policies should remain geared to supporting the exchange rate peg to the Indian rupee, stressing that the peg had served Nepal well given its close links with India. Looking forward, they noted that prospective external developments, such as the phasing out of the Multi-Fiber Agreement, would likely have implications for external competitiveness and the appropriate choice and level of the peg. Directors pointed to the need for policy measures to ensure that remittances are sustained, as well as for efforts to diversify Nepal's export base. They also noted that external competitiveness could be enhanced by measures to raise labor productivity and lower transport costs.

Directors commended the authorities for progress in financial sector reforms, but noted that much remained to be done. They stressed the need for strengthening Nepal Rastra Bank (NRB) supervision of the financial sector. The NRB should also improve performance incentives for skilled personnel, while encouraging separations at lower levels. Directors welcomed the appointment of external managers at the two largest insolvent commercial banks, and noted recent steps taken by the new managers to improve the financial condition of the banks. To help support these efforts and, more generally, to create a sound banking environment, Directors noted the authorities' intention to phase out priority sector lending requirements, and emphasized the effective implementation of recently adopted debt recovery mechanisms, including the Debt Recovery Tribunal and blacklisting of loan defaulters.

Directors welcomed ongoing public sector reforms, including the elimination of vacant positions, the introduction of merit-based promotions, the decompression of the wage scale, as well as improvements in the public procurement process. Looking forward, Directors recommended the adoption of civil service accountability in order to improve policy implementation. They welcomed the public enterprise reform efforts that would lower government ownership in the economy and increase the enterprises' net budgetary contribution—through privatization and restructuring of viable enterprises and liquidation of unviable ones. Several Directors stressed that due regard should be paid to the pace and sequencing of these reforms. Also, an appropriate compensation scheme could help smooth implementation of workforce reductions.

Directors welcomed recent efforts to combat corruption, but emphasized the need to pursue forcefully those responsible for the misuse of public funds. Directors supported the authorities' plans to increase decentralization to enhance service delivery. However, they noted that the implementation of these measures should be accompanied by improved public sector governance and capacity building at the local level.

Directors supported measures to improve the business climate for private sector development through legal reforms and streamlining of administrative procedures to facilitate trade. They recommended revisions to labor legislation to make labor hiring more flexible and modifications to the Company and Insolvency Acts to allow more orderly and timely exit of unviable firms.

Directors commended Nepal for its open trade regime, and welcomed the authorities' efforts to gain early WTO accession. Directors welcomed the elimination of the exchange restriction arising from quantitative limits on payments for personal travel.

Directors encouraged the authorities to further improve statistics to enhance policy formulation and monitoring. They urged full implementation of Fund technical assistance recommendations.

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

5. ICELAND—2003 ARTICLE IV CONSULTATION

Documents: Staff Report for the 2003 Article IV Consultation (SM/03/265, 7/31/03; and Cor. 1, 8/21/03); and Financial System Stability Assessment Update (SM/03/268, 7/31/03)

Staff: Escolano, EU1; Fetherston, PDR; Kupiec, MFD

Length: 1 hour, 15 minutes

Mr. Egilsson submitted the following statement:

My Icelandic authorities would like to thank Mr. Escolano and Mr. Kupiec and their teams for their consultations in Reykjavík and thank them for the well balanced staff report and a very useful FSSA update. My authorities are in broad agreement with the main conclusion of the staff report and the views on the challenges ahead. Moreover, the FSSA update report contains an excellent evaluation of the changes in the Icelandic financial sector in the past three years.

Economic Prospects

The Icelandic economy experienced growth rates above the industrialized countries' average from 1996 to 2001. This led to a period of overheating that peaked in the year 2000 when the current account deficit exceeded 10 percent of GDP. These imbalances have now been corrected with only a relatively mild recession and in 2002 the current account had returned to balance. We fully agree with the staff that the stability-oriented policies implemented during the 1990s played a large part in this achievement. This includes the adoption of inflation targeting, the floating of the exchange rate, the independence of the central bank and prudent fiscal policies. Moreover, significant improvements were undertaken in the financial sector to address vulnerabilities, including some that were identified in the 2001 FSAP review.

Growth is now picking up again after a standstill in 2002. GDP growth is now expected to be 2.5 to 3 percent for this year and at or above 3.5 percent for the next year. The outlook for the medium-term indicates that the economy is entering a period of strong growth led by investment in hydro-power facilities and energy-intensive industries.

My authorities agree with the staff analysis on the policy challenges that lie ahead. The greatest challenge will be to avoid overheating and an unsustainable appreciation of the Icelandic króna during the period of investment-led growth that is expected to last until the end of this decade. The cumulative investment in the projects decided so far is expected to amount to about 35 percent of GDP.

While risks of overheating should not be underestimated, the economy is in many respects better equipped than in recent years to take on the challenges associated with these investment projects. Moreover, the investments will contribute to increased export revenues and further diversify the economy. My authorities, however, acknowledge that an appropriate policy mix will be necessary to prevent overheating.

Monetary Policy

The inflation rate has been low and below the central bank's target of 2.5 percent for the whole of this year. This can be partly explained by the appreciation of the króna towards the end of last year and in the early part of this year and lower-than-expected global inflation. Assuming that the monetary stance does not change, inflation is now forecast to be below the target for the whole of next year, but will reach the target in early 2005.

The most likely outlook is still that interest rates will remain unchanged for the time being, then rise as the peak of aluminum-related investments approaches. However, the point at which it may be necessary to raise interest rates could be further away than was foreseen earlier this year, since inflation has been very low recently and will most likely continue to be so, for reasons including low global inflation and greater slack in the economy. As always, the outcome will depend on future developments as well as fiscal policy. In light of the present low rate of inflation, however, it cannot be ruled out that negative shocks to domestic demand and to imported inflation might call for a temporary reduction in interest rates from their present level.

The central bank has since September 2002 made regular purchases of currency in the domestic inter-bank market on the basis of a pre-announced plan. The purpose of these purchases is to increase the Bank's reserves. It is taking advantage of the current conditions in the foreign exchange market, which strengthened markedly as plans for the investment projects in the energy sector emerged. Since beginning regular currency purchases in September last year the central bank has significantly built up its net foreign exchange reserves, thereby strengthening its capacity to meet the need for liquidity.

Fiscal Policy

The Icelandic authorities have pursued a policy of fiscal consolidation during the last decade. As a result, the Treasury budget has registered a surplus since 1997, enabling debt reduction and funding of pension obligations. This effort has continued despite the slowdown in the economy as the cyclically adjusted fiscal stance has been restrictive in the past two years. The outcome for 2003 is expected to be broadly in balance. My authorities agree with the staff report that fiscal policy should remain restrictive and that it will be necessary to further increase the budget surplus in light of the upcoming demand pressures from the investment projects. My authorities therefore acknowledge that fiscal policy will play a major role in preventing overheating of the economy in the next few years.

Furthermore, we agree with the staff that a medium-term fiscal framework is important in order to facilitate fiscal consolidation. In this context the Government intends to strengthen the medium-term orientation of the fiscal framework along the lines proposed by the IMF with particular emphasis on expenditure restraint and implementation of tax reforms consistent with macroeconomic stability. This undertaking will confirm the authorities' intention to meet the challenges ahead with appropriate measures.

Structural Issues

The privatization program of recent years was stepped up after a short interlude and last year marked a milestone when the government sold its remaining stake in two commercial banks. The banking sector has now been fully privatized and this recent move facilitated a restructuring of the banking sector through mergers. The proceeds of the privatization of the banks have been used to pay down government debt. Further privatization is on the agenda and the government plans to privatize the state-owned telecommunications company, which will be the largest privatization project to date.

External Imbalances

My authorities generally concur with the staff's assessment of the external position in that it can be explained inter alia by demographics and a well funded pension system. Furthermore, the buildup in private sector gross debt is at least partly matched by strong growth of assets. The rapid increase in indebtedness followed financial liberalization and an investment boom in the mid-nineties. Most of the debt rests with the private sector. The banks have intermediated this flow of external debt and their external positions are under prudential supervision.

Nevertheless, my Icelandic authorities acknowledge that this trend should be contained to the extent possible and that policies should be pursued that aim at increasing national savings in the medium term.

Financial Sector

My authorities warmly appreciate the efforts of the FSAP review team and generally agree with the findings of the FSSA update report. This effort will play a part in the authorities' continuing efforts to strengthen further the robustness of the Icelandic financial system. The draft report confirms the significant improvements made to maintain economic and financial stability and to improve the regulatory framework since the initial FSAP review was conducted in late 2000 and early 2001. Also, the importance of the initiatives taken by the central bank regarding the safety of payment systems is recognized. Furthermore, it includes observations and recommendations which my Icelandic authorities consider helpful.

Mr. Martí and Mr. Siman submitted the following statement:

We thank the staff for an excellent report and assessment of the economy, and Mr. Egilsson for his informative and helpful statement.

Iceland has overcome the macroeconomic imbalances derived from the overheating of the economy and financial vulnerabilities that developed at the end of the 1990s. The economy has stabilized with a current account in balance in 2002, inflation on target and, as the staff indicates, most indicators point to a pick up activity in 2003. Prospects are strong for investment-led growth over the medium term. During the last decade, Iceland's authorities have managed to turn the country into one of the world's richest economies, as measured by per capita income, through the implementation of stability-oriented polices. We note in particular the progress made in market liberalization, fiscal consolidation and structural reforms aiming to promote investment improve competitiveness and diversify exports. Iceland's authorities should be commended for their strong commitment to the implementation of these measures.

The Macroeconomic Impact of the Planned Investment Projects

We share the staff's view that the new large foreign investment projects in smelting and associated energy-generating facilities projected during 2003 to 2010 will generate a significant demand stimulus that could complicate macroeconomic management. There is no doubt that in the end these investments will increase economic growth and will diversify export revenues, enhancing the stability of the economy. However, during the construction period, these large investments will put pressure on Iceland's limited resources with the main risk of overheating coming from excessive domestic demand growth. We support the staff's recommendation that a more restrictive fiscal policy might be necessary if signs of overheating emerge.

The Importance of Strengthening the Medium-Term Fiscal Framework while Continuing with the Reform Agenda

We welcome the authorities' discussions with the staff regarding their plan to design the 2004 budget within an explicit multi-year context in order to avoid an imbalanced policy mix and reinforce confidence in the stability of the economy. An explicit cyclically adjusted balance targets and expenditure limits would contribute to the predictability and credibility of the budget. We also welcome the authorities' advances in this direction, and specifically, their intention to build up budget surpluses to counteract the envisaged demand growth. We support the staff's recommendation to make public the details of this new medium-term orientation of the fiscal framework as soon as available, in order to increase confidence in market participants.

Despite the authorities' continued progress in the implementation of their market-oriented reform agenda, it is important to carry on some additional structural reforms in order to fully benefit from the new growth opportunities and to further protect the economy in the medium term. In this sense, we welcome Mr. Egilsson confirmation that further privatization is on the agenda, in particular for the state-owned telecommunications company. We encourage the authorities to press forward with the liberalization of the electricity and agricultural trade, as well as with the reforms to the Housing Financing Fund.

Dealing with External Private Sector Debt

Iceland's high private external debt levels, while not a cause of systemic concern at this point, pose potential medium-term vulnerabilities. Gross external debt has risen sharply since the mid-1990s, more than offsetting the increase in foreign assets. External debt represents about 127 percent of GDP and net external liabilities amount to 80 percent of GDP. Most of this gross debt—equal to 95 percent of GDP—corresponds to the private sector, of which banking sector accounts for 67 percent of GDP.

External debt appears abnormally high for a country with the sound fundamentals and good management of Iceland. It is reassuring to read in Mr. Egilsson's statement that his authorities are following the debt trend very carefully. Even if the public sector is about neutral on savings, private dissaving makes it unavoidable to rely upon foreign resources in order to finance investment. Debt growth has accelerated from 1999 on, so negative private savings imply increasingly unbalanced positions in the private sector, and it is not immediately obvious how this can be regarded as an equilibrium outcome. The staff is correct in pointing out that the situation allows little room for dealing with external shocks or for policy slippages.

The Icelandic banking system stands out as sound and well supervised, as the FSSA update report has again confirmed. The country report rules out any risk stemming from mismatches. External debt does not seem to be a direct menace on banks' balance sheets, a general perception borne out by the fact that banks enjoy high credit ratings and unrestricted access to international markets.

Non-financial corporations are on the other hand the main recipients of foreign currency loans, either intermediated by local banks or as direct borrowers. Lacking precise balance sheet information, it is more difficult to assess the extent of the exchange risks actually taken by corporate borrowers. The report mentions however that corporate borrowers are organically hedged, which presumably implies that this sector has the capacity to generate foreign earnings via cash flows, or holds foreign currency assets of a nature to match foreign currency liabilities. This is certainly reassuring, in that possible currency mismatches seem to be well under control and present no upstream risks on domestic lending banks or on the economy in general but we would welcome the staff's view on this specific point. It is obviously a crucial question whether the corporate sector is able to manage its liabilities in a way that actually keeps exchange risk under control and minimizes future roll-over difficulties. In this context, it would be of particular interest to confirm that forthcoming heavy investments planned in Iceland are not going to affect the existing levels of debt.

With these, we wish the authorities continuing success.

Mr. Reddell submitted the following statement:

Key Points

The reversal of the current account deficit is most impressive. But, how well understood is it? And can we really be confident that a recovering economy and strengthening currency will not lead to a reversal?

We wonder if it is appropriate to place as heavy a weight as the staff proposes on fiscal policy as a cyclical management tool.

The negative international investment position (IIP), is heavily concentrated in foreign currency debt, and should remain a concern. It is not entirely convincing that demographics explain the extent of dependence on foreign capital and, in a small highly concentrated economy, the continued availability of foreign credit should always be a concern.

Iceland remains probably the most vulnerable developed economy. In that light, it seems premature to return to a 24-month consultation cycle.

The reversal of Iceland's once-alarming current account deficit over the past couple of years must surely count as one of the most dramatic achieved in any industrial country. That a 10 percent current account deficit has become a balanced current account within two years, driven from the demand side while GDP barely contracted at all, is impressive to say the very least. Unemployment has remained low, the banking system has emerged largely unscathed, and the public finances remain in good order.

Looking to the period ahead, Iceland faces a number of challenges. In the immediate future, the large investment projects designed to allow Iceland to export more electricity, pose both opportunities and risks. We join with the staff in encouraging the authorities to seek to manage policy in such a way as to minimize the adverse transitional side-effects as these projects are developed. Having said that, however, it seems likely to be a particularly challenging task.

We wonder, for example, just how realistic it is to expect that the authorities will be able to achieve a structural fiscal tightening of around 2 percent of GDP at a time when the economy is recovering and any sense of crisis must have passed (and the measures discussed in the report, including the tax-cutting agenda, do little to increase our confidence). Moreover, we also wonder about the relative merits of relying on structural fiscal policy rather than monetary policy to accommodate the heavy investment expenditure. The Icelandic authorities do not appear to face the same sorts of pressing generational fiscal problems as many other European countries and net public debt is already low, suggesting that there is no overwhelming case for permanent change to fiscal policy parameters considered solely from a government balance sheet perspective. Monetary policy, which is typically better attuned to the cyclical management task on the other hand, does appear to have room to move. Real interest rates remain quite low by Icelandic standards and the real exchange rate does not appear to be at above-equilibrium levels. It is a little disappointing that the staff report did not explore this choice in more depth.

The longer-term issue and threat facing Iceland, is the large negative IIP position. Coming myself from New Zealand, which now vies with Iceland for the dubious distinction of having the heaviest reliance on international capital of any OECD economy, it is an area of particular interest.

The staff stressed the good news of the past couple of years, and there are certainly some encouraging aspects to the Icelandic story. First, the speed with which the current account deficit narrowed is impressive, suggests that (in a flow sense) the economy can cope reasonably readily with reduced access to new foreign credit. Moreover, the resilience of the banking system, with its large share of foreign-currency denominated assets, in the face of the exchange rate depreciation of 2001 was also encouraging. And the fact that ready access to household credit and strong economic growth since the mid-1990s does not seem to have resulted in unduly rapid house price growth, is also encouraging. And finally, the fact that Iceland recorded some of the strongest growth in Europe during the last decade provides some comfort that any income growth expectations that underpinned the willingness of households to borrow may be proving reasonably well-founded. That said household sector net worth remains low by OECD standards (and lower than the other young countries—e.g., the United States, New Zealand, Australia, and Ireland).

Nonetheless, a negative IIP position, equal to around of 80 percent of GDP, remains very high by developed country standards—not just in a cross-country comparative sense, but also in a historical perspective, inasmuch as the data are available. Not only is the IIP position large, but it is heavily in the form of (foreign currency) debt, increasingly of a relatively short-term nature. Moreover, Iceland remains an exceptionally small economy and one quite heavily concentrated in a narrow range of industries. And the combination of a past poor inflation record and the small size of the economy means that the foreign debt is largely hedged with foreign currency loans made by domestic banks (rather than, say, being hedged back to local currency). And while many of the borrowers are exporters, even exporting firms typically have a considerable local currency component to their cost structures. Moreover, the FSSA update tables tell us that 40 percent of all loans to the retail and service sectors are in foreign currency, where the natural hedges are less obvious. While the stress-testing being undertaken by the authorities is impressive, we note too that the real exchange rate has actually fluctuated in quite a narrow range over the past decade or more. The economy must be less well able to cope with large exchange rate fluctuations than if more of the debt were hedged back to the local currency, and must also be more vulnerable because of its size. Moreover, the flipside to the positive story of current account adjustment over the past couple of years is the risk that as a recovery takes hold and the currency strengthens, the current account deficit widens more rapidly than the authorities and the staff are assuming. Is the staff sure that they understand the contraction sufficiently well to be confident that the current account will not blow out again?

The staff appears to accept the authorities' view that the high level of debt and large IIP position are largely rooted in demographic trends. While it appears that public policy distortions do not explain the build-up of net external liabilities (and hence there are no immediate or first-best policy remedies at hand) it is not entirely convincing simply to combine demographics and financial market liberalization and conclude that the heavy dependence on foreign capital is all well-based in the fundamentals. At a superficial level, Ireland, another nearby country with strong growth and a young population, has a near-zero IIP position. A little more rigorously, the Lane and Milesi-Ferretti paper cited in the staff report certainly finds demographic factors important in explaining changes in IIP positions through time in individual countries, but noted that "neither public debt nor demography is helpful in explaining the 1990s cross-section for industrial countries". While it would be surprising if demographic factors play no role, the authorities would be well advised not to assume that all of the borrowing is appropriate and/or sustainable. Overshooting is not uncommon, and we understand little about the willingness of households to take on additional debt or how sustainable they will find that debt in years to come. Moreover, we must always be conscious not just of the willingness of borrowers to take on the debt, but also of the willingness of the (ultimate) lenders to continue to supply that debt.

In sum, my sense is that there are grounds for a more cautious conclusion than that adopted by the staff. But it is less clear what this should mean for policy. The prudential approach adopted by the authorities is to be commended, including their response to the FSAP review, and it will be important for the authorities to keep their eye on the ball as the immediate memory of the adjustment in the past couple of years begins to fade. The risks around the external position probably reinforce the case for fiscal consolidation, but they do with a longer-term risk management orientation in mind, rather than simply with a focus on accommodating investment projects over the next year or two.

I wonder whether it might be early for the Fund to shift back to a 24-month cycle for Article IV consultations with Iceland. Although Iceland is small, its economy is both open to, and heavily dependent on, continuing flows of international capital. Of all the developed countries, it must remain one of the most vulnerable. Although the international implications of adjustment in Iceland would seem unlikely to be large, Iceland is vulnerable both to domestic and international financial shocks. Add to this the significant macroeconomic management challenges facing Iceland in the next few years, and it would seem unwise for the Fund to risk taking its eye off the Icelandic ball, and not entirely consistent with our responsibilities to the country.

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

We thank the staff for the well-written report and FSSA update and Mr. Egilsson for his helpful statement. The Icelandic authorities are to be commended for the successful stabilization of the economy, following the economic boom of the late 1990s which resulted in overheating and the emergence of financial vulnerabilities. This stabilization has been possible largely due to strong monetary and financial supervisory frameworks and the successful implementation of stability-oriented structural reforms, to the authorities' credit. Following a sharp slowdown in activity in 2002—with the economy declining by .5 percent—most indicators now point to higher activity in 2003, led by a pickup in private consumption. Growth of about 2.25 percent is expected in 2003, and is expected to then accelerate through the medium term, due mainly to the large foreign investment projects in electricity generation and smelting of around 35 percent of 2003 GDP, which are planned over 2003 to 2010.

We broadly agree with the thrust of the staff appraisal and policy recommendations and will therefore confine our comments to a few areas only, for emphasis.

Monetary Policy

The adoption of inflation targeting, independence of the Central Bank of Iceland (CBI) and a floating exchange rate regime in March 2001 have resulted in a strong and transparent monetary policy framework that has successfully seen Iceland through a difficult transition period and has been crucial in subduing inflationary pressures and cementing confidence. The authorities have been effective in their conduct of monetary policy, first tightening monetary conditions and reining-in inflation which has remained close to the CBI's 2.5 percent inflation target since November 2002, and then reducing interest rates, as inflation declined, in light of the weak domestic economy and the firming of the krǿna. For now, the broadly neutral monetary stance in place is appropriate, however, as the recovery gathers momentum, monetary policy will likely need to tighten and remain restrictive over the medium term. Combined with an also necessary tight fiscal stance, this will be essential to avoid a rekindling of inflation and a recurrence of earlier imbalances as activity strengthens, spurred by the investment projects. It is reassuring to note that this is the policy intention of the authorities.

Fiscal Policy

On fiscal policy, we are somewhat concerned that, although the underlying position of the public finances remains sound and public debt is low, the general government budget balance has deteriorated markedly in recent years, which while being due to weaker economic conditions has also occurred as a result of expenditure slippages. We therefore join the staff in cautioning that fiscal restraint and a medium-term strategy for fiscal consolidation is necessary for economic stability. This is particularly vital as the planned projects, which will bring benefits such as diversification and stronger growth, will also place considerable pressure on the limited resources available, during the construction period.

We agree with the staff that policies should focus on avoiding an economic overheating during this time. Measures to avoid an over-appreciation of the real exchange rate and hence loss of competitiveness will also be necessary to reduce the adverse effects on the export and import-competing sectors, with resulting repercussions for the balance of payments. We also concur that given its size and expected extended duration, the envisaged demand shock, likely to emanate as the planned investment projects take place, should be countered primarily through a tight fiscal policy—with an emphasis on expenditure restraint. This will mitigate the need for high interest rates and alleviate upward pressures on the krǿna. In this regard, we join the staff in welcoming the authorities' assurances of a prudent and gradualist approach to implementing some of the more potentially expansionary aspects of the Coalition Party's electoral platforms. We agree that the authorities' stability objectives should focus first on cutting current spending, and as government wage increases have significantly outpaced those in the private sector for some time, the focus should be on the public wage bill. Given that planned tax cuts could complicate the achievement of fiscal targets, they should only be introduced once commensurate additional expenditure savings have been identified. Also, other structural reforms, including curbing subsidies, would alleviate strains on the budget and should be pursued. We were pleased to see in Mr. Egilsson's statement that the Icelandic Government intends to strengthen the medium-term orientation of the fiscal framework along the lines proposed by the Fund.

A fiscal retrenchment is also necessary to increase national saving in order to reduce the economy's vulnerability to external shocks resulting mainly from the rapid increase in external liabilities of the private sector, to its current high level, on which we are particularly concerned. Reflecting this high private sector indebtedness, Iceland's net external liabilities at the end of the first quarter of 2003 stood at around 80 percent of GDP (the highest level among advanced economies) and gross external debt at around 127 percent of GDP, leaving Iceland heavily susceptible to unexpected shifts in investor sentiment and external financial conditions. Such high levels of external debt are very worrying, particularly as short-term liabilities have more than doubled as a percent of GDP, to 52 percent, over only a 3-year span. Whilst Iceland's high private external debt levels may not be a cause of systemic concern at this point, they certainly pose potential medium-term vulnerabilities. They also reduce the room for policy slippages. However, we note that the authorities acknowledge that this trend should be contained to the extent possible and that policies should aim at increasing national savings in the medium-term, as pointed out in Mr. Egilsson's statement. It is vital that this is acted on. A strong regulatory framework is vital to reduce the macroeconomic risks such a position could engender.

Financial System

Regarding the financial sector, the authorities are to be commended for the proactive approach to prudential supervision by the Financial Supervisory Authority which has been instrumental in addressing the financial sector vulnerabilities identified in the 2001 FSAP review, resulting in a strengthened financial system. However, the authorities will need to remain vigilant in the coming years in light of the potential for emerging macroeconomic tensions, including from the high level of indebtedness.

Structural Issues

Iceland's strong economic foundations, prosperity and remarkable flexibility is, to a large extent, due to Iceland's impressive record of structural reforms, over the past decade, focusing on market and external liberalization, public finance consolidation, privatization, and public sector rationalization.

The authorities have done particularly well in promoting their privatization program, which has led to significant efficiency gains, and we welcome their determination to continue efforts in this area by divesting the public stake in the telecommunications sector. In addition, it is pleasing to note that the privatization proceeds have been utilized mainly to retire public debt and capitalize future public pension liabilities. We encourage the authorities to accelerate efforts in agricultural trade liberalization, as Iceland ranks among the advanced economies with the highest trade barriers relating to farm protection. Continued progress on reforms will allow the economy to reap the maximum benefits from the new growth opportunities and will further increase Iceland's resilience and flexibility.

In conclusion, we applaud the authorities for their efforts in increasing ODA, which currently stands at 0.16 percent of GNP, and encourage accelerated progress towards the UN target of 0.7 percent of GNP. We welcome the duty-free access granted to imports from the least developed countries and urge other industrial countries to follow Iceland's good example.

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

Mr. Portugal and Mr. De Silva submitted the following statement:

We thank the staff for a useful and well-written set of documents and Mr. Egilsson for his informative statement.

The Icelandic authorities are to be complimented for the decisive manner in which they moved to resolve the imbalances and financial sector vulnerabilities that emerged with the winding down of the high-growth phase of the latter 1990s. While the economy is not yet entirely out of the woods, the current external deficit has been all but eliminated, inflation has been trending in line with the central bank's target, and prospects now favor an early return to growth in the wake of the 0.5 percent contraction experienced in 2002. Nevertheless, the staff's analysis has highlighted a number of looming challenges for the Icelandic economy. Perhaps the most daunting of these is the expected demand shock linked to the coming investment boom in aluminum smelting and related construction activity. It also seems likely that Iceland will have to accept some degree of real exchange rate appreciation, which can be expected to place a damper on exports.

Iceland's inflation targeting framework has proved to be a major policy success, a result that owes much to the central bank's adroit management of monetary policy since introduction of the framework in 2001. Associated improvements in the institutional framework have enhanced central bank independence and strengthened the Bank's hand in maintaining financial stability, all of which leaves monetary policy well placed to respond to the challenges that will arise as the economy makes the transition into a new expansionary phase. For the moment, there appears to be a sufficient degree of slack remaining in the economy—the staff has estimates an output gap of around 1 percent in 2003—to justify the current relatively easy monetary stance.

Nevertheless, we note the convergence of views between the staff and the authorities regarding the future course of monetary and fiscal policies. Given the sustained nature of the expected stimulus, the authorities have prudently opted for preemptive policy action to guard against potential real overvaluation of the króna and a consequential erosion of competitiveness. We agree with the shared assessment of the authorities and the staff that the onus of adjusting to the expected demand shock should rest mainly on fiscal policy to ease the burden on monetary policy and obviate the need for unduly high interest rates. We, therefore, welcome the intention to progressively build up budget surpluses over the next three years. Nevertheless, the authorities' remain committed to their unfolding tax reform agenda, the emphasis of which is on tax reducing measures. Since this would appear to be at variance with the broader fiscal objective, this agenda will need to be implemented carefully and with a high degree of flexibility. The announcement of plans for strengthening the medium-term orientation of the fiscal framework, beginning with the 2004 budget, is relevant in this regard and, more generally, is a welcome development that should help to bring greater coherence and consistency to the budgetary process.

With regard to the financial sector, the Icelandic authorities have responded with commendable promptness and in a comprehensive manner to the risks identified in the 2001 FSSA. We are pleased that the system has now been put on a much stronger footing ahead of the impending surge in activity that is likely to test the resilience of the financial sector. Although the banks themselves appear to be adequately buttressed and closely supervised with regard to foreign exchange risk, the broader picture is less reassuring. The high level of net external liabilities, and the fact that much of it is attributable to increases in household debt, spells a degree of macroeconomic vulnerability even if the risk is judged to be small given the prospects for appreciation of the króna. It also reflects an overdependence on foreign savings that clearly strengthens the case for fiscal consolidation.

Finally, we commend the authorities for their good progress in implementing structural reforms, especially in privatizing the banking sector, and encourage them to proceed as quickly as possible with reform of the telecommunications and electricity sectors as efficiency gains in these areas can have pervasive effects on overall competitiveness. With these observations, we wish the authorities well as they prepare to meet the coming challenges.

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

After stabilization and adjustment in 2002 following overheating in the latter part of the 1990s, Iceland seems very well positioned for a new round of enviable economic growth, due to its sound macroeconomic policy mix and the sizeable foreign investment planned for the coming years. However, as the staff clearly points out in the well-written report, on the next part of their voyage, the authorities face the risk of potential internal and external imbalances in the too rapid expansion of domestic demand and pressure on real exchange rate appreciation. In addition, the high level of external liabilities can by no means be overlooked. In this context, Mr. Egilsson's helpful statement reassures us that the authorities are well aware of the risks ahead and stand ready to take swift action to sustain healthy growth.

As we broadly agree with the staff appraisal, we will confine our comments to macroeconomic policies, external sustainability and financial sector development.

Macroeconomic Policies

During the stabilization, the inflation targeting and floating exchange rate regimes successfully helped to anchor inflation expectation and adjust the imbalances quickly by boosting exports and containing domestic demand. The stabilization was also supported by fiscal consolidation policy pursued by the authorities during the last decade.

For the period ahead, given the potential demand pressures and the cooling effect of the appreciation of the króna, the Central Bank of Iceland is wise to be vigilant to the two-way inflation development. While an interest rate increase is warranted when upward risks become clear, a temporary reduction is needed when negative shocks cannot be ruled out. We welcome the authorities' efforts to improve market infrastructure to shore up confidence in the inflation targeting framework.

The authorities are to be commended for their sound fiscal management over the past decade, which allowed them to maintain a favorable fiscal balance and low debt burden. A restrictive fiscal stance is warranted over a number of years to dampen the demand upswing and lessen the burden of monetary policy. The authorities are astute in exerting discipline on the expenditure side while pursuing tax cuts to boost the supply side of the economy. Their concentration on a medium-term fiscal framework is also welcome. However, we urge caution on the surge in wage increases in the public sector which may have a demonstrably negative effect on private sector wage negotiations.

External Sustainability

Despite gross external debt at over 130 percent of GDP and the dollarization feature in the economy (in terms of the ratio of foreign currency deposits to total deposits), external sustainability does not appear to be a cause for concern. From the staff's clear analysis and Mr. Egilsson strong argument, market confidence in Iceland's economic fundamentals is strong and its liabilities are well hedged by strong asset growth. What is most important, banks—the major siphon for external debt—are in good shape. Nonetheless, huge exchange rate depreciation may amplify the private sector's debt burden and weaken households' and banks' balance sheets, thus dampening private consumption demand and the household credit expansion. Having said that, the authorities are encouraged to explore ways to mitigate exchange rate volatility and increase national savings over the medium term to reduce the high external debt lever. Can the authorities' buildup of net foreign reserves through a pre-announced schedule help mitigate exchange rate volatility? Has the relatively high domestic real interest rate prevented the private sector from making use of domestic currency loans? The staff's comments are welcome.

Financial Sector Development

The staff has done an excellent job in updating Iceland's FSAP review. It is encouraging that the authorities have corrected financial vulnerabilities in light of the staff's last FSAP review recommendations. While strengthened financial regulation has been a factor in the economy's resilience to external shocks, divestment of the public stake in banking has prompted sectoral efficiencies. As above mentioned, given the impact of banks on external sustainability, their financial conditions and those of their major customers should be overseen closely.

Before concluding, we join the staff in welcoming the authorities' move to grant duty-free access to imports from the least developed countries and urge them to further open their markets to all developing countries. At the same time, the authorities are encouraged to meet the UN ODA target as soon as possible.

We can go along with the staff's suggestion to move Iceland's Article IV consultation back to a 24-month cycle, but urge the staff to monitor future economic developments closely.

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

Mr. Rutayisire submitted the following statement:

We commend Iceland's authorities for the successful implementation of the stabilization program aimed at correcting macroeconomic imbalances that occurred a few years ago. Significant structural reform measures were also implemented, and good progress was achieved in many areas. Although the króna recovered, competitiveness was maintained and inflation remained contained thanks to a tight monetary policy.

The economic prospects for Iceland are set to be good as large foreign investments are expected to take place over the medium term. However the increase in demand that those investments will bring about calls for an appropriate set of macroeconomic and structural policies in order to avoid an overheating and an appreciation of the local currency. We are glad to note from Mr. Egilsson's informative statement that the authorities are aware of the challenges they are facing and, intend to follow a prudent policy. We are also reassured that many of the envisaged measures are broadly supported by the private sector and social groups.

We agree that a prudent fiscal policy will need to be pursued in order to prevent overheating over the next years. The reduction in taxes promised in the run up to the elections calls for a further adjustment, particularly on the expenditure side. As to the sequencing, we concur with the staff that emphasis should be first on adjustment on expenditures before the envisaged tax cuts take place. We welcome the authorities' intention to elaborate the 2004 budget within a multi-year horizon. We believe that providing medium-term objectives for the fiscal policy will be well received by the markets.

On the monetary front, the inflation targeting framework is working well and we think that the current monetary policy stance is appropriate. We welcome the efforts being made by the authorities to improve the transparency of monetary policy. We also welcome progress made to strengthen the prudential supervisory framework and improvements in the BCP compliance, as indicated by the recent FSSA update report. We encourage the monetary authorities to continue monitoring closely the evolution of the market sentiment, and to mitigate any vulnerability stemming from the external short-term debt through increased banking supervision and build up of reserves.

Turning to structural reforms, the privatization program is progressing well with the last step being the divestment of the remaining government shares in the banking sector. We note that the preparation for the privatization of the telecommunications company is now completed and that the privatization will take place as soon as market conditions are favorable. We encourage further progress in the liberalization of the agricultural trade while acknowledging the need for a more gradualist approach. As regards the Housing Finance Fund, we think that assessment of continued financial soundness by the new and well-functioning FME will be necessary before initiating any reforms.

We welcome the duty-free access that the authorities have accorded to imports from least developed countries and appreciate their continued increasing provision of ODA.

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

Mr. Reddy submitted the following statement:

We thank the staff for a well balanced report reflecting the achievement of the Icelandic economy. We also thank Mr. Egilsson for his helpful statement. The impressive achievement including dramatic reduction in the current account deficit witnessed in 1990s has been possible by correcting major imbalances through well coordinated policies for financial stability, intensified structural reforms, effective central bank supervision, export diversification, and increased private sector activity. We note that these policies were generally in line with the Board's recommendations made at the conclusion of the consultations last year.

Against the backdrop of contraction in the domestic demand, the economy had rapidly adjusted through export growth and avoided sever recession. Exchange rate is now back to long term average levels. Guided by the recently introduced inflation targeting framework, the expectations appear to be that the inflation would remain within the target. The real GDP growth rate is expected to be progressively attaining higher levels in next two years, essentially driven by expectations from the energy intensive infrastructure investment that has potential to bring down unemployment as well. In this regard, we generally agree with the staff recommendations and their assessment of risk associated with hesitant global recovery. We are happy to note that the authorities' views converge with most of the recommendations contained in the report. Thus, for emphasis we limit our comments on challenges emerging from high investment, private foreign debt and protection measures.

We agree with the staff on their apprehensions in the context of the impact of heavy investment on the current account deficit during the construction period and time lag for external debt to come down below 100 percent of the GDP. Such a heavy investment has potential to boost the domestic demand as well. However, in view of the potentially accelerated impact on employment generation and growth in the medium term, a journey through such a phase need not be worrisome. In this context, we welcome authorities' intention to build up budget surpluses through expenditure restraint, tax rationalization and restructuring of fee for various public services.

We recognize the fact that low domestic savings are due to demographic factors and the high external private debt is instrumental in private sector growth and concur with the staff on the need for measures to reduce external vulnerabilities and increase national savings. However, we feel that a more detailed diagnosis of this phenomenon may be helpful for framing a sustainable policy response.

We are happy to note that trade policy, particularly relating to agricultural support, is shifting away from a restrictive regime. The authorities' apprehensions about the likely adverse effects of bolder reforms on rural poverty and regional inequality are more appropriate particularly for developing countries. As such and in view of the general global welfare gains from removal of trade distorting subsidies by developed countries we welcome the staff's suggestion on the need for further liberalization. More so because current levels of agricultural protection in Iceland happen to be the highest among the OECD countries. Finally, in the context of structural reforms, we join the staff on the need for accelerating rationalization and liberalization of electricity sector particularly because of large investments being made in energy intensive industries.

We wish the authorities all the success in their policy endeavors.

Mr. Usman submitted the following statement:

Key Points

The remarkable performance of the economy of Iceland during the last decade is a testimony to the authorities' policies of market liberalization, public sector rationalization, privatization and other structural reforms that promoted entrepreneurship, investment, and growth.

We note progress achieved in restoring the imbalances during the period of economic overheating and commend the authorities for taking corrective measures aimed at stabilization of the economy and resumption of sustainable growth.

We commend the authorities' proactive approach in addressing the financial sector vulnerabilities identified in the 2001 FSSA and for bringing about improvements in the management of financial institutions.

Despite the adoption of an inflation-targeting framework, the authorities' are encouraged to maintain a tight monetary policy stance in order to cement the monetary policy framework, and to anchor inflationary expectations. We welcome the authorities' commitment to increase ODA allocations and encourage them to accelerate progress toward meeting the UN target of 0.7 percent of GNP. Moreover, we appreciate the authorities' decision to provide duty-free access to imports from developing countries and are delighted to note that Iceland has unilaterally granted concessions to developing countries similar to those that apply to the European Economic Area members.

We thank the staff for a set of concise and focused reports and Mr. Egilsson for his insightful and comprehensive statement. Since we agree with the thrust of the staff report, we will focus on a few selected issues.

The growth performance of the Icelandic economy during the last decade has been remarkable during 1992-2001 making Iceland's GDP per capita one of the highest in the OECD. The rapid economic growth led to overheating, the emergence of financial vulnerabilities, and widening of the current account deficit. Despite these imbalances, the economy has stabilized reflecting the authorities resolve to address the challenges by pursuing prudent macroeconomic policies and effective monetary policy that stressed stability. However, as pointed out in Mr. Egilsson's statement, the authorities should be watchful of overheating and an unsustainable appreciation of the currency remains a major challenge.

Looking forward, the staff's projections envisage a resumption of growth in 2003 after a standstill in 2002, as power-generation and smelting construction investment projects come on stream during the later part of 2003. Over the medium term, the staff projects a period of strong growth and a widening of the current account as construction-related imports increase. Despite the significant demand stimulus from investment projects in power generating facilities, the growth momentum may not be robust in view of a weak global outlook, and the risks overheating and loss of external competitiveness. We are however, encouraged by Mr. Egilsson's statement that the authorities acknowledge the need for an appropriate policy mix to avert overheating.

Monetary Policy

The authorities' effective management of monetary policy successfully stabilized inflation close to its target in part due to the appreciation of the króna and lower than expected global inflation. This has in turn allowed the Central Bank of Iceland (CBI) to cut the policy repo rate gradually, while maintaining a tight real stance and consolidating confidence in the monetary policy framework. The CBI has further enhanced confidence in understanding of the monetary policy framework by market participants and has helped anchor inflation expectations through its policy actions. In addition, we observe that the authorities have reformed the payment and securities settlement systems in line with best international practices to enhance efficiency and safety. We commend the authorities for their efforts in conducting prudent monetary policy.

Financial Sector

The authorities' proactive approach in addressing financial sector vulnerabilities reported in the 2001 FSSA has strengthened Iceland's financial sector and has brought about a more balanced risk profile as concluded in the FSSA' s update. As a result, the Icelandic banks recorded increased profits and bolstered their regulatory capital ratios. The legal, regulatory, and supervisory frameworks have been significantly strengthened, while the most recent assessment found major improvements in the degree of compliance with Basle Core Principles (BCP). We commend the authorities for their efforts in undertaking various measures to address the remaining weaknesses of the prudential, regulatory and supervisory system. These efforts have made Iceland largely compliant with all but one of the BCP. Nonetheless, we urge the authorities to remain vigilant in view of potential for emerging macroeconomic tensions and high levels of private sector indebtedness.

ODA and Duty-Free Access

We are pleased to note that Iceland has increased its budgetary allocation for official development assistance (ODA) in real terms and encourage the authorities' to accelerate progress toward meeting the UN target of 0.7 percent of GNP. Moreover, we welcome the authorities' decision to provide duty-free access to developing countries' exports and are delighted to note that Iceland has granted concessions to developing countries similar to those that apply to the European Economic Area members. We commend the authorities for this very important gesture which would contribute towards enhancement of income levels in developing countries and as a consequence of poverty alleviation.

We wish the authorities success in the future.

Mr. Yagi submitted the following statement:

I commend the authorities for their skillful and prudent economic policy implementation that successfully guided the economy to a soft landing following the aftermath of the overheating experienced in the second half of the 1990s. Iceland represents a good example of how an appropriate policy mix adopted and implemented with proper timing can guide an economy to follow the right track and strengthen its resilience.

Growth for 2003 is expected to rebound 2.3 percent and to be above 3.5 percent in 2004, with a small output gap and inflation remaining close to the target. Upcoming large investments in aluminum smelting, and construction of associated power-generating facilities are expected to engine this growth, and the authorities intend to formulate their policies in order to bolster it.

While welcoming these favorable prospects for the economy and giving credit to the authorities' good track record of prudent policy management, I nevertheless tend to be cautious about potential risks that might cloud the future of the economy. In the current evolving market environment, and given that the economy is susceptible to currency fluctuations and the state of the economy of neighboring countries, inflation, competitiveness, and development of public expectations should be monitored carefully in order to take precautionary steps to maintain the economy on a sustainable growth path in case the external environment turns unfavorable. Given the size of the economy, its dependence on external factors, and the likely impact of the large investment program forthcoming, I feel that the staff's recommendation for monitoring on a 24-month cycle would be acceptable if Iceland wishes the same.

The sheer size of the investment project, whose total amount during 2003 to 2010 will equal 35 percent of 2003 GDP, and the magnitude of its potential spill-over effects on the economy naturally lead us to inquire about further elaboration of the project viability. In this regard, I welcome the staff providing some current and quantitative information as to how they see the impact of this project spread over to the economy as well as prospects for its viability under different scenarios.

In this regard, I welcome the authorities' intention to maintain a restrictive fiscal stance to further increase the budget surplus in light of the upcoming demand pressure stemming from the forthcoming investment project, which would allow monetary policy to focus on unexpected and short-term demand and external shocks, and could contribute to the reduction of external debt. The authorities intention to take a gradualist approach to tax cuts is well justified.

Given the important role fiscal policy has to play in the coming years by restoring confidence in market participants, I echo the staff's encouragement of the authorities' announcement of a medium-term fiscal policy strategy, including budget targets and commitments to contain expenditures. The economy might be better equipped to take on the challenges, as was stated in Mr. Egilsson's statement, but the authorities should not become complacent, and should continue to pursue addressing weakness still lingering in the economy and securing market confidence.

Monetary policy has attracted strong confidence from market participants through the Central Bank of Iceland (CBI)'s success in containing inflation under the inflation target framework, which seems to suit this country well. The CBI's communication efforts played a definite role in enhancing understanding of their policy among market participants, illustrating the importance of increased transparency. To this end, I would encourage the CBI to make further strides in this direction.

I welcome the update of the FSSA and commend the authorities for their efforts in successfully implementing recommendations of the past FSSA, which led to a favorable overall assessment. The outlook for banking has improved, and banks' capital and supervisory oversight have both been strengthened. I commend the authorities' innovation in incorporating stress testing into routine supervisory exercises, but, at the same time, would like them to pay due attention and further explore how such testing can be best used to increase the effectiveness of the supervision.

Mr. Mirakhor submitted the following statement:

We thank the staff for a concise and well-written report and Mr. Egilsson for his informative statement. The economy of Iceland has shown a remarkable capacity to cope with the imbalances that had built up during earlier period of rapid growth. After a mild recession in 2002, growth is projected to pick up in 2003, inflation remained in line with the central bank's target, and the large current account deficit was eliminated, contributing to the recovery of the króna. The authorities deserve to be commended for these achievements, which, to a large extent, reflect sustained implementation of sound macroeconomic policies and structural reforms, including market and external liberalization, rationalization of the public sector, privatization, and financial sector strengthening.

Monetary policy, anchored on inflation targeting, a floating exchange rate regime, and strengthened independence of the central bank, together with a prudent fiscal policy, have served well the authorities' objective of macroeconomic-stability. As a result, inflation has been brought under control, while public finances remained sound. At the same time, financial vulnerabilities that emerged during the period of overheating were promptly addressed, in line with the FSSA recommendations—including through the strengthening of the legal, regulatory, and supervisory frameworks, and implementation of related measures. Important progress has also been made in privatization, with the banking sector now fully privatized. As noted by Mr. Egilsson, this move facilitated the restructuring of the sector through mergers, and should further enhance its efficiency, which should also benefit from the recent upgrading of the payments and securities settlement systems according to best international practices. We look forward to the envisaged privatization of the Telecommunications Company and to the liberalization of other sectors, including the electricity sector.

As the staff and Mr. Egilsson point out, medium-term prospects are for strong growth, led by the planned important investment in aluminum smelting and related energy-generating plants. While this expected resumption of growth over the medium term is welcome, it entails risks of overheating and reemergence of external and domestic imbalances, fueled by expected acceleration of domestic demand. We are encouraged by the authorities' awareness of these risks and their readiness to take the necessary preventive actions. In this regard, we note with satisfaction that they are in broad agreement with the staff on the appropriate policy mix and the remaining structural reforms. In particular, the emphasis on fiscal consolidation within a medium-term fiscal framework is most appropriate, as fiscal policy is expected to bear most of the adjustment burden related to the necessary containment of domestic demand over the next few years. The authorities' resolve to build up fiscal surpluses, focusing on expenditure restraint, goes in the right direction. We welcome their intention to introduce the envisaged tax cuts only progressively and when commensurate with additional expenditure savings. As the staff noted, fiscal consolidation would allow room for monetary policy to play its stabilization role, while avoiding sustained high interest rates. At the same time, in view of the high level of Iceland's external debt, which is mostly in the private sector, the authorities should, when formulating their fiscal policy, take into account the need to encourage private savings in the medium term.

We agree with Ms. Indrawati and Ms. Rogers, Mr. Reddy, and Mr. Martí and Mr. Simán that the high levels of Iceland's private sector's external debt poses potential medium-term vulnerabilities that should be carefully addressed, if the economy is to be safeguarded from, in Ms. Indrawati's and Ms. Rogers's words, "unexpected shifts in investor sentiment and external financing conditions." In this regard, we are encouraged by the authorities' acknowledgement that the upward trend of external debt should be contained, as reported in Mr. Egilsson's statement.

We concur with Mr. Egilsson that the economy is now better equipped than in recent years, and we are confident that it will successfully face the challenges ahead, particularly in view of the authorities' past achievements, and their strong commitment to pursue appropriate macroeconomic and structural adjustment policies.

We welcome Iceland's increased Official Development Assistance, and encourage the authorities to further progress toward the U.N. target of 0.7 percent of GNP. We also commend them for granting duty-free access to imports from least developed countries, and for affording imports from developing countries equal treatment to those from the European Union. We encourage them to take decisive steps toward further trade liberalization, particularly in the agriculture sector.

Finally, two days after Board discussion on strengthening Fund surveillance, we are puzzled by the staff's recommendation to put Iceland on the 24-month consultation cycle.

The staff representative from the Policy Development and Review Department (Mr. Fetherston) noted that several Directors had expressed concern about the staff's recommendation to return Iceland to a 24-month Article IV consultation cycle. Following the 1997 Biennial Review of Surveillance, the Board moved a number of countries to the 24-month cycle, in order to focus and improve the effectiveness of surveillance, given the limited available resources. At that time, 13 countries, including Iceland, were moved from the 12- to the 24-month cycle. As a result of that Board discussion, four criteria were set out that could disqualify countries from the 24-month consultation cycle, including: systemic or regional importance; the completion of a Fund-supported program within one year of the proposed shift; outstanding Fund credit above 25 percent of quota; and, risks related to policy imbalances, exogenous developments, or pressing issues of broad interest to Fund membership. The fourth criterion was most relevant for Iceland, as it involved a somewhat subjective judgment of the relevant risks.

The staff representative from the European I Department (Mr. Escolano) made the following remarks in response to questions and comments from Directors:

> The 2001 Article IV consultation with Iceland, which was based on a 24-month cycle, was temporarily transferred to a 12-month cycle because macroeconomic imbalances had developed in 2000, and owing to financial vulnerabilities that were highlighted by the 2001 FSSA report. In 2002, despite the fact that macroeconomic and financial imbalances were being righted, the staff proposed and the Board agreed to maintain the 12-month consultation cycle in view of the FSSA update that was going to be undertaken in 2003. In light of the information that is now available regarding the success of the macroeconomic adjustment and generally positive FSSA update, the staff recommends that the authorities' request to be placed back on a 24-month cycle should be granted. Nevertheless, the staff remains conscious of the country's level of external debt, which was a major focus of this year's Article IV consultation discussions, as outlined in Annex II of the staff report. Furthermore, the staff intends to undertake interim visits to the country for the purpose of monitoring developments, which the authorities welcome.
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> There were some questions about the profitability and viability of the planned investment projects in the aluminum industry. There have been many such projects in the past, going back as far as the 1960s. The national power company is highly profitable—it maintains a credit rating of AAA from Moody's—and has ample experience in selling electricity to these companies. These investments should produce returns to the government through increased tax revenues, since they are not subject special tax exemptions, and from the power company.
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> In terms of the profitability of these investments, studies produced by a committee of experts on behalf of the company found the current arrangement with Alcoa to be highly profitable, and that the government could expect a return on equity similar to the long-term return on investments in the U.S. stock market. This study developed several scenarios based on conservative assumptions about the cost of capital. It also determined that the main risks

associated with these investments stemmed from the potential volatility of aluminum prices. Nevertheless, the probability that these investments would not produce the envisioned returns is estimated to be about 20 percent, and it is considered highly unlikely that they will not return any profit at all.

Furthermore, social returns associated with these projects are also estimated to be significant. For instance, over the long-term, this initiative might increase exports by the equivalent of 8 percent of GDP, and raise GDP by about 2 percent. Over the short to medium terms, these returns will also be significant in terms of the construction and related activities that they generate. Several Directors also asked about the short-term impact of the projects. Their effect on growth should peak at about 1.4 percent of GDP in 2005, then decline slowly until 2010. With respect to the projects' impact on the current account, as you can see from Box 1 of the staff report, the contribution may be relatively large in 2005 through an increase in both the level of direct investment and its impact on consumption, which might result in a current account deficit of 5 percent of GDP.

Regarding the policies required to face challenges that lie ahead, the authorities and staff are primarily concerned with the possibility of an overvaluation of the króna, which might damage export and import competing industries. Furthermore, after years of construction associated with the investment projects, the Dutch Disease may emerge, which might cause irreversible damage to exports and imports. In this light, the staff has recommended that the authorities undertake policies aimed at avoiding a possible real overvaluation of the króna, and the exacerbation of external imbalances. The most adequate way to address this problem would be concerted fiscal restraint and prudent monetary policy. Placing the burden solely on monetary policy would have implied containing demand through higher interest rates, and attracting savings through a widening of the current account deficit. This is was exactly what the authorities were trying to avoid.

One Director asked about the realism of current account projections, and the likelihood of another rapid deterioration of the current account resulting from an appreciation of the currency. Again, the major risks are associated with the fiscal stance. The staff's projections are based on a fiscal retrenchment of about 2 percent of GDP in structural terms, and 3 percent in nominal terms. These projections roughly coincide with the authorities', and assume that the savings rate of the private sector will decline from its current level by about 2.5 percent of GDP over the next four to five years, and that increasing activity during the investment and construction period will result in an increase in consumption.

Based on past experiences, the envisioned fiscal retrenchment seems feasible. For instance, in 1998/1999, the structural balance improved from a deficit of 0.2 percent of GDP, to a 1.7 percent surplus. Similarly, large retrenchments or adjustments occurred in 1991/1992 and 1994/1995. The staff's proposed retrenchment spans three years, which the authorities consider to be realistic. The staff also emphasized the containment of current spending, amounting to about .75 to 1.0 percent of GDP in government consumption, particularly in the form of wages. The proposal would hold the growth of public sector wages slightly below those in the private sector, which the authorities accept. Investments would also contribute about 1 percent of GDP, and another 1 percent of GDP would come from savings of interest payments that this type of retrenchment would generate.

Finally the political economy implications of these actions center on a remarkable consensus on the need to undertake tight policies in both the monetary and fiscal areas. When the authorities released a public statement regarding the staff's proposals, it was very well received by the press; the only real criticism seemed to come from public sector unions.

The staff representative from the Monetary and Financial Systems Department (Mr. Kupiec) made the following remarks in response to questions and comments from Directors:

A number of Directors raised questions about organic hedging. The FSSA report does not suggest that the staff considers all foreign currency loans to be organically hedged. However, it seems that a large portion of these borrowers do have some hedge against exchange rate risk, either organically, owing to their foreign receipts, or through the use of derivatives. All major Icelandic banks have loan underwriting standards in place that require them to consider the suitability of foreign exchange loans for borrowers. The FME, the banking supervisory agency, reviews the underwriting standards of banks, and it independently confirmed that banks consider the borrower's ability to generate foreign exchange receipts when underwriting foreign loans. Moreover, the historical performance of corporate foreign borrowing of this type is encouraging. Figure 1 of the FSSA report—particularly Table 4 and Box 1—show that non-performing loan rates for commercial banks, which are responsible for the bulk of the sector's foreign exchange exposure, are significantly lower than the those of the savings banks; even during the recent recession and subsequent period of significant exchange rate volatility. Thus, in our view, there is strong evidence that banks are screening potential borrowers in order to mitigate foreign exchange risks.

Clearly, some foreign exchange lending is not naturally hedged. Mr. Reddell noted that the FSSA update report's tables suggest that the retail sector has significant foreign exposure—this actually accounts for about 14 percent of total lending. This sector includes wholesalers that import goods, which require foreign exchange financing. However, the staff is unclear about the proportion of this sector that is made up of importers versus domestic retailers, or if wholesalers hedge their exposures using derivatives.

Nevertheless, their historical performance in recent years has been good, and there is no reason to suspect that banks are ignoring their underwriting standards.

In terms of the implications for the financial sector of the new aluminum smelting and electricity facilities, most of this is new foreign direct investment that is not financed domestically. Alcoa finances itself in international markets, and the primary contractor for much of the infrastructure is an Italian company that also finances itself externally. The electric company is domestic, and will finance itself on foreign markets, using internationally syndicated loans; some of which have already been arranged. According to the authorities, domestic banks have very little exposure to the electric company, and they do not anticipate that this exposure will increase significantly. Some of the subcontractors involved in these projects will use domestic financing facilities, and banks will benefit from the secondary impacts of this investment through an increase in credit demands, which are likely to be associated with higher consumer demand for housing, consumer durables, and services.

Mr. Wang asked about high domestic interest rates, which might discourage domestic borrowing. In fact, there is healthy demand for domestic credit in the form of inflation-indexed housing bonds. The staff is not concerned that the demand for credit is being inhibited, but relatively high domestic rates clearly encourage foreign exchange borrowing for those that are able to do so.

Mr. Sipko made the following statement:

Iceland's authorities are to be commended for their correction of major imbalances. Inflation is lower than targeted. The current account has passed from a deficit of 10.3 percent of GDP in 2000 to a surplus of 0.3 percent of GDP in 2002, and the consolidated government accounts are in balance. A recovery began around the middle of the year and large scale investments in power intensive industries are expected to boost demand and push growth beyond its potential rate. Once growth picks up and the positive output gap emerges, the authorities will need to tighten monetary conditions to prevent overheating in mid-decade. The stance of fiscal policy should be restrictive. The authorities are determined to keep their public infrastructure investments from conflicting with the financing of the power-intensive projects.

We welcome the authorities' determination to run budget surpluses. But fiscal policy should aim first at reducing marginal tax rates, both for supply side reasons and because revenues will likely exceed the conservative budget estimates. Although Iceland's taxation system has changed significantly in the direction of simplification, much still remains to be done. Some needed changes in the tax base have not made significant progress, and the new conditions would make some room for a revenue neutral tax reform.

Even though the fiscal accounts are in balance, let me stress the importance of accompanying ambitious investment projects with matching fiscal consolidation. Here let me underline that the authorities should redouble their efforts to establish a strong and credible medium-term spending plan, including multi year budget plans with explicit spending limits. This framework must also specify the priorities and means required to achieve them, and should be based on multi-year spending targets rather than ad hoc decisions. Based on the experiences of some other developed countries, a stronger health care package including enhanced efficiency is needed. Iceland spends more on public educational institutions than any other developed country, but sadly the quality and efficiency of that education is not comparable to that in other countries.

This brings us to the issue of the past year's unbalanced expansion, which has created a legacy of high external liabilities for Iceland. Gross external debt amounts to 130 percent of GDP, and the share of debt with short term maturities appears to be trending upward. Even though it consists mostly of private sector indebtedness, this level of debt is worrisome for a relatively small and highly open economy. I join the staff in urging the authorities to increase national savings and gradually reduce the high level of indebtedness.

As noted at the beginning of my remarks, the size and duration of projects calls for a monetary policy tightening to maintain price stability and defend against unexpected short-term demand shocks and external shocks. I also want to express my concern about the announced expansion of credit by the Housing Financial Fund (HFF). Unless this is kept within strict limits, this could undermine the central bank's management of liquidity and lead to higher real interest and exchange rates as well as increases in the price of housing.

The report of the Financial System Stability Assessment is very useful. I note that the authorities are committed to follow the recommendations of the Fund mission. I welcome the planned strengthening of legal, regulatory, and supervisory frameworks to conform to Basle Core Principles (BCP), but note that the required report on country risks (principle no. 11) is missing. I would appreciate the staff's comment on the omission.

My last comment has to do with trade liberalization. The official data show that Iceland has the highest barriers to trade in farm products of any advanced economy. Here, I join the staff in urging the authorities to continue to liberalize agriculture over the medium term, and meanwhile to replace production linked support and quotas with direct income support.

Ms. Jacklin made the following statement:

We would like to thank the staff for their well written report and their responses today, and Mr. Egilsson for his helpful statement, which reiterates

Iceland's commitment to meeting the challenges ahead. We also agree with the staff that moving Iceland to a 24-month cycle appears appropriate, notwithstanding some foreseeable risks.

We congratulate the authorities on their success in steering the economy through the difficult circumstances that followed the end of the last decade. Floating the króna, establishing central bank independence, and adopting an inflation-targeting framework have all helped to create an effective monetary policy regime that has succeeded in controlling inflation and providing the flexibility required to respond to external shocks. This is particularly important as Iceland returns to higher growth levels over the course of the next few years.

Plans to increase reserves from their currently low levels will promote greater resiliency. Furthermore, the policy flexibility that has been introduced in recent years will likely prove invaluable to maintaining economic stability as massive foreign investment in aluminum smelting and power projects over the next four years will require the maintenance of tight fiscal control in order to avoid undermining competitiveness. Mr. Egilsson's statement noted that the authorities recognize the need to increase budget surpluses and to avoid overheating, which is reassuring. We join Mr. Wang and Ms. Cao in noting, however, that rapid increases in public sector wages in recent years could have an effect on spending, private sector wage negotiations, and competitiveness.

The staff attempted to explain some of the factors driving Iceland's high levels of external debt and private sector borrowing, which is thought to reflect demographic issues and low savings rates. It will be important for the authorities to follow through on the approach they have proposed, especially with respect to a tight fiscal stance aimed at raising public savings and restraining current account deficits. The authorities are to be commended for their response to the findings of the 2001 FSSA, especially the strengthening of the financial supervisory authority and concrete steps to counter money laundering and terrorist financing. Strong supervisory capacity is critical for an economy as open to global markets as Iceland. Implementing the staff's recommendations in order to improve the supervisory oversight of the Housing Financing Fund would further strengthen the financial sector, and we encourage the early implementation of such a policy.

Regarding trade-related issues, as Mr. Sipko and a number of other Directors noted earlier, we encourage faster liberalization, particularly of the agricultural sector, where levels of protection remain among the highest in the OECD.

Mr. Harzer made the following statement:

Let me first thank the staff for a well- focused report as well as Mr. Egilsson for his helpful statement.

We commend the authorities for having successfully managed to correct the major macroeconomic imbalances which had been built-up as a result of the economy's overheating at the end of the 1990s by pursuing tight economic policies since mid-2001. Quite impressively, tight monetary and fiscal policies have eased pressure in the goods and labor markets, eradicated the large current account deficit and brought about a rapid fall in inflation. Furthermore, these major corrections have been achieved with the economy going through an only relatively mild recession. This is mainly due to the authorities' laudable earlier policy shift towards market liberalization and privatization, including the termination of the state's involvement in commercial banking activities, as also pointed out by Mr. Egilsson. We share staff's and other Directors' view that the main challenge for the authorities in the medium term will be to conduct macroeconomic policies in a flexible manner so as to minimize possible negative effects on the external competitiveness stemming from an investment-led overheating of the economy. We also agree with staff that fiscal policy will have to bear the brunt of the burden of the necessary policy adjustment by further increasing the budget surplus in view of demand pressures stemming from the investment projects. It is particularly encouraging that, as with most other staff recommendations, there seems to be broad agreement between staff and the authorities on this necessity. In this context, the government could face the difficult task to deliver on its election campaign-promise to lower the tax burden while at the same time achieving fiscal surpluses and maintaining them over the medium-term in order to prevent a possible return of the imbalances which occurred in the late 1990s.We concur with staff's recommendation that restraining current spending would be the first line of defense, if warranted. At the same time, indeed, the envisioned tax cuts should only be introduced once compensating expenditure savings have been identified.

Against this background and since we broadly share the staff assessment, I have only a few specific remarks.

On monetary policy, like staff, we expect the impact of the envisaged investment projects and the tax cuts to increase inflationary pressures. Ultimately, this may require a tightening of monetary policy. While the possibility of negative shocks to domestic demand and/or imported inflation cannot be completely ruled out, we would not put to much weight on it. Therefore, on balance, it would be better to err on the side of caution by considering a tightening of monetary policy earlier rather than later. At the same time we fully concur with staff and the authorities that, in order not to undermine Iceland's external competitiveness, the obligation to contain demand pressures must, first and foremost, lie with fiscal and structural policies. We understand the rationale behind staff's recommendation to increase the transparency of monetary policy by publishing the minutes of the meetings of the CBI Board of Governors. But let me draw your attention to the fact that our own experience at the Bundesbank indicates that, even without immediate publishing of such minutes, monetary policy can be very successful.

In order not be misunderstood, I would like to emphasize in this context that we remain firmly dedicated to improving transparency of economic policy making whenever it is useful.

On fiscal policy, like Mr. Martí and Mr. Siman, we welcome the authorities' intention to design the 2004 budget within an explicit multi-year budgetary framework. Indeed, a well-communicated structural balance target and expenditure limits would go a long way to increase the predictability and credibility of the budgetary process and, thus, economic policy. We, too, welcome Mr. Egilsson's confirmation that further privatisations are being prepared which is in line with the government's stated medium-term economic policy.

Finally, on the risks posed by the high level of private sector external debt, we agree with the concerns voiced by Mr. Reddell that the sheer volume of that debt position makes a longer-term risk management-oriented approach to this problem advisable, rather than simply with a focus on accommodating investment projects over the next couple of years. Needless to say, the external position makes the need for further fiscal consolidation even more pressing.

With these remarks we wish the authorities continued success.

Mr. Alazzaz made the following statement:

I commend Iceland's successful management of the soft-landing following the boom from 1996 to 2001. Indeed, the slight contraction in output last year has to be viewed in the context of the preceding sustained expansion. The improved macroeconomic environment is evident in the sharp drop in inflation, the sound fiscal position, and the greatly improved external accounts. The financial sector reforms and the forthcoming major investment undertakings also bode well for the economy's longer-term prospects.

Against that background, the staff is right to stress the importance of continued policy prudence during the transitional period before the new investment projects come on stream. As evident from Mr. Egilsson's comprehensive statement, the authorities are clearly cognizant of the importance of averting excessive overheating of the economy and the appreciation of the króna. Considering the adjustments and reforms already in place, the economy is indeed better-placed now to absorb the upcoming pressures. In that regard, the broad consensus on the policy priorities, as outlined in the staff appraisal is reassuring. Here, I will only add a few brief remarks for emphasis.

The policy consensus is particularly evident on the fiscal front. Here, the focus is rightly on continuing the consolidation in view of the anticipated strong demand pressure until completion of the major projects. The staff's advice to ensure adequate spending restraint and to make tax cuts contingent on additional trimming of expenditures is appropriate. I welcome the authorities' agreement with the staff in this regard. The intent to follow the staff's recommendation for a medium-term policy framework is also reassuring.

Regarding monetary policy, I agree on the current neutral stance. Given the below-target rate of inflation, I also share Mr. Egilsson's perception that the need for raising the policy interest rate has likely receded farther into the future. Vigilance is, however, important in view of the economy's imminent expansive phase. Here, I also commend the authorities' proactive stance for financial system reforms indicated in the FSAP review.

Regarding broader structural reforms, I welcome the progress in privatization. I also commend the reduction in trade distorting farm subsidies and quota restrictions. Here, I share the staff's stress on taking the process further. I note specifically the desirability of allowing developing countries generally to have the benefits of duty-free export access that are now available only to the least developed countries.

Finally, I commend Iceland's ODA commitment and endorse the staff's encouragement for an additional increase in allocations to meet the UN target of 0.7 percent of GNP.

With these remarks, I wish the authorities success.

Mr. Ayala made the following statement:

We thank the staff for their impressive report, and Mr. Egilsson for his informative statement. We would like to commend the authorities for their successful policies on the monetary, financial, and structural fronts, which were crucial to righting Iceland's economic imbalances over the last few years, and have contributed to macroeconomic stability. We are also pleased that the economy will resume higher levels of growth over the next few years, mainly due to large foreign investments. Nevertheless we believe that the authorities should remain cautious, and that they should continue pursuing prudent policies aimed at the resolution of earlier imbalances, especially those driven by excessive domestic demand growth. Since we are in broad agreement with the staff appraisal, we will make some brief comments for emphasis.

Regarding monetary policy, we consider the measures taken by the CBI to be appropriate and successful, particularly regarding the reduction of interest rates, the appreciation of the króna, and the reduction in the rate of inflation. Nevertheless, we concur with the staff that the monetary stance should be kept under review and tightened as needed in order to keep inflation low. We also welcome the measures undertaken by the CBI to enhance confidence in the monetary policy framework, and encourage the authorities to continue their efforts to make this process more transparent.

We welcome the authorities' recognition that in order to maintain stability and competitiveness in light of the upcoming demand expansion, it will be necessary to build up budget surpluses over a number of years. It will also be important to allow monetary policy to work flexibly against domestic and external shocks. To facilitate fiscal consolidation, we welcome the authorities' intention to introduce a multi-year budgeting plan. Moreover, we are encouraged by the authorities' plan to strengthen the medium-term policy strategy, which includes recommendations by the IMF regarding the need for expenditure restraint and the implementation of tax reforms that are consistent with macroeconomic stability. Steps in that direction will be critical to boosting market confidence.

Regarding the financial sector, the authorities should be commended for their efforts to implement the recommendations of the 2001 FSSA report in order to address outstanding financial vulnerabilities. Improvements in the banking system as a result of prudent policies and enhanced supervision, as noted in this year's FSSA update, were reflected by improved profitability and an enhancement of the capital base. We welcome the latest amendments to the banking law that will strengthen the financial supervisory authorities' investment powers, which are crucial to maintaining a sound and efficient financial system. On the other hand, formal supervision and prudential guidelines for the Housing Financing Fund should be considered by the authorities during the period ahead.

With these comments, we wish the authorities success in the future.

Mr. Gigineishvili made the following statement:

Iceland's successful macroeconomic stabilization is largely the result of sound policies and stability-oriented structural reforms. We commend the authorities for their prudent economic policies and sound management.

Central bank independence and the adoption of an inflation-targeting framework and floating exchange rate regime provided strong grounds for the efficient implementation of monetary policy and for anchoring inflation. Subsequently, inflation has effectively been kept under control, and the central bank has managed to strike a balance between domestic demand pressures and an appreciation of the króna. Iceland can be viewed as a good example of a successful transition to an inflation-targeting framework.

Notwithstanding some fiscal slippages, it is particularly encouraging to see how the authorities managed to achieve an optimal mix of monetary and fiscal policies by using fiscal measures to influence structural demand policies, while targeting monetary policy at short-term demand swings related to temporary domestic and external shocks. In this respect, we are delighted to learn about the government's plan to move to a multi-year budgetary framework starting in 2004. This will certainly increase the flexibility and efficiency of fiscal policy and macroeconomic management.

We share the staff's assessment that the main risk to the outlook stems from a possible overheating of the economy resulting from the large investment projects. While these investment projects will benefit the economy in several ways, the emergence of demand pressures during the construction period also seems unavoidable. We agree with the staff on the need for significant fiscal tightening in order to curb demand pressure and to restrain the deterioration of the current account deficit. In this light, we welcome the authorities' readiness to strengthen fiscal consolidation and to build up surpluses primarily via expenditure cuts.

A rapid increase in Iceland's external debt is also a concern, particularly because more than half of this debt is short term in nature, and a large proportion of the total foreign debt burden is on the balance sheets of the banking sector, which makes the financial system particularly vulnerable to external shocks and shifts in the business climate. Furthermore, as most foreign debt is denominated in foreign currencies, a depreciation of the exchange rate may further aggravate the problem. In this light, we are delighted by Mr. Egilsson's assurances that the authorities are prepared to pursue policies aimed at increasing national savings. We also urge the authorities to continue their scrutiny of the banking sector.

Mr. Boitreaud made the following statement:

Let me join other Directors and thank the staff for a concise and balanced set of papers. I would like to make a few comments, echoing what my colleagues have written or said today. First of all, I very much welcome the fact that we are discussing an Article IV consultation on an industrialized country where the main risk over the next years is not protracted recession but overheating, which is a bit puzzling, at least from a geographical point of view. Overall, Iceland's performances are indeed impressive: the country ranks among the world's wealthiest in terms of GDP-per-capita, the health indicators are very high and Iceland publishes more books per head than any other country in the world, quite a challenge for a small and remote country.

Against this background, I have only two comments and one question.

The first comment relates to the impressive reversal of Iceland's current account from a very high deficit to a balanced position over just two years. It is a positive and welcome step that owes much to the prudent and balanced policies implemented by the authorities. It could however raise some concerns, as mentioned by Mr. Reddell in his very interesting preliminary statement: the risk is that an acceleration in the rate of growth could lead to a sharp increase in the current account deficit.

Second, like almost all speakers, I believe that Iceland's main vulnerability lies with its very high level of private sector external debt. True, assessing the appropriateness of a large negative IIP position is far from easy because it depends so heavily on country specific circumstances but, still, I am not fully convinced by the government' explanations, relying mainly on demographic considerations coupled with the effects of the recent financial liberalization. The authorities should therefore remain very cautious in their approach and try to encourage private savings in the medium term, a point made by Mr. Sipko among others. In this perspective, the authorities' acknowledgment of the need to contain the current trend, as stated in Mr. Egilsson's insightful statement, is encouraging.

Third and lastly, I would be very interested to hear, either from the staff or from Mr. Egilsson about the prospect of Iceland joining the EU at some stage. I understand that this a highly sensitive issue but any hints, at least from an economic perspective, about the terms of the debate, if there is a debate, would be welcome.

Finally, like Mr. Mirakhor and others, I was a bit puzzled by the staff's recommendation to put Iceland on a 24-month consultation cycle. As a general matter, this chair is not very supportive of placing any country on a 24-month cycle but with regard to Iceland it seems really premature. I therefore thank Messrs. Fetherston and Escolano for their explanations at the outset of the discussion. However, I still believe that placing Iceland back on a 24-month cycle would be a bit premature.

Having said that, I wish the authorities every success.

The staff representative from the Monetary and Financial Systems Department (Mr. Kupiec), in response to Mr. Sipko's question regarding the Basle Core Principles and the lack of regular reports on country risk exposures, remarked that Icelandic banks tended to lend primarily to domestic companies, and consequently the authorities have held the view that country exposure and related risks could be adequately monitored through annual report data. Nevertheless, the practice of reviewing exposures primarily at the industry or sectoral level was under review by the authorities.

The staff representative from the European I Department (Mr. Escolano), in response to Mr. Boitreaud's question about Iceland's prospects for EU accession, noted that the latest Gallup poll found that 42 percent of the public favored accession, which was a substantial increase over the previous February, when support stood at only 36 percent. However, public opinion regarding accession seemed somewhat volatile, particularly during the period when the króna had depreciated. Nevertheless, the debate was focused primarily on political issues, and after the elections that took place in May of 2003, the government made it clear that they were not in favor of joining the Union.

Mr. Egilsson made the following concluding statement:

I would like to thank the staff for their hard work and useful advice, and Directors for their helpful suggestions. There is a lot of coherence between the authorities and the staff regarding the challenges facing Iceland. As noted by Mr. Boitreaud, many of Iceland's problems are somewhat enviable.

There was a question about the potential impact of the planned investment projects. These projects are very important for Iceland, and as a Member of Parliament, I was directly involved in approving them. During our parliamentary discussions on this issue, it became clear to me at that it is impossible to foresee the impact that this type of undertaking will have in 50 years, or to rely on present value calculations for conditions in 2040. Ultimately, we should focus on the impact that this project might have on individuals and the industries in which they work, and whether it is likely that they will remain competitive in the face of changing conditions and other global and regional challenges. The main question is whether we believe in the people. Based on this type of assessment, I am very optimistic about this project and its potential impact on the country.

I also feel quite strongly about the issue of farm subsidies, particularly in light of the fact that I represented a farming constituency as a parliamentarian. Iceland is competing with Switzerland and Norway, which maintain very generous farm subsidies. Nevertheless, the farming industry simply cannot keep pace with other sectors of the economy, particularly with respect to productivity growth and living standards, which is why it seems to be disappearing. Furthermore, these subsidies are primarily linked to meat and dairy products, because Iceland imports almost all fruits, and most vegetables and grains. Thus, most agricultural products are not subject to any trade restrictions.

Finally, despite the fact that the polls seem to demonstrate that support for EU accession is on the rise, I am not sure that this is particularly relevant. There are two basic obstacles to EU accession in Iceland. The first obstacle relates to the EU's common fisheries policy, which is not easily compatible with Iceland's own preferences. Second, after accession, Iceland would be forced to become a large net contributor to the EU. This is one of the major reasons why three of the richest countries in Europe—Iceland, Norway, and Switzerland—have not joined the EU, while Eastern European countries are eager to accede.

With respect to the return to a 24-month Article IV consultation cycle, despite our willingness to discuss the relevant issues with the staff of the Fund and Board as often as possible, we do not think it necessary for the Fund to reinitiate the entire consultation process every year, particularly in light of resource constraints.

The Acting Chair made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for rapidly overcoming macroeconomic imbalances and financial vulnerabilities that had developed at the end of the 1990s, through the sustained implementation of stability-oriented policies—including the introduction of inflation targeting, central bank independence, a floating exchange rate regime, and a substantial strengthening of the financial supervisory framework. They noted that the resilience shown by the Icelandic economy during the recent recession was also due to the underlying flexibility afforded by a decade of structural reforms aimed at enhancing long-term economic performance through improved competitiveness and more diversified exports.

Directors agreed that there were good prospects for a resumption of growth in the near term, accelerating over the medium term as the large planned foreign investments in aluminum smelting and associated power-generating facilities gather pace. They warned, however, that while these investments will ultimately expand the export base and thus buttress economic stability, they will also generate a significant demand impetus during the construction phase that will strain resources and increase upside risks, thus complicating macroeconomic management.

Against this background, Directors agreed that the main policy challenge for the period ahead will be forestalling a re-emergence of overheating and containing external imbalances given the already high private external debt level. In this regard, Directors supported the authorities' view that macroeconomic policies would have to remain restrictive to counteract the expected demand pressures over the medium term. In particular, they agreed that fiscal policy would need to bear most of the burden of adjustment, leaving room for monetary policy to respond to unexpected shocks while avoiding an extended period of high interest rates and possible real over-appreciation of the króna. Directors stressed the need for appropriately tight policies to contain the external current account deficit at a level commensurate to direct project-related imports and compatible with a gradual decline in Iceland's net external liabilities as a share of GDP.

While noting that the public finances remain fundamentally sound, Directors welcomed the authorities' intention to build up significant budget surpluses to counteract the envisaged demand push, and urged that this be reflected in the 2004 budget proposal. This would require an early focus on restraining current spending, particularly the public wage bill, an area where repeated slippages have occurred in recent years. Directors also recommended increasing the scope for private sector participation and the use of means-tested fees and co-payments in the provision of public services. Moreover, Directors generally cautioned that the announced tax reductions should be introduced cautiously, and only when countervailing expenditure cuts have been identified.

Directors welcomed the authorities' decision to cast the 2004 budget in a transparent multi-year policy framework, which would facilitate efforts at fiscal consolidation. Directors thought that firm expenditure limits would contribute to the predictability and credibility of budgetary policies and reinforce market confidence. Directors also noted that the planned adoption of national accounts methodology for budgeting purposes would further enhance fiscal transparency.

Directors considered the current Central Bank of Iceland's (CBI) broadly neutral monetary stance to be appropriate. They concurred with the authorities that this stance would have to be tightened as the recovery strengthened, remaining moderately restrictive over the investment projects' implementation period. Directors cautioned against a destabilizing expansion of credit by the Housing Financing Fund (HFF) that could be prompted by the relaxation of its lending criteria.

Directors commended the authorities for their success in implementing the inflation-targeting monetary policy framework introduced in 2001, as evidenced by the swift decline in inflation to the CBI's target. They also noted that recent reforms had improved the operation and safety of the payments systems infrastructure, and that the ongoing net foreign reserve accumulation would enhance confidence and policy flexibility. Some Directors suggested that, to further promote monetary policy transparency, consideration be given to holding regular rate-setting meetings of the CBI Board of Governors and publishing their minutes.

Directors welcomed the positive conclusions of the Financial Sector Stability Assessment (FSSA) update, reflecting the authorities' forceful efforts in addressing financial system vulnerabilities identified in the 2001 FSSA. They noted that the banking sector had increased its profitability and capital base, returning to a more balanced risk profile. Directors commended the authorities for the strengthening of the legal and supervisory prudential framework, including the increased powers and resources granted to the Financial Supervisory Authority, as well as the major improvements in compliance with Basle Core Principles of Effective Banking Supervision. Directors nevertheless advised that continued vigilance would be required in the upcoming period of possible macroeconomic tension. They recommended applying explicit prudential rules to the HFF, and carefully monitoring the weaker savings banks.

Directors expressed concern that private sector external liabilities, including short-term maturities, had risen to high levels in recent years while the net international investment position was in deficit, but noted that this might in part be rooted in demographic factors as well as in the buildup of private assets, including through fully-funded pension schemes. Directors considered that banks' foreign exchange open positions, and liquid assets and liabilities were well regulated and carefully monitored, while a significant part of the exchange rate risk was borne by naturally hedged borrowers. Nevertheless, Directors cautioned that the level of external liabilities, while not a cause of immediate systemic concern, posed medium-term vulnerabilities and reduced the room for policy slippages. They supported, in this connection, the authorities' objective of raising domestic saving, including through fiscal consolidation, and urged them to carefully monitor the debt levels of households and non-financial corporate borrowers.

Directors commended the authorities' continued progress in privatization, as evidenced by the recent divestment of the remaining public stake in the banking sector, and encouraged them to privatize telecommunications as early as feasible. They also encouraged them to press forward with liberalization of the electricity sector, and of agricultural trade, where distortions and welfare losses remained large.

Directors welcomed the duty-free access accorded to imports from least developed countries and encouraged the authorities to increase official development assistance toward the UN target of 0.7 percent of GNP. They also supported the authorities' efforts at combating money laundering, the financing of terrorism, and other financial crimes.

Iceland publishes statistical data on a sufficiently timely and comprehensive basis to permit effective surveillance.

In light of the positive assessment of the FSSA update and encouraging macroeconomic performance, Directors agreed that Iceland return to a 24-month cycle for Article IV consultations.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/03/79 (8/20/03) and EBM/03/80 (8/22/03).

6. OVERDUE FINANCIAL OBLIGATIONS—STRENGTHENED COOPERATIVE STRATEGY—REVIEW

The Fund has reviewed progress under the strengthened cooperative strategy with respect to overdue financial obligations to the Fund as described in EBS/03/118 (8/14/03).

The Fund reaffirms its support for the strengthened cooperative strategy and agrees to extend the availability of the rights approach until end-August 2004. (EBS/03/118, 8/14/03)

Decision No. 13080–(03/80), adopted
August 21, 2003

7. SENIOR DEPUTY DIRECTORS—SALARY SUPPLEMENT

It is recommended that, with effect from August 1, 2003, the Managing Director be authorized to award each Senior Deputy Director an annual salary supplement in an amount between $3,000 and $8,000. (EBAP/03/103, 8/6/03)

Adopted August 21, 2003

8. EXECUTIVE BOARD TRAVEL

Travel by Assistants to Executive Directors, by Advisors to Executive Directors, and by Executive Directors as set forth in EBAM/03/109 (8/19/03) are approved.

APPROVAL: November 5, 2003

SHAILENDRA J. ANJARIA
Secretary