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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 02/89

10:00 a.m., August 28, 2002

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Decisions Taken Since Previous Board Meeting

Executive Board Attendance
H. Köhler, Chairman
E. Aninat, Acting Chair

Executive Directors	**Alternate Executive Directors**
S.M. Al-Turki	M.F. Melhem, Temporary
	A.A. Al-Nassar, Temporary
	D. Ondo Mañe
	N. Mensah-Zekpa, Temporary
	E. Pinto Moreira, Temporary
	N. O'Murchú
	P.R. Fenton, Temporary
	F. Vermaeten, Temporary
M.J. Callaghan	H.-H. Jang, Temporary
	M. Di Maio, Temporary
	W. Szczuka
	T. Skurzewski, Temporary
	F. Zurbrügg, Temporary
K. Bischofberger	R. von Kleist
	C. Harzer, Temporary
P.C. Padoan	A. Lanza, Temporary
D.I. Djojosubroto	Low K.M.
	M.P. Bhatta, Temporary
Y.V. Reddy	R.A. Jayatissa
	P.R.D. Prasad, Temporary
W. Kiekens	M. Marques, Temporary
	J. Sipko, Temporary
Ó. Ísleifsson	B. Andersen
	A. Alber, Temporary
	M. Lundsager
	J.W. Ralyea III, Temporary
	A. Baukol, Temporary
	S. Boitreaud
	S. Boucher, Temporary
	B. Couillault, Temporary
A. Mirakhor	G. Nadali-Ataabadi, Temporary
A.V. Mozhin	L. Palei, Temporary
	S. Vtyurina, Temporary
	I. Zakharchenkov, Temporary
H. Oyarzábal	O.E. Garner, Temporary
	P. Moreno, Temporary
	M.A. Brooke
	B. Mellor, Temporary
M. Portugal	V. de los Santos, Temporary
	A.A. Tombini, Temporary
	A. Rambarran, Temporary
	I. Usman
	A.S.F. Atoloye, Temporary
	G.M. Campos, Temporary
	J.T. Kanu, Temporary
A.S. Shaalan	T. Koranchelian, Temporary
	K. Sakr, Temporary

Wei Benhua	Wei X., Temporary Yu J., Temporary
J. de Beaufort Wijnholds	Y.G. Yakusha D. Radev, Temporary
K. Yagi	N. Watanabe, Temporary
A.G. Zoccali	G.R. Le Fort D. Vogel, Temporary

S.J. Anjaria, Secretary
A. Mountford, Acting Secretary
M. Watson, Acting Secretary
O. Vongthieres, Assistant
H. Mooney, Assistant
J. Puig, Assistant

Also Present
IBRD: B. Bryce, P. Conroy, O. Kalantzopoulos, R. Hood, C. Nuamah. ECB: B. Kisselevsky African Department: N. Kirmani. Asia and Pacific Department: Y. Horiguchi, Director; K. Kochhar. European I Department: B. Banerjee, N. Gueorguiev, T. Harjes, N. Mates. European II Department: J. Dodsworth, Deputy Director. External Relations Department: G. Hacche, Deputy Director; M. Bell, A. Gaviria, J. Hayden, C. Lotze, R. Nord. Independent Evaluation Office: M.S. Ahluwalia, Director. Legal Department: M. Luedersen. Middle Eastern Department: N. Carnot. Monetary and Exchange Affairs Department: A. Gulde, H. Huang, G. Sensenbrenner. Policy Development and Review Department: M. Allen, Deputy Director; N. Blancher, W. Brown, A. Kapteyn, R. Kincaid, S. Lall, A. Matzen, M. Schulze-Ghattas, M. Walsh. Research Department: A. Husain, M. Kumar, D.J. Robinson. Secretary's Department: L. Hubloue, M. Miller, P. Ramlogan. Statistics Department: C.A. Sisson. Treasurer's Department: E. Canetti, C. Hatch. Western Hemisphere Department: T. Boote, S. Elbe, J. Guzman, M. Jul, R. Pearson, A. Salehizadeh. Office of the Managing Director: A.A.E. Bertuch-Samuels, Special Advisor. Office of Technical Assistance Management: R. Carey. Advisors to Executive Directors: M. Beauregard, S. Çakir, S.S. Farid, N. Guetat, A.R. Ismael, J. Jonáš, K. Kanagasabapathy, D. Lewis-Bynoe, H. Litman, Liu F., A.D. Marinescu, P.A. Nijsse, C.E. Pereyra, H.E. Phang, S. Rouai. Assistants to Executive Directors: C. Adam Gust, A.S. Al Azzaz, T. Belay, J.G. Borpujari, Cao L., N. Epstein, H. Fabig, N.H. Farhan, B. Gulbrandsen, T. Hadded, Jin Z., T. Komatsuzaki, P. Lathouly, A. Maciá, R. Maino, T. May, T. Moser, L. Rizzotti, B. Siegenthaler, A. Stuart, S. Urinbaev, D.B. Waluyo, A.Y.T. Wong.

1. GLOBAL FINANCIAL STABILITY REPORT

Document: Global Financial Stability Report (SM/02/257, 8/14/02)

Staff: Häusler (ICM); Tran (ICM); Odenius (ICM)

Length: 3 hours

Mr. Shaalan submitted the following statement:

In spite of the sharp turnaround in the economic outlook, and in the deterioration in financial markets reflected in a number of key indicators cited in the Report since the end of the first quarter, and the many potential and identifiable risks to the global economy that lie ahead, the Report is rather sanguine on the near-term prospects for the world economy. While the Report points out that, on balance, investment sentiment has moved down a notch from "caution" to "anxiety", it is not in a state of "panic"; the global financial system reportedly remains resilient and market adjustments have been orderly. So far, this may well be true, but in projecting the current state of affairs to the future, in our view, more weight should be accorded to the potential, and in some cases realistic risks. This is particularly true for those markets that have been greatly disrupted, including, in particular, the corporate sector bond market.

The Report rightly refers to the observed increase in risk aversion associated with a cloudy global economic outlook occasioned by a number of factors cited, which could give rise to investor, both domestic and foreign, liquidation of equity positions. However, it is maintained that continued value erosion of equity is judged not to have much of an impact on the economy. In contrast, the Report also points to the possibility of a confidence engendered equity price correction that could derail the global economic environment. It would have been useful to further elaborate on these two differing conclusions possibly with regard to the extent of the equity price erosion that would trigger a recession or a derailment of the nascent recovery, in contrast to the aforementioned relatively muted impact. Moreover, should an equity price decline be accompanied by a burst in the real estate bubble, the negative impact on economic recovery through the consumption and investment channels, which could reinforce each other, would be magnified. This phenomenon could have been brought forward and assessed in the Report.

Notwithstanding the aforementioned reservations, we would have liked to see considerably more analysis on the interaction between the financial and the real sectors of the global economy, and the reasons for the recently observed dichotomy between developments in the two sectors. Hopefully in the next Report, an attempt will be made to more fully integrate developments in the two sectors.

While on the subject of integration, we also wish to point out that reading the *Global Financial Stability Report* after having read the last *WEO* report, I was struck by the amount of the information overlap between the two documents, as much of the information was duplicated in both reports. If this observation has merit, considerably more coordination and collaboration between the Research Department and the International Capital Markets Department would be called for to enhance the analytical value of both reports.

Regarding adjustments in currency markets, and in particular, the large and still rising U.S. current account deficit, the Report, while recognizing risks, notes that the adjustment of what is reportedly an overvalued dollar need not be abrupt or disruptive. Among the reasons given for this conclusion is the considerable emphasis placed on the premise that other viable global investment outlets are in short supply. Hence, there are limited alternatives to capital inflows that would prevent a sharp slowdown in net capital inflows into the United States, thereby limiting the scope of a disorderly currency adjustments. The historical analogies of orderly current account adjustments in the past may not be a useful guide to future developments in view of the considerably more integrated and complex financial markets and its vast network of information technology. Moreover, there surely must be other options to attract capital flows should the U.S. economy's prospects deteriorate.

Admittedly, with the high level of uncertainty, and the fact that in some important respects we are treading uncharted waters, given the nature of the rapid integration of the global economy. In these circumstances, it is difficult to foresee future economic developments. If indeed that is the case , this position needs to be clearly stated.

On emerging market development and financing, we very much appreciate the focus on the potential for contagion, which has recently been, in my view, underplayed. Here, the Report could have benefited from distinguishing between two types of contagion (e.g., Argentina spilling over into Uruguay, which is specific; and generalized risk aversion that can cover a whole asset class, and sometimes beyond that). The Report rightly points out that the threat of contagion, both direct and indirect, while not reaching the peak levels attained in past crises, is a matter of some concern. This concern could be aggravated should interest rates in mature markets face upward pressures, particularly as the process is being driven by global risk aversion. This is an eventuality that cannot be discounted, particularly that it would likely be accompanied by tight capital markets, both in the form of syndicated loans and bond issuance. The increasing difficulties for a number of emerging market economies in financing their requirements through bond issuance is already evident; this has been aggravated by what appears to be generalized retrenchment of banks from credit markets. This is a major development.

These considerations, as well as the fact that bilateral financial blows seem to be drying up, should be taken into account in defining the financial role of the Fund when we discuss the paper on Access to Fund Resources in Capital Crisis Situations.

Finally, the section on the recent developments of emerging local markets is a valuable addition to the Report. Not surprisingly, government debt instruments have developed at a faster pace than corporate issuance. In both cases, these instruments have a potential to reduce the dependence on risks associated with international flows, but this will take some years. We urge further study of the topic and the provision of technical assistance to emerging market countries to develop the infrastructure that would underpin promoting this activity on a sound basis.

Mr. Mirakhor submitted the following statement:

Key Points

- The *Global Financial Stability Report* is becoming a valuable tool for Fund's multilateral surveillance.

- While the Report depicts a somewhat troubling picture of recent developments, the staff assessment that the global financial system remains resilient and that stability will be maintained is reassuring.

- Problems of corporate governance, reporting of earnings, and accounting practices, in general, continue to affect investor confidence and increase risk aversion in mature markets, which further exacerbate financial conditions for and market access by emerging economies.

- Advanced economies have an important role to play in restoring investor confidence in the functioning of markets.

- The Report highlights the risk of market developments on some financial institutions, particularly in Europe. This reinforces the relevance of relying on FSAP and other ROSCs as tools for Fund's surveillance of financial markets in advanced economies.

- The analysis of a sudden slowdown of net capital inflows into the United States is handled in the Report sensitively and competently. It is important for advanced economies to pursue policies that foster orderly reduction in global imbalances.

- The Report makes a valuable contribution to assessing the risk of contagion in emerging markets, and highlights the importance of well-developed local bond markets as a cushion against shifts in international investor sentiment.

- The inclusion of data in the Report on the use of collective action clauses by sovereign borrowers is appreciated.

We thank the International Capital Markets Department for another excellent *Global Financial Stability Report*, which is becoming a valuable tool for Fund's multilateral surveillance. The selection of the Report's topics is timely and appropriate. We appreciate, in particular, the analysis of the risks associated with changes in the pattern of global capital flows, as well as the selected topic on emerging local bond markets. We also welcome the inclusion of recommendations for actions to be taken by the IFIs, as well as by advanced and emerging-market economies, to strengthen global financial stability.

The Report depicts a somewhat troubling picture of recent developments in the international capital markets, including loss of investor trust and confidence and increasing volatility and risk aversion in mature markets, closure of market access for most emerging-market economies, and emergence of contagion. However, the staff assessment that the global financial system remains resilient and that stability will be maintained is reassuring. The Report notes the continued investor discrimination between classes of emerging-market countries and the stabilizing role being played by well-developed local bond markets. It is little comfort, however, that economic fundamentals do not seem to play an effective role in the formation of the basis for this discrimination; Brazil is a case in point.

The Report points to three main sources of risk in mature economies' financial markets: continued erosion of investor confidence, impairment of the capital positions of key financial institutions, especially in Europe, and the risk emanating from a rapid slowdown of net capital flows into the United States. As the Report notes, problems of corporate governance, reporting of earnings, and accounting practices, in general, continue to affect investor confidence and increase risk aversion in mature markets, which further exacerbates financial conditions for emerging markets and reduces their market access. Advanced economies have an important role to play in restoring investor confidence in the functioning of markets. In this connection, while the initiatives to address weaknesses in corporate governance and accounting, detailed in Box 2.1 of the staff report, are welcome, there is a need for continuous vigilance and concerted efforts on the part of financial markets regulators and supervisors. The Report rightly highlights the risk of market developments on some financial institutions, in particular in Europe. This reinforces the relevance of relying on FSAP and other ROSCs as tools for the conduct of Fund's surveillance on financial markets in advanced economies.

The analysis of the risk of a sudden slowdown of net capital inflows into the United States is handled sensitively and competently. The Report's assessment that the risk of disorderly financial adjustment may be mitigated by perception by international investors that U.S. financial assets remain attractive, is reassuring. However, the Report indicates that developing countries remain vulnerable to shocks affecting capital flows, international financial markets, and the U.S. dollar. It is, therefore, important for advanced economies to pursue policies that foster orderly reduction in global imbalances—an issue covered extensively in the current *WEO*.

Developments in emerging-market financing during the second quarter of 2002 were characterized by a slowdown in capital inflows, emergence of contagion, and retrenchment of bank lending as a result of the erosion of investor confidence in mature markets. The Report makes a valuable contribution to assessing the risk of contagion in emerging markets. Among the three potential channels identified, financial contagion, reflected in the retrenchment of cross-border lending and roll-over, constitutes the most direct threat.

The Report highlights the importance of well-developed local bond markets as a cushion against shifts in international investor sentiment. Such markets also play an important role in the promotion of domestic savings and, therefore, in the alleviation of vulnerabilities associated with foreign borrowing. The staff should be encouraged to continue to seek ways to promote domestic saving, and, in particular, local bond markets, with broader geographic coverage. While we appreciate the advice and assistance of the International Capital Markets Department to the countries of our constituency, it is disappointing that no country in Africa and the Middle East was covered in the otherwise very interesting analysis. Be that as it may, some recommendations on best practices, drawing on experience, for local bond market development would be helpful. Finally, the inclusion of data in the Report on the use of collective action clauses by sovereign borrowers is appreciated. The staff is encouraged to keep this issue under close review.

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

General Remarks

Regarding the sizable adjustment of stock prices and the elevation of risk aversion in the U.S. stock market, while the staff places as a baseline scenario the projection that internal market forces, such as contrarian investors buying stocks at depressed prices, would keep the market at bay, it also presents an alternative scenario in which the U.S. market would suffer a further adjustment if individual or overseas investors begin panic selling. As the *Global Financial Stability Report* in March accurately pointed out the risk that excessive expectations on recovery of corporate profits would invite an adjustment, at this juncture, we need sufficient vigilance on a further downward risk. With the bandwagon effect caused by the increase in leveraged positions, markets have become more vulnerable to a sea change and are apt to be maneuvered down further with the tide. In addition, heightened volatility in the market will cause a knee-jerk reaction on the part of nervous participants in responding to news headlines. Meanwhile, we must closely watch the market movements.

While it is difficult to prevent overshooting when excessive expectations collapse, the world authorities have no option but to put forth their utmost efforts to do just that. In this regard, this Report appropriately lays out measures industrial countries and emerging market economies are required to take in a simple but pointed manner. Obviously, the proximity in timing to the *WEO* has made drafting this Report a difficult task due to the need to avoid redundancy in a short period of time, among other things. Having witnessed a significant change in the market since the last issue of the *Global Financial Stability Report*, the case is now abundantly clear for the need to quarterly monitor the market movement. Also, it is appropriate that the Report present policy recommendations, particularly at the time of implications of the market movements, as key to the real economy. Staff's efforts to ensure consistency with WEO are to be commended. That said, there is some room for improvement on thc relationship between the two reports.

The Disturbance of Mature Markets

Mature markets in general—not only stock markets, but also bond markets and foreign exchange markets—have suffered large adjustments, with the epicenter seemingly in the U.S. stock market. A series of accounting fraud incidents, along with the continued process of the bursting of the TMT bubble and unwinding of excessive expectations on corporate profits, have pushed down stock prices and deprived investors of their inclination to take risks. While we applaud the U.S. Congress' initiative to strengthen corporate governance as a first step toward restoring confidence in the markets, the process of restoring investors' confidence may last quite a while until it is widely perceived that all large accounting fraud incidents have been revealed. The authorities are required to make that process as short as possible by conducting strong enforcement under the new legislation. However, markets will remain vulnerable to any additional external shocks for a while.

The most serious concern lies in the possibility of a downward spiral materializing between the markets and the real economy in which continuation of the market disturbance further pushes down the recovery pace of the real economy. In our view, housing prices will be key to the behavior of individual investors and, therefore, have to be monitored carefully. So far, these prices have maintained an upward trend, underpinned partly by the decline in long-term interest rates, and have mitigated the impact of the plunges in stock prices. It is not reasonable to assume, however, that growth expectations on corporate profits and on rent will continue to deviate from one another, as both should be correlated to income growth. Also, it is possible that a substantial decline in stock prices would force many homeowners into selling real estate.

The decline in stock prices in the United States has spread to the Japanese and European stock markets almost in parallel, with the background that the recovery of Japan and Europe has been led by net exports and that the relationships beyond national borders in capital and corporate activities has been strengthened. A prolonged stock market slump will possibly have serious impacts on the European banking and insurance sectors that have large direct and indirect exposures to stocks. The U.K. and Swiss authorities seem to have responded to the capital loss at insurance companies by loosening capital regulations. We would appreciate the staff's views on the validity of such a policy.

The *WEO* that the Board will discuss next week presents the view that the capital flow into the United States in the 1990s has been rooted to excessive expectations on productivity growth associated with the IT revolution. At the same time, the staff sees a dim possibility of a rapid adjustment in capital flow into the United States. Once such expectations change courses, however, there is risk that the momentum for reversal will be strong. In addition, given that the repeated accounting fraud incidents have substantially impaired credibility in the U.S. stock market, the U.S. authorities and the Fund need to monitor developments in the capital market closely.

The Stagnation of Capital Flow into Emerging Economies

The strengthening of risk aversion in mature markets and the increasing concern for political risks in Brazil and Turkey that might cause reform efforts to come to a halt have thinned capital flow into, and even withdrawn capital from, emerging market economies, and have dealt a serious blow to those economies that depend on external financing. Except for countries that have experienced net capital outflow, however, the fact that a number of emerging market economies had already completed required financing for the year 2002 in the first quarter when market access was once restored for emerging market economies has somewhat contributed to avoidance of a rapid squeezing of liquidity.

In contrast to the initially limited contagion from the Argentine crisis, concern for the debt sustainability of Brazil has had significant repercussions on other emerging market economies in general. In addition to Brazil's economy being far larger than Argentina's, the fact that the market sentiment for Brazil has abruptly reversed from the optimistic one that prevailed in the first quarter may explain such a difference. Also, the Brazilian authorities' failure to reverse excessive dependence on bonds indexed to overnight interest rates and foreign exchange rates despite repeated warnings by the Executive Board has worsened the debt sustainability. It would not be an exaggeration to say that whether capital flow into emerging market economies can be restored hinges on improvement in market sentiment on Brazilian debt sustainability. We sincerely hope the Brazilian authorities will adhere to prudent policy management while the Fund's commitment is given.

While all emerging market economies have been more or less adversely affected by the disturbance of the market, a number of Asian and East European economies were able to issue new bonds or equities during the second quarter. This shows the market has not lost its function for discrimination. For crisis-hit Asian economies in particular, the current disturbance was the touchstone of achievements by the reform efforts. The marked reduction of external vulnerability due to the shift to a flexible exchange rate regime and the improvement in composition of debts, among other things, as well as the maintenance of momentum of recovery amid the slowdown of recovery pace of the world economy, have been fully appreciated in the markets.

Bond Markets in Emerging Markets

The outlook on bond markets in emerging markets shows a significant difference in the degree of development in bond markets among economies and the authorities of the economies with deeper bond markets often show a clear desire to nurture the market. Those who are behind are required to nurture their own market following the successful experiences of others. It is interesting to know that economies such as Hong Kong and Singapore, where the needs from the fiscal side do not exist, also aim at nurturing bond markets with the recognition that drawing a reliable risk-free yield curve is key to development of the overall financial market. The development of a bond market would also provide important methods for monetary policy operations.

The staff concludes from the study that, in some emerging market economies, the cultivating of bond markets would prevent contagion of a crisis from other economies and also provide an alternative channel for corporations during a time of stress. As the case of Brazil has revealed by chance, such positive results could be rewarded only in tandem with prudent public debt management.

Mr. Rustomjee submitted the following statement:

We thank the staff for producing another very detailed *Global Financial Stability Report (GFSR)*. We welcome in particular the improved organization of the *GFSR*, which provides very useful highlights, which are complemented by detailed analysis of financial market developments in mature markets and emerging markets in separate chapters of the *GFSR*. We also very much welcome the in-depth analysis of the development of local securities markets in emerging economies, with the emphasis on the bond market as an alternative source of funding for both sovereign and foreign borrowers.

Market Developments in Mature Markets

The *GFSR* highlights that financial markets in mature economies remained volatile during the last quarter. Global financial markets have weakened significantly and equity markets have fallen sharply, since end-March 2002. This has been driven by a combination of factors, including downward revisions of earlier profit forecasts; concerns about the sustainability of the recovery; and widespread concerns about accounting and auditing practices, particularly in the United States. While the equity markets have recovered recently, they have nevertheless remained volatile. Notwithstanding these developments, we are reassured by the observation in the *GFSR* that the global financial system remained resilient as a result of wider dispersion of corporate and financial risks to non-bank financial institution. Continued reports of lower than expected corporate earnings, corporate scandals, and volatile equity markets could, however, have a negative impact on the sustainability of the current growth outlook and the prevailing financial resilience in mature economies. We remain, therefore, concerned at the likely impact on emerging economies should the current growth outlook and resilient financial environment in mature economies prove less sustainable.

The *GFSR* also highlights the depreciation of the U.S. dollar against the euro and yen, although more moderately in trade-weighted terms. Many market observers attribute the euro's recent surge to the dollar weakness, rather than to euro strength. In part, this appears to have reflected growing concerns about the large U.S. current account deficit, and a diminution in the attractiveness of U.S. assets. The possibility of a further realignment of the U.S. dollar vis-à-vis other major currencies appear to remain a risk, particularly since doubts exist about the sustainability of capital flows needed to finance the U.S. current account deficit. In this regard, in our view, the possibility of a disorderly unwinding of the U.S. current account deficit should not be completely discounted with possible negative ramifications for the global growth outlook.

Market Developments in Emerging Market Economies

While the spreading of contagion in emerging economies was relatively well contained during the previous quarter, the favorable climate in emerging economies, particularly in Latin America, dissipated during this quarter. The weakening of the global financial conditions, as well as local developments, led to a deterioration of financial market conditions in emerging economies. We concur that this increased volatility in emerging markets partly reflected higher risk aversion and global uncertainties, but, more fundamentally, country specific factors. From mid-April, sentiment toward Latin America, and particularly Brazil, has deteriorated, prompted by rising political uncertainties and concerns about debt dynamics. As spreads rose, these concerns became increasingly self-reinforcing, culminating in mid-June with a full-scale sell-off of emerging market debt and a decline in emerging market financing.

We welcome the pro-active stance adopted by the Fund Management to address the escalating uncertainty in emerging economies. In this regard, the announcement of a new $30 billion Stand-By Arrangement with Brazil, subject to Board approval, is in our view appropriate. This policy stance could lead to reducing vulnerabilities and uncertainties both in Brazil and in emerging markets more generally.

The *GFSR* also mentions a strong tendency towards risk aversion in the euro- and yen-denominated markets, largely due to a fall-off in retail demand for emerging market bonds in these markets after Argentina's default. We have been concerned to note that this deterioration in sentiment is particularly prevalent in Latin American countries. Nevertheless, it is also noted that countries with investment grade credits could still access the market. In this regard, since April 2002 euro and yen markets remained opened primarily to issuers with an investment grade rating, or to those providing diversification and considered to be unlikely to be affected by broader market turmoil. Among the countries that could under these conditions access foreign capital markets, South Africa successfully issued a bond of $1,000 million.

Emerging Equity Markets

We note that while emerging equity markets declined in synchrony with that of mature equity markets, they outperformed their mature market counterparts. The declines recorded were the largest in Latin American economies, followed by those in Asian economies, while the Middle East and Africa indexes suffered only moderate decline. The South African index recorded a 7.3 percent gain during the last quarter, notwithstanding a decline in mid-June.

Foreign Exchange in Emerging Markets

Developments in the foreign exchange markets during the period under review in emerging economies were mixed, with the exchange markets deteriorating sharply in Latin America, and rising in Asian economies. The decline in the foreign exchange position in Latin American economies remains particularly worrisome in the light of the sovereign and corporate foreign debt dynamics. A rebalancing of the domestic and foreign debt in Latin American countries is required over the medium to long run to reduce this source of vulnerability.

Selected Topic: Emerging Local Bond Markets

We welcome the inclusion of the very detailed analysis concerning emerging local bond markets in the *GFSR*. The analysis highlights the growth of the local bond markets in emerging economies in recent years, as an alternative source of funding for both sovereigns and corporates. We broadly concur with this analysis. We would urge the staff to consider a broader dissemination of this interesting analytical article.

Mr. Al-Turki submitted the following statement:

I thank the staff for the comprehensive update of recent international financial market developments and prospects. The presentation captures the complexities of an increasingly integrated global financial market and its risks and vulnerabilities. These complexities along with the rapid shifts in sentiment and investment flows highlight the importance of close Fund surveillance of financial markets. Here, I will add a few comments.

Developments in Mature Markets

Recent developments in international financial markets could well be summed up as an unfolding of further weakness and continued vulnerability with instances of averted dangers. The slowing down of the global recovery in the second quarter, coupled with new revelations of inappropriate accounting and fraud in some high profile U.S. companies, undermined confidence further and led to sharp declines in global equity prices during June and July. This decline notwithstanding, it is encouraging that the equity markets remained resilient and panic selling did not materialize. Moreover, there are indications that equity prices may have bottomed out. As the staff notes, valuations of U.S. and European equity markets have moved closer to historical averages. In addition, the certification of financial statements by the CEOs of major U.S. corporations appears to have improved the outlook. Indeed, equity prices have been on an uptrend over the past three weeks.

That said, I agree that the outlook remains subject to substantial risks. The staff is right to express concerns over dangers posed by a possible sudden realignment of exchange rates involving a sharp depreciation of the U.S. dollar. A worsening of the economic picture in the U.S. or further corporate scandals could undermine the U.S. image as a safe haven, thus leading to a reversal of capital flows and putting pressure on the U.S. dollar. At the same time, the size of the U.S. in the global economy, as well as the lack of obvious better investment alternatives at this time should reduce this risk.

Another risk is the increased level of bankruptcies and the implications of a further shift to quality by investors. In this regard, a further rise in spreads on riskier lending could lead to additional bankruptcies, thus pressuring financial institutions, profitability, and leading to even tighter credit conditions for second tier borrowers. A credit setback in emerging markets could also greatly aggravate the situation for a number of large banks. The continued security and military uncertainties pose another major risk that weighs on financial markets. While quantifying this risk may be difficult, it is important not to underestimate its impact on confidence in both the industrial and the developing countries.

Against that background, the priority of restoring investor confidence and supporting the recovery is clear. Indications that the monetary stance will be maintained or further loosened if the recovery stalls are, therefore, welcome. It is also important to allow the fiscal stabilizers to operate. In addition, an intensification of actions to improve corporate accounting and disclosures, as well as enhancing prudential supervision of financial institutions remains essential.

Developments in Emerging Market Economies

Developments in emerging market economies mirrored to a large extent the developments in mature markets. The slowing down of the global recovery along with increased risk aversion have led to a decline in capital flows to emerging market economies. Uncertainties over policy continuity following the coming elections in Turkey and Brazil along with contagion from developments in Argentina and Brazil have further aggravated the situation. Indeed, as the staff notes, contagion effects were felt since end-June even in countries with high grade ratings, like Mexico. This is worrisome, especially since the outlook remains subject to a number of risks. If interest rate spreads widen further, the already difficult debt situation facing many emerging market economies and companies could become untenable. This could increase contagion and, as I noted earlier, put substantial strain on the financial sector in the mature economies. Here, I agree with the staff that "dollarization of financial sector balance sheets poses systemic risks and is a potential further channel of contagion." In that context, I would like an elaboration on the conclusion that "...systemic risks associated with dollarization most likely manifest themselves as a result of a crisis rather than as a potential cause..."

That said, I share the staff's view that there are factors that mitigate the risks in the outlook. The continued market access for bond issuers in Asia, Eastern Europe, and the Middle East is encouraging. Moreover, as the staff notes, the increased market attractiveness of bond issues and the rising cash holding of dedicated investors could help support bond prices. The improvement in the outlook for earnings growth in emerging market economies is a further positive sign. Nevertheless, the timing of a turnaround remains uncertain and vigilance is essential. In this regard, I fully agree on the need to encourage domestic savings and to effectively channel those savings to domestic investments. Here, I found the chapter on Emerging Local Bond Markets very useful. While the progress made in expanding domestic bond markets is encouraging, further efforts are still needed in order to reduce dependence on foreign financing and thus help minimize vulnerability to contagion.

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

At the outset, we would like to thank the staff for preparing the third issue of the *Global Financial Stability Report (GFSR).*

We would like to make the following comments regarding the format of the report, the risks outlined in the Report, and the development of local bond markets in emerging economies. We conclude with some comments on financial contagion and the role of the Fund, and on some specific quotes to some countries of this constituency.

Format of the *GFSR*

Being the third issue of the *GFSR*, it is important to further streamline its content in order to give a better idea of where we stand and the risks we face. In that vein, we think considerable progress has been done in improving its structure, although we would have preferred to treat each group of countries by subsections (mature, emerging, and developing economies). This way, the reader would focus its attention in each grouping, instead of jumping from one set of countries to another as a new paragraph begins. The same comment applies to Chapter II, where the sources of risks are analyzed.

With regard to Chapter III, which constitutes an addendum to the last two issues of the *GFSR*, but contains information that used to be reported in its predecessors (the *International Capitals Markets Report* and the *Emerging Market Financing*), we would suggest to include this information in boxes, at the end of the Report, in the form of annexes. These boxes should be merely informative and descriptive of recent developments with regard to the issue under analysis. This way, the reader interested in a particular topic could refer to the relevant box. Standardizing this section will also help make the *GFSR* more user friendly. Finally, presenting only one selected topic reflects the suggestions made by many Directors in the last meeting, including this chair, a change that we strongly support.

Risks to the Global Financial System

The most important message of this issue of the *GFSR* is that "(…) the most likely outcome is that financial resilience and stability will be maintained." We strongly support this view, given the efforts done in the past in both mature and most emerging market economies to improve the resilience of financial markets. Having said this, we should not put aside important risks that will put to the test these efforts.

With regard to the risks pointed out by the staff, we would like to make two general comments. First, the last issue of the *GFSR* stressed the fact that the recovery and quality of corporate profits in mature markets were the major uncertainty to the global financial system. We hardly found in this issue references to this risk, which in our view has played a major role in capital markets. Second, and in line with the incoming *WEO*, one of the most important risks to the future economic growth in industrialized economies are the prospects in the real estate market. More analysis of this sector would have been welcomed. The staff's comments on these two issues would be welcomed.

With regard to the industrialized economies, lower expected economic growth in the United States and Europe, and the still fragile situation in Japan, calls for continuous monitoring of developments in these economies and in their financial systems. Special attention deserves the situation in the corporate sector in these economies. Investor confidence has been badly hurt by recent scandals and fraud practices, particularly in the Unites States. Swift actions in this country are quite welcomed, although it remains to be seen if the proposed reforms are enough to solve this problem. In this regard, emerging market economies can draw invaluable lessons from this experience.

Turning to emerging market economies, it seems that this group of countries is trapped in this uncertain environment. On the one hand, specific risks related to developments in South America seem to be well contained. The effects of contagion throughout the region, both financial and through real channels, is indisputable. However, neither emerging Asia nor Chile and Mexico have experimented massive disruptions in their financing flows. For example, just last week HSBC announced it would invest more than a $1 billion in the Mexican financial system this year. On the other hand, nor have the domestic financial markets in these economies been seriously affected. In most cases, exchange rate depreciations and higher interest rates constitute the normal response to higher uncertainty in global financial markets. But, what is important to highlight is that these adjustments have taken place in an orderly manner. We think this is a very important outcome that needs to be emphasized in the report.

A risk that is still evolving is the one related with the slowdown in net capital flows to the United States. Information recently released confirms that this trend continues. However, it is important to emphasize that this issue should be analyzed cautiously. Investors could well disinvest from the United States, but the amount needed to really cause a disorderly adjustment of the global imbalances would call for very large amounts of capital outflows. Are there, under present circumstances, real investment alternatives to host such amounts of capital? Like the staff, we think there are not. Although this could be reassuring and provide time to work on reducing said global imbalances in an orderly manner, it would be important to tackle what has caused these imbalances. In this regard, the priority in the United States should be to maintain a healthy fiscal position in the medium term; more emphasis should be put in the structural reform agenda and growth oriented policies in Europe, and in Japan, both a supportive economic policy with emphasis to the medium-term fiscal consolidation process and more efforts to pursue the structural reform agenda should be the priority.

Emerging Local Bond Markets

Securing a stable source of funding is always important, more so in times of increased uncertainty in the international financial system. But this is an effort that takes time. In doing so, reforms need to mature, investors, financial institutions and country authorities need to learn and the latter need also to react swiftly to changing circumstances.

A precondition to promote the development of a domestic bond market is to have a good institutional framework, with good corporate and governance practices that provides confidence to investors. A stable macroeconomic outlook is also fundamental to attract the attention of investors. Good supervision and regulation is key to maintain a healthy financial system capable to intermediate bond issuance and advise both corporations and investors. We think these issues were not covered in Chapter IV and are fundamental to promote the development of domestic bond markets.

Is the Fund doing something to reduce Financial Contagion?

It has always been explained that financial contagion arises due to herd behavior. And herd behavior is explained because same economic problems in different countries seem to worry investors, despite different institutional frameworks and authorities' track record. This type of contagion first took place after the Mexican crisis in 1994, and then in subsequent crises that other important emerging market economies experienced later in the decade. But as time has passed, it seems that investors are discriminating among economies. The Fund has clearly played a crucial role in this process by making transparency a cornerstone of the reform the institution has undergone in recent years. Countries have been motivated to become more transparent and to disseminate more and better information. But there can also be drawbacks in this progress. If vulnerabilities are the only thing that is highlighted, then investors will be more prone to act as a herd rather than to take discriminative actions.

A delicate balance needs to be worked out, between informing on relevant vulnerabilities and the differences among emerging market economies. This is a very important way to induce less herd behavior and to make investors more careful in "analyzing before acting." The Fund plays an important role in this process. In this regard, the reports released by the Fund are an important input to the investor community because they are viewed as a third and neutral opinion. But is this true, or is the Fund also a risk-adverse institution that prefers to err on the side of caution, highlighting mostly vulnerabilities rather than the authorities' policy efforts to promote more resilient economies?

Box 3.1—"The Scope for Emerging Market Contagion"—is a clear example how the Fund can promote financial contagion. Or being less sanguine, how this institution does not help to promote more differentiation among economies. Simple comparisons are dangerous. For example, saying that Mexico is more exposed to roll-over risk because an index that measures the type of creditor to an economy, currently under difficulties due to political reasons, is similar to Mexico's is quite a simple and dangerous comparison. This does not take into account differences in risk levels, institutional frameworks, differences in economic policies or in levels of integration to the world economy. Furthermore, we strongly doubt the figure that is being reported in this box corresponds to cross-border lending, which could indeed be subject to short-term investment decisions and thus retrenchment, but rather Mexican domestic banks with Spanish capital.

In the first place, the message that the Fund will convey to the market will be contradictory. The Fund has recently emphasized that the problems faced by Brazil are political and that its fundamentals are strong. Box 3.1 conveys a totally different message by pointing out the possibility of financial contagion to other emerging market economies without taking into account differentiating factors, such as risk levels or institutional frameworks, to mention just two. We must say that this type of comparisons only encourages, rather than reduces, financial contagion. The Fund needs to play a more active role in informing market participants about differences among economies that make them more resilient and less subject to financial contagion.

In conclusion, and recalling what the Managing Director recently pointed out in a luncheon with Executive Directors, that the analysis of the Fund needs to be balanced and focused on preventing crises in member countries, we strongly suggest the staff to delete Box 3.1 from the Report.

Specific Quotes to Countries of this Constituency

On page 26, "European banks have also been adversely affected by the deterioration in emerging markets. This included Spanish banks exposed to Latin America (see Figure 2.2), whose stock prices were highly correlated with Brazilian bond prices (up to 94 percent correlation for one bank)." We think this sentence is confusing and unwarranted and we strongly ask for its deletion. By mentioning such correlation, one could get the impression that Spanish financial institutions have a complete dependence on developments in Brazil, which is obviously untrue, since their exposure to Brazil is less than 2 percent of total assets for the banking system on a consolidated basis. Furthermore, we believe that there is a factual mistake in the reference to Figure 2.2, it should be Figure 2.3. Finally, as a general rule, we strongly object references being made to particular institutions. Therefore, we believe that the lower right box of Figure 2.3 should be deleted or replaced by the U.S. and European banking sector stock price indices, which would preserve the symmetry with the rest of the graphs in Figure 2.3 and better relate to the main message conveyed, i.e. the possible European and Spanish banks sensitivity to emerging markets.

Also on page 26, the Report indicates that "European bank's share prices—which have performed more poorly than those of U.S. institutions—may also have been affected by concerns over their complex accounting structures, similar to some of the more diversified U.S. financial institutions." This is by no means an intuitive statement that raises more questions than answers. It may be misleading, and if it is a hypothesis linking different accounting practices with share prices, it should be substantiated before being included in this Report.

On page 50, the staff points out that the correlation between Mexico and Brazil has increased sharply. We think this sentence needs to be qualified because there could also be other factors that may explain this increased correlation. In particular, increased correlations across the board can also be explained by higher risk aversion.

On page 62, the staff explains that the looser monetary policy adopted by the Bank of Mexico last April was done as an expression of concern about the overvaluation of the peso. Although the monetary authorities do not deny that the relaxation of the policy stance could have affected the level of the exchange rate, they have widely explained that their motive was not to depreciate the peso, but to adjust the monetary stance to prevailing information regarding inflation expectations under the inflation-targeting framework in place. If the staff wants to report what the market believes was the motive of said change in policy stance, we would ask the staff to also give due attention to the central bank's public explanation.

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

A Worrying Global Scenario

We welcome this *Global Financial Stability Report*. It provides a comprehensive, while worrying, overview of the sources of risk and uncertainty in the global financial system, and it nicely complements the information contained in the *WEO* to be discussed next week.

The Report identifies a number of causes for the deterioration of the global environment, namely: the bursting of the TMT bubble; the disclosure of a number of corporate bankruptcies and of several cases of unethical and illegal business practices; growing payment imbalances associated with a weakening dollar and reversal of capital inflows to the United States; and increasing signs of widespread contagion in emerging markets concentrated especially, but not only, in Latin America (the "geography of contagion" illustrated on page 52 of the Report depicts a worrying scenario).

Market reactions are leading to greater investor discrimination against high-yield borrowers and greater liquidity preference. While sources of instability are present in both industrial and emerging markets, the latter are taking the strongest hit, adding to the strains generated by the global slowdown. This asymmetry is an additional source of fragility for the global financial system that will have to be addressed, including through the development of local markets, a point we will return to below.

Two General Implications

Two general points are worth making with respect to the overall picture.

First, the sources of risk and vulnerability listed above are different aspects of a single event, the conclusion of a long phase of financial euphoria associated with the wave of innovation that started at the beginning of the past decade.

Second, there are only a few elements of support in the system—mentioned in the Report—working to prevent further deterioration: the (expected) recovery in activity and growth in advanced countries; the fact that the fall in asset prices is encouraging the acquisition of some underpriced assets, thereby generating the build up of a floor in prices; and the fact that, while the dollar is depreciating and is expected to fall further due to the decrease in profitability of U.S. assets, there are for the time being few, if any, realistic alternatives to dollar-denominated investments that could absorb funds flowing out of the United States.

Both these points suggest that the risk of an abrupt downward correction and the unfolding of panic selling might be larger than expected (a point well documented in the *WEO* also) and that, in addition to further progress in structural reform, which will bring results only over the medium term, the need might arise for policy authorities to take prompt action to avoid disorderly market dynamics in the short term. Joint policy action in financial and currency markets is useful and appropriate under exceptional circumstances and when market uncertainty is particularly high, a situation which might materialize in the near future.

True, both the *GFSR* and the *WEO* remind us that historical experience indicates that corrections to major payment imbalances have, in general, followed an orderly pattern. However, there have been episodes where this was not the case, and, more importantly, historical experience does not account for all future possibilities.

Weakness of EU Financial Institutions

The Report's assessment of the exposure of EU banks and the vulnerability of the bank-based EU system is overly negative, in our view, as it conveys the message that EU financial institutions somehow have to cope with a worse financial environment than U.S. financial institutions. Little evidence is included in the Report to support such a strong assertion. We believe that this issue needs to be further explored, including by providing comparative data on the recent performance of large U.S. financial institutions with significant exposure in distressed emerging markets and/or U.S. corporations. The partial evidence provided in the bottom right panel of Figure 2.3 suggests, if anything, that U.S. financial conglomerates have been as seriously affected by recent events as some of their most heavily exposed European counterparts. But the sample of institutions that have been considered is very small and does not allow any valid judgments to be made.

Contagion

The analysis is welcome, though it comes too late. A point stressed in the Report is that contagion is emanating from Brazil. While the situation in Brazil remains a source of concern, we are puzzled by the limited attention given to the contagion implications of the situation in Argentina. Indeed, this reinforces our perplexities at by the fact that contagion was ruled out forcefully when Argentina's crisis broke out and suggests that we may be running the risk of compounding past errors in the discharge of our surveillance responsibilities.

Looking ahead, other sources of contagion might break out, adding to global instability. One could be the situation in Turkey, which is now hopefully improving but that could turn around dramatically if security events in the region precipitate. The staff's comments on this possibility would be welcome.

Local Financial Markets

This is an important aspect and we welcome its inclusion in the Report. Efforts should be made to suggest policies to develop and strengthen local markets as complements to international markets. Strong local markets could mitigate the adverse consequences on emerging markets of a deterioration of global confidence, by allowing domestic savings to be channeled to local investors more efficiently. However, the relationship with international markets should be further explored. In particular, the risk that domestic markets may remain separated from international markets deserves further analysis.

Mr. Reddy submitted the following statement:

We would like to compliment the staff for bringing out another insightful and analytical *Global Financial Stability Report (GFSR)*. Recently, the conditions in global financial markets have deteriorated significantly. In this context, the *GFSR* has highlighted key developments in various segments of financial markets and identified the main sources of risks in a comprehensive manner. We broadly endorse the overall thrust of the Report and the proposed steps suggested to promote stability in terms of increased vigilance on the part of all countries and orderly reduction in global imbalances in advanced economies, while indicating the need for encouraging domestic savings and developing local securities markets by the emerging economies.

Towards the objectives of crises prevention and promoting global financial stability, the *GFSR* as a lead report, may consider an added thrust or emphasis in specific policy areas providing clues for market corrections and adjustments. From this perspective, we would like to offer a few suggestions:

As the *GFSR* rightly recognizes, it was the fear psychosis which caused the destabilizing behavior and unexpected contagion. We also appreciate the various steps taken at the international level to improve the integrity of accounting and auditing standards. It would be useful if the Report furnishes more details about the timely and comprehensive steps taken by the U.S. government and how these steps will adequately address the specific points of breach from accounting principles by certain companies as listed in Box 2.1. Similarly, the immediate steps taken or to be taken by other agencies and authorities in locations of other major financial centers may be highlighted in the Report. This could, to a certain extent help counter-balance the associated risks and build confidence of investors.

We agree that the improved market maturity is reflected in better investor discrimination between markets. In this regard, while there has been a general perception that in mature markets, the risks are better assessed by market participants, the recent events have belied this expectation. In this context, it may be useful if the factors contributing to better assessment of risks on the part of market participants are analyzed and highlighted in the report. This would help strengthen forces of market discrimination, minimize the contagion, reduce volatilities not consistent with economic fundamentals and bridge the dichotomy between real and financial sector developments, an issue rightly highlighted by Mr. Shaalan.

Part of the resilience in market adjustments is rightly attributed to the dispersed investment pattern and risk sharing through larger participation of retail investors and non-bank financial institutions. The report at the same time recognizes that the investor trust and confidence may continue to erode to the point of en masse withdrawal from financial and economic risk taking. It is already evident that there has been a portfolio shift from equities to fixed income markets. Furthermore, even the credit market response is expected to be adverse in these circumstances. These developments could have two implications. One, when the recovery picks up and gains momentum in the real economy, the equity market's positive response in particular in primary issues market may be delayed and prolonged dampening the investment demand. Two, it may have a secondary impact upon even the primary issuance market of bonds, since the leverage through bonds depend very much upon the growth of risk capital in the form of equities. The staff may consider adding, in brief, the implications of such possible consequences to global economic revival.

We fully support the *GFSR* that the advanced economies should pursue macroeconomic policies conducive to foster an orderly reduction in global imbalances. We also agree with the staff assessment that any significant portfolio shifts from the U.S. to other markets will have serious implications for both asset price movements and global economic revival. One of the recent features of global economic developments has been the lead role of the U.S. economy and U.S. financial markets in setting the trend in other economies. This role has to be treated as given in the short term. Hence, while some moderation in capital flows to the United States may be welcome, the Report may consider highlighting the criticality of the United States intensifying its policies to restore investor and business confidence as a global risk mitigating measure.

The wealth effect of financial market revaluation has been absorbed on household balance sheets and amounts to about 70 percent of disposable income. We would appreciate the staff's comments on the possible implication of this for U.S. current account balance and exchange rate of the U.S. dollar.

The *GFSR*, besides providing an assessment of short-term vulnerabilities and risks, also throws issues for consideration in the medium term. It would be useful to identify such issues for further examination.

First is the issue of corporate governance and integrity and the need for placing accounting and auditing standards on a sound footing. While the regulatory response in both the United States and elsewhere is encouraging, the intervention of IFIs may be necessary for swift follow up particularly in jurisdictions where major financial centers are located. In this regard, we support Mr. Mirakhor on the need for FSAP and other ROSCs as tools of surveillance in advanced economies. Can the IFIs consider a quick ROSC on accounting and auditing standards in major financial centers? We welcome the staff's comments.

The analysis of emerging market vulnerabilities shows some spill-over effects from advanced economies besides the impact of likely discontinuity in policies in some of the economies. Yet, the staff assessment shows several risk mitigating factors which are encouraging. The risks of trade-related contagion is assessed to be lower than the possible financial market contagion. This is an area which may need to be examined on a continuous basis.

We would also like to offer our views on the possible subjects of further research which over a period may improve the analytical content of the *GFSR*. Following are our observations in this regard:

The dollarization and the associated systematic risks in Latin America raise issues for the medium term in regard to evolution of exchange rate regimes. This may require continued attention and a focused study on this subject may be useful.

As the *GFSR* rightly recognizes, the recent market turbulence is not fully attributable to the reduced confidence in global recovery. It has been contributed more by the intertwined factors of uncertainties about corporate performances exacerbated by the non-transparent accounting practices and doubtful integrity of auditing and accounting practices. It was the fear psychosis which caused the destabilizing behavior and unexpected contagion. Will it be technically possible to isolate or segregate the extent of influence of the fear and "uncertainties" from the normal and expected influence of perceived and quantifiable `risks' in explaining the market behavior especially of equities markets? The recent events also underscore the need for a detailed review and assessment of traditional thinking on public policy and regulatory approach towards functioning of financial markets and large corporates. This is critical for restoring financial soundness and stability both at national and international levels. These aspects need to be studied in greater detail. We invite the staff's comments.

The selected topic coverage on "Emerging Local Bond Markets" provides an interesting analysis. We agree that the development of local bond markets could substantially provide an alternative and supplementary source of development financing. The thrust at the international policy level to development of local securities markets emanated out of the lessons from the East Asian financial crisis. In that sense, it could even be considered as a prerequisite for aggressive entry of a country into global capital markets. In studying domestic equity or bond markets, there is a need to recognize two linkages. First is the linkage between the domestic securities markets and the financial system. The securities market development has implications for the asset structure of financial institutions which are the major participants and the local credit market. Second is the linkage between the domestic financial market with the international capital market. With increased openness for investments in capital markets across borders, the risks of even local bond markets are linked to international capital market developments and it needs to be recognized that in the long run, the capital markets in an integrated world cannot be considered in isolation in terms of "local" or "domestic markets" as insulated from the global influences. With increased foreign participation in local markets, a greater integration of domestic with international markets is taking place. This may, in future, reduce the comfort of local bond markets providing a cushion against cross-border risks in financial markets. From this perspective, it may be useful to study the above linkages and the attendant risks from the point of view of strategically developing local securities markets and also the timing and proper sequencing of such market reforms. We welcome the staff's comments on this possible approach.

In analyzing strategies for bond market development across countries, there are certain country specific dimensions which may need to be kept in view. First is the distinction between low saving and high saving economies; second is the extent and size of government borrowing; third is the extent of capital account and capital market openness; and fourth is stage of development of equity market. Also important are the coordinated improvements required in development of technological infrastructure for payments and settlement, institutional infrastructure for deepening primary and secondary markets and legal and regulatory framework. The staff may consider bringing out a separate paper on the variety of practices and appropriate strategies for development of local securities markets.

We once again express our appreciation to the staff for making the *GFSR* a useful instrument of surveillance and making constant improvements to it to serve the purpose of identifying risks to prevent crises and promote global financial stability.

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

We thank the staff for the third *Global Financial Stability Report*. As before, its quality and the amount of work that lies behind it are impressive. The Report has continued to improve and the staff has made further efforts to respond to wishes expressed by Directors in the previous discussions. The Report has become more focused and forward looking, and we welcome the expanded and more explicit analysis of risks to financial stability. It may be sensitive to go further in candidness in writing, but it would be useful if the staff could elaborate a little more on the main risks in their oral interventions in the Board. We welcome that the Report not only analyzes the risks, but also makes policy recommendations based on the analysis. We support the measures suggested on page 11 to promote global financial stability. We also welcome that the Report is more closely linked to the *WEO* this time. Although we agree with Mr. Shaalan that there is some unnecessary overlap and duplication between the two Reports.

On the whole, the Report is developing in a positive way, but it has not found its final form yet. We would suggest that the format of the Report is reviewed after its first year, in light of the experience gained. One issue that could be considered in that context is the frequency of the Report. While discussing financial market developments quarterly in the Board seems to be an appropriate frequency, it may be a more efficient use of the International Capital Markets Department's resources to produce only two full-length Reports per year, and have additional, briefer capital market presentations in connection with the *WEMD* discussions in between. We are also wondering to what extent the Report is drawing on existing stability reports of central banks and supervisory institutions. It seems to us that they would be useful complements to private market sources.

The Report notes that conditions in financial markets have deteriorated since the last Report. The deterioration has been associated with a fall in asset prices, which to a large extent constitutes the bursting of a financial bubble, and therefore should be welcomed, in particular since the process has been orderly. As the Report accurately points out, there has been no panic selling this time. But the correction has been compounded by mismanagement, irregularities, and bankruptcies in the corporate sector, revealing structural weaknesses in governance and in accounting and auditing practices that have dramatically lowered investors' confidence in equity investments. This has lead to higher risk aversion among investors and may have caused some overshooting, but on the whole, valuations in equity markets in the U.S. and Europe have moved closer to historical averages. As the Report notes, this development has removed one source of financial instability.

The turbulence in financial markets has also led to higher risk aversion in general. The key question is whether the risk aversion is excessive, and how long it will last. There has been a widespread move to quality, which is creating financing difficulties for many emerging markets. Signs of contagion are more evident now than at the time of the previous *Global Financial Stability Report*. But in spite of the increased risks, we would caution against taking an excessively pessimistic view at this point.

The Report has a strong focus on the U.S. economy and the U.S. financial markets. This is understandable, since the U.S. markets certainly play a central role for global financial flows and recent events in the U.S. have been instrumental in driving asset prices down. It is crucial that the governance problems in the U.S. corporate sector are addressed forcefully. We welcome the steps that are being taken, including the SEC order that chief executive officers and chief financial officers sign an oath on the completeness accurateness of the financial statements of their companies. It has been argued, however, that the threshold for selecting the companies to comply has not been set low enough to catch highly priced start-up companies and that the sample is skewed towards "blue-chip" companies. The staff's comments would be appreciated.

In spite of the importance of the U.S. markets, we would see merit in a more balanced approach in future Reports. It would also be interesting to see more analysis of the financial links between the U.S. and Europe. In this context, an important factor for future financial developments will be to what extent investors move funds from the United States to Europe. Press reports have pointed to some rebalancing of portfolios. Does the staff have any evidence of on what scale this is happening?

It would also have been helpful with more substantiation of some statements concerning Europe. For example, the Report argues that the environment is more difficult for banks in Europe than in the United States. Admittedly economic growth has been lower in Europe, but on the other hand, the downturn has not been as sharp as in the United States. Pointing to above-target core inflation as a general problem in Europe seems to be exaggerated. Another statement that we found intriguing was that surplus countries should implement badly needed structural reforms. We are not sure whether it refers to Europe or other parts of the world, but it seems to us that some nuances would have been well placed here. We concur with Messrs. Padoan and Vittas that the assessment of the exposure of EU banks and the vulnerability of the banks-based European system seems overly negative and lacking sufficient evidence. Furthermore, we wonder to what extent financial stability reports and other financial market analysis by central banks and supervisory authorities have been used for reference. In a recent article in the ECB Monthly Bulletin, it is argued that euro area banks have shown robustness in the face of adverse developments in 2001 and that forward–looking indicators of banks' financial strength show some improvement for 2002.

The last Report included an interesting discussion about insurance and reinsurance companies. Another category that could usefully be the subject of a study is pension funds. In Europe, for instance, low interest rates and falling share prices have created problems for several of these institutions.

Emerging markets have suffered recently from the loss of investor confidence and the increased risk aversion. It is encouraging to note, though, that there has not been the large scale contagion that we have seen in earlier financial crises so far. We thank the staff for the analysis of contagion, in particular in the highly informative Box 3.1. Contagion effects have been most pronounced in Latin America, and focus continues to be on Brazil. But there have been disturbing signs that contagion may be spreading more widely. Spreads in Turkey, Malaysia, and the Philippines have increased in recent weeks, although it may be too early to establish clear trends. Also Russian and Polish spreads have increased, but domestic factors seem to be at least partly responsible.

We welcome the chapter about emerging local bond markets. Developing such markets should help countries to mobilize domestic savings and achieve more stability in their financing. Good progress has obviously been made in many countries, but in others, a lot of work remains to be done. This is an area where technical assistance from the Fund and the World Bank can be very productive.

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

We thank the staff for this thorough and well-written third issue of the *Global Financial Stability Report*, which incorporates a systematic and insightful analysis of the interlinkages of financial markets and global economic conditions. In particular, we welcome the candid assessment of risks in mature markets, and the examination of vulnerabilities in emerging market financing. The Report is becoming a useful device to focus the attention on drawbacks and weaknesses arising in the global financial system. In order to enhance its role in preventing crises, the Report would benefit from further coordination with the *World Economic Outlook* to take advantage of potential synergies in this area and to avoid overlapping and repetition. In this regard, additional complementarities between the work of International Capital Markets Department and Research Department would provide more efficient assessment of multilateral surveillance. We wonder whether this coordination could take the form of alternated quarterly reports, thus avoiding the discussion by the Board of the *GFSR* and the *WEO* only a few days apart.

The higher generalized risk aversion and the dramatic adjustments in the level and volatility of asset prices and trading volumes reported are signals of a turnaround in financial markets that entail significant systemic risks, if this trend continues. We remain concerned about the resolution of structural imbalances in the global economy in light of the reduction in net capital flows into the United States This could develop into a hasty pull back out of equity funds, given possible confidence shocks, which could arise as a result of "the continuous stream of accounting irregularities." The assessment and mitigation of financial risks resulting from a disorderly resolution in global imbalances and exchange rate volatility remains a first priority for the international financial community.

Furthermore, the abrupt turnaround in the economic outlook since the last issue of the *GFSR* calls for redoubling efforts to exercise sufficient vigilance in the event of a further deterioration in key financial market indicators and heightened volatility and risk in capital markets. In this regard, we welcome the recommendations for actions to strengthen global financial stability that would improve the quality of possible policy responses both for industrial as well as for emerging market economies.

As we share the main thrust of the analysis—including that on the patterns of global capital flows and the emerging local bond markets—we will underline several elements of risk and uncertainty both in mature markets as well as in emerging market economies.

Mature Markets

Notwithstanding the initiatives adopted to reinforce corporate governance in the United States, the loss of investor, together with the increased volatility and risk aversion in mature markets, have exerted significant protracted pressures toward further adjustment in other mature economies. The latter has concomitantly exacerbated the closure of market access for many emerging market economies and enlarged risk aversion for corporate credit risk, thus inducing wider spreads during much of the quarter.

The deteriorated level of corporate profitability in mature markets and the accounting fraud events in the United States have generated a high level of uncertainty that threatens global financial stability. These risks are being propagated throughout globalized markets, thereby undermining the confidence in institutions that are allegedly well supervised and observing best practices and standards. Notwithstanding the aforementioned initiatives to address weaknesses in corporate governance and accounting methods, described in Box 2.1 of the staff report, there is a need for concerted efforts on the part of financial market regulators and supervisors, as Mr. Mirakhor rightly underscores. In this regard, we would like to associate ourselves with Mr. Yagi and Mr. Toyama in asking the staff about the U.K. and the Swiss strategies to loosen capital regulations in response to capital losses at insurance companies. In any event, we would find it appropriate to consolidate the Fund's bilateral surveillance by underpinning the scope of FSAPs and ROSCs tools in advanced economies.

The recent corporate events draw attention to the uncompleted task of adapting standards and codes worldwide—even in advanced economies. Effective corporate governance and enhanced financial disclosure, among other issues, underscore the need for a suitable regulatory framework encompassing adequate accounting, clear audit rules, standards and codes, and effective supervision of over-the-counter derivatives. We should keep in mind that the existence of arbitrage conditions and the extensive use of credit risk instruments might transfer risk to institutions that are not properly or prudentially regulated. We would like to ask the staff about the private sector exposure in the United States to abrupt changes in the direction of capital flows and the possible extent of the adjustment.

Uncertainties surrounding the bursting of the TMT bubble are still unfolding and they will continue to impose severe hardship into the adjustment of global asset markets. Additionally, although housing prices have maintained their pace, underpinned by historically low long-term interest rates, a possible correction incorporating a subsequent wealth effect might induce an aggregate demand correction and additional volatility among major currencies that could seriously threaten the global recovery, thereby generating further systemic financial market instability. We would like to ask the staff for their assessment on the consistency between real estate prices and wage and employment developments in the United States, and the risk for a bubble being developed in those markets.

Emerging Market Economies

We remain concerned about the possible protracted financial instability that could impose further damage on emerging market economies. Currency turmoil and the reversal of net capital flows, during the contractionary phase of the cycle, could entail the need for additional external financing to mitigate the adverse impact stemming from debt denominated in foreign currencies. In addition, currency mismatches may further weaken the balance sheet of corporations and the financial systems.

Emerging bond markets vulnerabilities and the drain of financing flows indicate the significant risks of an everlasting low growth scenario for emerging markets economies, with sizeable consequences for a potential global recovery. Additionally, the ongoing corrections in currency markets are also advancing a risky scenario in international financial markets that heavily affects emerging economies. In our view, the global recovery scenario is unlikely to materialize without a rebound in net financing flows to emerging markets, which are key for the recovery of domestic demand in open economies. We would like to ask the staff's comments about the potential redirection of international liquidity towards emerging markets.

In trying to assess the dynamic implications of market disturbances and corrections, the Report falls short of providing an exhaustive picture of the possible adjustment in major currencies. The deterioration of investor sentiment towards U.S. assets is causing a major realignment in international money markets. The resolution of the crisis stemming from present imbalances and the erosion of investor confidence will induce further movements in major currencies. In this connection, it is important to closely monitor the behavior of major currencies, given the impact that the increased volatility might trigger in national and international financial markets.

We welcome the special section on emerging local bond markets, and we concur with the staff on the relevance of developing those markets as a strategy to better manage risks and increase liquidity. In this sense, the advantages for the private sector of developing local markets for medium- and long-term financial instruments in emerging market currencies cannot be minimized. We encourage the staff to continue to seek alternatives to develop these markets, including further analysis of the experience with privatized pension systems, which often entail significant fiscal transitional costs, but significantly contribute to market deepening.

Local financial markets do not constitute a substitute for net capital flows into emerging market economies. In this regard, the availability of official external financing during cyclical contractions is key to lessen balance of payments pressures and favor an orderly adjustment process. Economic growth in most emerging markets is expected to remain gloomy during the second half of the present year, most especially in Latin America. The deteriorating external financing conditions and the retrenchment of FDI, cross-border lending and rollover in developing countries, continue to impose severe restrictions on aggregate demand.

Finally, concerning the issuance of indexed instruments and given their useful role for the development of local financial market in emerging economies, we consider it important that the Fund disseminate an analysis of their characteristics to make this class of instruments more understandable by international market participants. In particular, we see room for the Fund to document recent experiences with indexed instruments in Asia and Latin America and the benefits in terms of risk management arising from this practice, including more complete financial markets, which usually complement the development of a local investor base.

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

We wish to compliment the staff for another very useful *Global Financial Stability Report*. The Report provides, in a systematic way, selected factual information on main developments in equity, sovereign bonds, corporate debt, credit and currency markets, in both mature and emerging economies, as well as insightful analysis of inter-linkages of these various markets. We also welcome progress made from previous reports in spelling out more clearly and systematically the implications of the analysis in terms of appropriate policy responses. The events and risks analyzed in the Report underscore the need to examine in vulnerability assessments the substantial cross-border adverse externalities that may arise from events and policies in major industrial countries. We share the overall thrust of the Report and believe it contributes to improve the IMF's multilateral surveillance. The global perspective adopted in this Report allows a better view of market developments, their interconnections and spillovers. We hope that such an approach feeds back into bilateral surveillance, helping to place member countries' developments in a global context.

Global Portfolio

As noted in the report, nowadays "...financial market shocks are more easily transmitted between global financial centers and institutions than in years past, reflecting portfolio rebalancing by large complex financial institutions that hold positions and intermediate flows in a variety of markets and countries. Shocks to one part of this portfolio can reduce the capital cushion allocated to it, and efforts to rebuild that cushion can transmit the shock to other markets as institutions rebalance their exposures and/or reduce risk through widespread cutbacks in market-making and positions." The currency crises of the 1990s were the first manifestations of a globalized market, where global portfolio management by key players affected considerably the distribution of financing amongst different groups of countries. Perhaps a role for the Fund is to identify distortions and imperfections in global markets in order to propose policies and mechanisms to achieve a more appropriate allocation of financial resources globally.

Capital account crises in emerging market countries are usually accompanied by capital flight that transfers financial resources of non-residents from emerging countries to major financial centers. These financial resources remain within the major countries' financial systems, which are major "hubs" for gross international capital flows and investment, taking in gross inflows of capital from abroad, retaining some of these flows, and distributing the rest internationally. In emerging countries, capital flight leads to credit contraction—or increase in interest rates—and pressures on the foreign exchange market—or depreciation of the exchange rate. In industrial countries, there would be an increment in liquidity in domestic money market and perhaps appreciation of the exchange rate. Given the difference in size between these two markets, price effects are felt more sharply in the former with damaging impact on the real economy. The Fund's lending may help to restore a better global balance by transferring resources back from industrial to emerging countries.

Global Financial Stability: Outlook and Risks

We agree with the staff's assessment that global financial conditions and investors' sentiment have deteriorated since the last Report. With increased pessimism on global economic prospects, lower confidence on corporate sector earning prospects and heightened risk aversion, financial conditions deteriorated markedly and riskier asset markets both in mature and emerging markets suffered significant losses of liquidity. Nevertheless, as the staff pointed out, this recent deterioration stopped short of evolving into a massive flight of resources out of riskier markets, a development that would likely have resulted in a derailment of the incipient global recovery.

The resilience of global financial markets is predicated on a number of factors including, inter alia, the partial downward correction in equity markets, the continued economic growth in major economies, albeit at a slower pace, the appropriate policy stance maintained in the major advanced economies, and the more widespread distribution of financial risks. However, as pointed out in the report, added corporate distrust could further retract retail investors from mature equity markets, hardening overall financial conditions.

The risk identified during the first quarter of 2002 that upbeat market expectations could be frustrated by insufficient evidence of a sustained recovery in the United States seems to have materialized, not so much by lack of contemporaneous real sector evidence, but rather by a sharp downward revision in prospects for future corporate earnings. The underlying factor behind the recent and ongoing correction is largely associated with notorious corporate fraud and failures, which gave rise to growing skepticism on the quality of corporate governance and accounting practices in the United States, thereby sparking a wave of uncertainty about the quality of reported earnings of major corporations. To prevent this situation from deteriorating further, it is crucial to implement promptly a corporate reform that addresses the main concerns. In this respect, we welcome the recently approved reform package in the United States. Its effective implementation and enforcement could dissipate existing concerns on corporate governance and accounting practices, paving the way to restore investors' confidence.

Recent corrections in mature equity markets and the less than reassuring prospects for corporate profitability increased concerns regarding a shift in global portfolios away from U.S. dollar assets that could potentially lead to a more disruptive adjustment in major currencies. In spite of the recent weakening of the U.S. dollar, we do not expect a sharp correction in the dollar exchange rate. We have seen in the last couple of years that the linkages amongst advanced economies are sufficiently strong and the relative weight of the U.S. economy is sufficiently large to avoid an abrupt adjustment in the dollar. The lack of alternative investment opportunities to those available in U.S. financial markets, and the need to fight deflation and stabilize banks' portfolios in Japan should mitigate the risks of a more abrupt adjustment in foreign exchange markets. Nevertheless, the current imbalances and the lackluster prospects for corporate earnings in the United States are likely to keep the downward pressure on the dollar, leading to its gradual adjustment.

Short-term macroeconomic policies in Japan—both monetary and fiscal—seem to be oriented toward inflating asset prices, or improving the portfolio value of the financial system, to avoid further deflation. The Bank of Japan (BOJ) interventions in the foreign exchange and government bond markets, and direct or indirect intervention by the government to inject resources in the financial system appear to be instruments to inflate financial assets.

The BOJ monetary policy actions seek basically to reduce long-term interest rates, or sustain the price of government bonds by purchasing them from the private sector in the domestic market. Policy actions also seek to sustain the yen value of assets denominated in foreign currency through interventions in the foreign exchange market. Under current circumstances of stress in the domestic financial system, monetary policy has not been operating domestically through credit channels as usually understood. It has simply worked to preserve banks' asset values and to facilitate refinancing of outstanding credit, instead of allowing for an expansion of credit to the private sector. Sufficiently low rates produce arbitrage gains improving the cash flow of financial institutions.

Monetary and especially foreign exchange policies followed by the BOJ have had a stabilizing impact not only on the domestic banking system, but also on international capital markets given Japan's considerable investment position abroad. When the BOJ intervenes in the foreign exchange market to sustain the value of the U.S. dollar, it seems to do so with two economic objectives: trade and hedging.

In the real sector, an appreciation of the yen would make the Japanese exporters less competitive and imports cheaper. As private domestic demand has remained weak and exports have been the main engine to sustain economic activities, it is crucial that the exchange rate remains competitive. But more importantly, to the extent that the problem in the Japanese domestic financial system remains unresolved with debt and capital overhangs from the bubble years, maintenance of the exchange rate is important to preserve the asset value of Japanese residents in foreign currency, especially the U.S. dollar, in order not to deteriorate further the portfolio of financial institutions.

Assets accumulated over the years by the current account surpluses, especially against the United States, are mainly denominated in U.S. dollar. A depreciation of the dollar against the yen would thus reduce the nominal value of those assets leading to net worth losses for the private sector. Heavy ownership of U.S. financial assets means that deterioration in U.S. markets together with an appreciation of the yen could impose mark-to-market losses in the Japanese financial institutions. Therefore, the BOJ needs to intervene to support the value of the U.S. dollar not only to preserve competitiveness of Japanese goods and services, but also to preserve asset values of Japanese firms and financial institutions. The BOJ seems to be ultimately taking a role of main counterpart in the hedging process. By purchasing U.S. dollars in the foreign exchange market, it is shifting its portfolio from yens to U.S. dollars, thus assuming potential losses that could result from a further appreciation of the yen.

Heightened global risk aversion and low appetite for risk have made it significantly more difficult for emerging markets, in general, to tap international capital markets, despite their willingness to continue implementing robust macroeconomic policies. Financial market variables in Brazil came under increasing pressure beginning in the second quarter, as political uncertainties about the course of future economic policies were compounded by the generalized increase in global risk aversion that came along with the sharp downturn in mature equity markets. Access to international capital markets, which had already become more constrained during the second quarter, worsened significantly in July and August. Rollover rates of medium- and long-term debt fell sharply. Although the rollover rates of interbank credits were still high, this partly reflected the conversion of longer-term trade credits into short-term credit lines. The credit squeeze experienced by Brazil reached a point where even foreign trade lines, traditionally resilient in earlier balance of payments crises, were significantly affected.

In spite of Brazil's strong macroeconomic policies, uncertainty about the direction of policy following the elections and a worsening international environment, in addition to a significant deterioration in financial market variables, have contributed to a slowdown in economic growth in the second quarter of this year, and have given rise to renewed concerns on debt sustainability. However, recent studies have confirmed that, with the maintenance of current levels of primary surpluses, even under very conservative assumptions concerning GDP growth and real interest rates, the debt dynamics would follow a declining path in the medium term. The initial concerns on debt sustainability have begun to dissipate as market participants became more informed about the characteristics of the Brazilian debt structure and of its dynamics.

To address these developments, the Brazilian government committed to an additional strengthening of policies in 2002 and further structural reforms, sought support for a new Stand-By Arrangement with the IMF, and worked to dispel concerns about the stance of macroeconomic policies following the presidential transition. Expressions of support by the leading presidential candidates to the core elements of the program contributed to mitigate the early concerns about policy continuity. The pledge received yesterday by the government from leading international banks operating in Brazil to sustain their general level of business in the country, including trade lines, is an important indication that the international investors' confidence started to improve. Given the wide readership of the present report, we strongly recommend that the text and tone of the report be updated to incorporate these most recent developments. This would be important given the current Fund effort of confidence building around the Brazilian program.

The Role of the Regulatory and Supervisory Framework

The asymmetry between creditor and debtor countries, and between investment grade and non-investment grade sovereigns should be a key aspect of any analysis of international financial markets, and the remedies prescribed. For example, in Chapter 1 (p. 11), when discussing actions to promote global financial stability, the report recommends to all countries to "increase vigilance by those in charge of financial stability—in the areas of market surveillance, prudential supervision, and financial regulation—(...) Emphasis should be placed (...) on enhancing the soundness of institutions and improving the profitability of the core businesses of the various types of financial institutions."

Notwithstanding the obvious benefits of pursuing an ever-improved regulatory and supervisory framework, more careful consideration needs to be given to the asymmetric effects of those measures in circumstances of global distress. The reinforcement of prudential regulation might, in practice, result in a sudden reduction of mature markets banks' exposure towards emerging countries (and lower rated corporations) both in terms of international lending and intra-firm credit. This phenomenon partly explains the unprecedented cutting-off of export credit lines that has been affecting Brazil recently, something that had not happened even in the heights of the debt crisis in the 1980s. For that reason, in a moment of low international liquidity and high risk aversion, stricter prudential standards could contribute to worsening emerging markets difficulties and convert a manageable situation into open financial distress.

The prescription also gives the impression of being in contradiction with the analysis of mature markets in Chapter 2. On page 27, the Report mentions that losses in the insurance market have put "pressure on solvency ratios [and] could lead insurers to sell liquid financial assets" or look for capital injections from their parent companies. The response from the U.K. Financial Services Authority was a relaxation of capital requirements (also being considered by the Swiss government) by means of a modification in the resilience test methodology. The Report rightly portrays a benign picture of that experience.

In a state of worn-out investor confidence, financial and monetary authorities both in mature and emerging markets should act in ways that could foster assurance and bring financial markets globally into normalcy. Trying to solve domestic situations and insulate the domestic financial system from eventual contagion, while increasing the economic difficulties elsewhere does not seem to be a suitable way of promoting global financial stability.

Other Issues

In page 81, referring to international investment banks operating in Brazil, the Report suggests that the "Chinese walls" between Brazilian investment banks and their asset management companies are not so solid. While the "Chinese walls" between investment or mutual funds and the financial institutions that manage them do not prohibit a fund from purchasing securities underwritten by the fund's manager, it is felt that prohibiting this type of business is not the appropriate manner in which to approach this issue, which is similar to loans granted by financial institutions to related parties, practice permitted in almost all of the major financial centers. Experience in the Brazilian market indicates that transparency is the best means of assuring that transactions that include sales of this nature are undertaken in a proper fashion, especially in regard to the price charged. Negotiations of securities between the manager and the fund are insufficient grounds to condemn these transactions. Reasonable investment opportunities for funds could be lost simply by prohibitions of this nature.

Regulations issued by the Central Bank and the Securities Exchange Commission, therefore, determine that: (a) financial institutions that manage mutual funds may not purchase the shares issued by them, nor may related parties, unless those funds are active in the derivatives markets; (b) fund managers must maintain separate entries, containing complete information regarding any and all transactions carried out with the funds that they manage; (c) managers may not (i) furnish any type of guarantee or collateral for transactions carried out by the fund; (ii) utilize their own assets as a guarantee or collateral in favor of the fund; nor (iii) commit financial resources to the fund, directly or indirectly.

The prohibitions mentioned above also apply to related parties of the manager of the fund. The director or other senior manager, who takes the responsibility of overseeing compliance with regulations and acts as principal contact with shareholders of the fund, must prepare quarterly statements making evident that transactions carried out in the name of the fund strictly followed the investment policy of the fund, were executed within the diversification limits and involved assets permitted in regulation to form part of the fund's portfolio. Furthermore, the statements must demonstrate that any transaction between the manager and the fund was carried out at market rates. These documents must be reviewed and certified by the external auditor and made available to the supervisory agency and for consultation by shareholders.

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

Key Points:

- The *GFSR* importantly notes that markets have remained orderly in recent months and suggests that the main risks going forward are unlikely to derail the recovery.

- The Report underscores that the risk of a reversal of capital flows from the United States leading to a disorderly adjustment in markets is low for a number of reasons. As a result, we encourage the Fund to spend more time on other issues going forward.

- We continue to believe that the *GFSR* could be more concise and focused. A semi-annual report, more focused on emerging markets, would be more helpful to the Board and would allow the staff more time to refine the presentation of their analysis.

While not quite as reassuring as the last issue, this Report indicates that adjustments in equity and exchange rate markets have remained orderly in recent months and that global economic recovery still is on track. The Report cites three key risks: the potential for withdrawal en masse from risk taking; the potential that the capital positions of key financial institutions may be impaired; and the potential for slowing capital flows to the United States. We agree with the judgment that there are counterbalancing aspects that mitigate these risks, so that it is reasonable to expect that financial resilience and stability will be maintained.

Pattern of Global Capital Flows

One part of the Report somewhat overdone is the risk related to the possibility that "foreign investors will significantly reduce investment in U.S. equity markets" or more broadly, the issue of the "sustainability of capital flows needed to finance the U.S. current account deficit." The second formulation is more interesting than the first, since overall capital flows are most relevant to the possibility of disorderly adjustment. Nonetheless, the second formulation is also inexact, since both history and accounting tell us that current account deficits will be balanced by capital inflows and changes in reserves. So the real issue is the sustainability of capital flows at unchanged relative interest rates and exchange rates.

The issue is then the old one of a possible "disorderly" change in exchange rates. Disorderly market conditions emerge when a market cannot adjust to various shocks. But the Report makes clear that "U.S. markets are...among the largest, most liquid, and diverse in the world, and it is unclear whether other markets could accommodate the sizable flows that U.S. markets have absorbed without outsized price adjustments." In addition, the Report notes that sizable adjustments in current accounts have taken place in the past, such as 1987-1991, in an orderly manner that did not trigger turbulence in markets.

The Report outlines ways in which such a disorderly event might occur, but the Report itself indicates why the probabilities are low. The United States remains an attractive place to invest, with better growth prospects than other major regions, sound economic policies, flexible labor, financial, and product markets, continued high productivity growth, and resolute action in both the regulatory sphere and in exchanges to address corporate misbehavior. Exchange rates in major currency areas have adjusted this summer with no signs of disorder. A clear revival of growth outside the United States would enhance the attractiveness of these economies, but would also strengthen U.S. exports and facilitate adjustment of global current accounts. All these points suggest that the risk identified in the Report is minimal. Given this, the Fund should spend less time on this issue going forward.

Absorption of World Savings

Figure 2.7 and the text indicate that the United States absorbed 70 percent of the world's "net saving" last year; that is, the U.S. current account deficit is equal to 70 percent of the sum of world current account surpluses. In our view, this computation is given too much prominence in this Report since it is relatively meaningless and potentially misleading.

We note that it is not clear that there would be anything amiss if a country were absorbing a disproportionate amount of world savings, so long as foreign investors are freely choosing to acquire productive assets whose returns are relatively high on a risk-adjusted basis, as has been the case in the United States, as noted in the report. Indeed, it would be economically inefficient to restrict such investment flows.

Instead, it is more useful to look at the share of U.S. uses of world saving (as cited in the *WEO*) relative to the size of the U.S. economy. Based on the *WEO* data, uses of saving in the form of investment and negative public sector saving in the United States are less than 30 percent of total global saving, with GDP measured by current exchange rates, while U.S. GDP is about 32 percent of the world total. When measured by PPPs, the United States used 19 percent of world saving, but has GDP equal to 21 percent of the world total. Thus, the United States is clearly not using up a disproportionate amount of global saving.

Emerging Markets

The report indicates that financial flows to emerging markets overall have been somewhat lower this year relative to last year. Part of the story relates to lower demand since private banks and corporations in emerging markets are turning more to domestic borrowing rather than foreign currency borrowing. Nonetheless, with spreads rising to a fairly high level, it seems likely that overall financial flows will remain below the levels of recent years. Of course, markets are differentiating by risks. As noted by Mr. Yagi, regions that are relatively calm, particularly Central Europe and Asia, are having less difficulty finding financing.

The Report raises the concern (page 26) that a strategic reorientation of wholesale banking may lead to a curtailment of credit to riskier borrowers, including emerging markets, in the longer run. Other factors cited in the Report, such as the search for higher profit margins among some European banks, suggest that there are countervailing pressures that will support lending to emerging markets. In any case, credit will flow more readily to emerging markets that are able to reduce risks, such as by strengthening financial sectors and enforcing the rule of law. The staff's comments are welcome.

We appreciate Box 3.1 on the scope for emerging market contagion, even though the box may be too focused on Brazil. The Report suggests that a number of countries face some risk of contagion from a variety of factors, including retrenchment of credit and trade competition. We encourage the staff to continue to pursue such analysis and present the results to the Board in this and other vehicles with suggestions for policies that can help mitigate risks.

The Report indicates that most sovereign bonds issued by emerging markets so far this year do not include collective action clauses since most were issued in New York where market practice does not normally include such clauses. Does the staff know of any case this year where a bond issued in New York did include CACs?

We welcome the section on emerging local bond markets, which are becoming an alternative source of funding to external markets. We share the expressed view that regulatory issues are often a key hurdle to development of domestic bond markets, and that government borrowing often crowds out the private sector. We encourage the staff, both in programs and technical assistance, to do more to assist emerging markets in the development of local bond and equity markets.

Comment on the *GFSR*

Finally, some general concerns about the Report itself. We remain concerned that the staff is too ambitious in its scope for a quarterly publication. Again, we think a semi-annual report would be more useful and be a better use of scarce staff resources. Alternatively, the staff could issue a short summary of emerging market financing trends on a quarterly basis, perhaps in conjunction with the *WEMD*, with a longer semi-annual report focused on special topics. We also concur with Mr. Shaalan's comment on the need for stronger coordination between departments in drafting the *GFSR* and *WEO*.

The *GFSR* should be more concise and focus on key developments in financial markets, key risks, and the implications for industrial and emerging countries. A much shorter and refined report that emphasizes these issues would be more helpful to the Board readership. Where risks are small, the discussion should be brief. The Report also tends to focus too much on U.S. market trends, where there is already ample information, and not enough on markets in other industrial and emerging markets where IMF analysis could add more value.

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

The developments in Latin America since the issuance of the last report, with the Fund having to grant another high access program for Uruguay and to announce a record loan for Brazil, provide a rather clear evidence that the end-March *Global Financial Stability Report* failed to foresee the relevant vulnerabilities, let alone call them to attention. This suggests that this Report, at least in its present form, can play only a limited role "in preventing crises before they erupt" (p. 4). It also, once again, raises the question of the format and the implied audience of this Report, including—as pointed out by Mr. Shaalan—its relation to the *WEO*, and we seriously wonder whether it would not be better to either go back to a short quarterly financing report and an annual volume of in-depth analysis or to move to a semi-annual cycle with additional short reviews issued alongside the *WEO*.

While the Report certainly contains some interesting and useful information, it seems to be too long in proportion to its contents. The first 32 pages in particular are in need of substantial editing and refocusing. While this part might contain some potentially interesting thoughts, it is difficult to grasp its message, or to get an idea of the importance of the issues that are brought up. Similarly disappointing are the policy recommendations for promoting global financial stability on page 11. They read as if they were written by a commission, seeking the largest common denominator of the views of its members. As a result, one may have the impression that the staff is simply restating the obvious and not breaking any new ground.

Should we continue with the current format of the Report, its central messages will have to be better focused. We would also prefer to have scenarios of possible risks, i.e., simulations, in order to get an idea of how large certain effects could be. It might also be worth thinking once again about including results from the Fund's early warning systems or at least a set of standard vulnerability indicators.

Developments and Sources of Risk in the Major Financial Centers

The risks of further corrections of equity market and U.S. dollar valuations remain, and some financial institutions and insurers would undoubtedly have difficulties to bear another round of stock market losses. The Report suggests that insurers may sell equities to raise cash, and there are indeed indications from the Swiss stock market that some Swiss insurers began selling parts of their portfolios in July. The Swiss insurance sector is still sufficiently capitalized, however, and it is not true that the Swiss government is considering easing capital requirements, as stated on page 27 of the Report. The authorities are only considering a more flexible formula for the mandatory minimum rates of return and payout ratios on pension assets, as it has been recommended by the staff and the recent FSAP mission.

According to the staff, market adjustment in July were caused, in part, by U.S. based equity funds, which had a record high outflow of US$48 billion, adding to a substantial dollar correction (p. 28). Based on the staff's criteria, we think we were quite near panic selling then, and we would be less sanguine about the financial system's resilience. There may be lags of impacts that have weakened the financial sector more than currently apparent. In addition, Box 3.1 of the Report points to the challenges that arise for some advanced countries from the large and relatively concentrated bank exposure to Brazil. Apart from possible systemic implications, this also raises the question of a possible credit squeeze in the countries concerned.

Growth projections for advanced countries have been substantially revised and discussions of "double-dip" scenarios have revived. Moreover, more and more people are getting worried about a possible bubble in the U.S. housing market. We know from the U.S. Article IV discussion that the staff does not believe that the U.S. housing market is out of line with economic fundamentals, but given the importance of the housing market for the current recovery, we agree with Mr. Shaalan that this question, and the associated risk, could have been assessed in the Report. As to the EU, there are uncertainties regarding the Stability and Growth Pact, as manifested by Germany's raising costs of the flood damages and the difficulties with the 3 percent deficit requirement in Portugal, and the upward revision of next year's deficit target in Italy. This might further hamper recovery in Europe and weaken the euro.

Regarding the Public Company Accounting Reform and Investor Protection Act (Box 2.1), we wonder whether the staff would endorse the conclusion that this did help to stabilize investor confidence? It could also be possible that the new regulations lead to substantial uncertainty among corporate decision-makers and ultimately hamper economic activity. Maybe the staff can inform whether the equity risk premiums (Box 2.2) remain high or whether they have already decreased.

The analysis concerning the risk to financial markets associated with shifts in the pattern of global capital flows is a very useful, and we share the staff's assessment. Yet, regarding further selling pressure, we think that there is probably a bigger risk coming from institutional than from retail investors. At least in Europe, we have indications that retail investors are not selling to a major extent and prefer to sit out their losses.

Emerging Markets Developments and Financing

The analysis in Box 3.1 is interesting and makes an innovative use of relevant indicators and vulnerabilities. As to the mentioned contagion emanating from Brazil, however, we wonder how much of the correlation between emerging market bond movements with developments in Brazil were caused by the later and how much of it was driven by the global decline in risk appetite. Could the staff clarify the extent of contagion coming from Brazil as opposed to that affecting it?

Regarding Turkey, we are less optimistic than the staff as to the resolution of political uncertainty. Many comments published recently in the Turkish press indicate that the risk of prolonged political uncertainty after the November elections remains substantial. In contrast to Brazil, however, the impact of policy uncertainty on market developments seems to be rather limited at this point in time. As pointed out by the staff, Turkey remains vulnerable to investor retrenchment, which could become critical if we consider the heavy debt repayment schedule Turkey faces in 2004/05.

Finally, we welcome the information on the use of CACs in bonds issued in the first half of 2002. To be useful in monitoring the use of CACs, however, this information needs to be broadened in future reports. An additional table could be included, which would convey the size and jurisdiction of emissions of individual countries, including developments over time.

Selected Topic: Emerging Local Bond Markets

> Chapter IV offers an informative analysis, presenting the chances as well as the challenges. The experience with Brazil, however, is certainly frustrating. The need to index domestic debt in order to attract sufficient buyers has hardly helped to improve financing conditions. Moreover, as pointed out in the Report, a main handicap of such markets is the restricted access for private corporates; the persistent small share of the corporate sector in Table 4.2 highlights this problem. Overall, decoupling from external financing and related risks will not be easy, especially as long as foreign investors play a critical role in secondary markets. It is thus questionable whether local bond markets will become attractive enough to the corporate sector in the near future. It might just as well be worth to increase efforts in improving lending conditions in local credit markets.

Ms. Lundsager suggested that it might be useful for the staff to look into issues related to the financing of foreign direct investment (FDI), such as how much of the investments were locally financed versus externally financed, and whether foreign investors completely hedged their investments. Although the *WEO* had a section on corporate health in emerging markets, it did not analyze the sources of FDI financing. Perhaps it would be an interesting subject for the International Capital Markets Department and the Research Department to examine, going forward.

On the issue of contagion, Ms. Lundsager supported Mr. Oyarzábal's and Mr. Beauregard's comment in their statement that the Fund had played a crucial role by making transparency a cornerstone of its reform programs. While not agreeing with Mr. Oyarzábal's and Mr. Beauregard's suggestion to delete Box 3.1 in the Report, their point that the analysis on financial contagion in Box 3.1 should be more balanced was valid. Perhaps mentioning some of the positive reasons why certain emerging market countries had not been adversely affected by contagion or how they had managed to mitigate the effects of contagion would be a good way to improve the presentation of Box 3.1. Analyzing the sources of positive contagion—such as flexible exchange rates, low debt levels, and open trade regimes—could help strengthen the Fund's multilateral surveillance and have positive spill-over effects on policymaking in individual countries.

The *GFSR* should also adopt a more balanced approach and focus on other financial markets beside the United States, Ms. Lundsager reiterated. As mentioned in Mr. Andersen's statement, the Report focused heavily on the United States, which was perhaps natural, given that it was the largest financial market. However, as there were already many publicly available analyses on the U.S. market, the *GFSR* would add more value by focusing on other markets on which not much public information had been available.

On the topic of emerging local bond markets, Mr. Reddy made a good point that the Fund should analyze the different practices and strategies of developing domestic bond markets, so as to benefit emerging market countries that are trying to develop their own local bond markets, Ms. Lundsager said. However, as the World Bank was also heavily involved in that area, the Fund would need to coordinate its efforts closely with the World Bank.

Regarding the periodicity of the *GFSR*, as mentioned by Messrs. Andersen, Le Fort, and Szczuka, it might be a more efficient use of staff resources to publish the Report semi-annually, Ms. Lundsager emphasized. Alternatively, the staff could return to the previous practice of issuing shorter quarterly reports on emerging markets, which could be a useful complement to the *WEMD* discussions, with the semi-annual or annual *GFSR* covering special topics. Messrs. Szczuka and Moser also suggested that the Report incorporate some elements of the Fund's early warning system, which could again complement the *WEMD* discussions in terms of raising concerns that staff and management might have regarding the stability of the international financial system.

As mentioned by Messrs. Shaalan and Yagi, there was more scope for reducing the amount of information overlap between the *GFSR* and the *WEO*, Ms. Lundsager stated. Adopting a more complementary approach would increase the efficient use of staff resources, and prevent the duplication of work.

Mr. Szczuka said that the presentation in the Report on the causes of Brazil's problems could be further broadened. The critical issue to examine was whether those problems had been mainly caused by domestic issues, or by external factors, such as contagion from the U.S. financial markets and Argentina. It was important to clearly analyze the main reason for the developments in Brazil, especially as there were many references in the Report that the instability in many emerging markets had been caused by developments in mature markets, particularly the United States. Perhaps the staff could comment on the reasons behind the increased risk aversion of investors toward emerging markets, even though they provided significantly higher returns on investment than mature markets. Even in the second quarter of 2002, Latin American equity markets performed better than the NASDAQ. Perhaps the Fund could play a role in mitigating the withdrawal of investments from emerging markets? As the staff had mentioned, the resilience of the international financial system was in part due to the diversification of portfolios; however, by reducing their exposure to emerging markets, investors were decreasing that very element of risk diversification.

Greater analysis on the risks of contagion from Brazil to other emerging market countries was needed, Mr. Szczuka added. For example, the staff mentioned that Poland had a similar trade structure to Brazil, but did that meant that Poland would be more vulnerable to contagion from Brazil?

On the topic of emerging local bond markets, other factors could also influence financial stability in emerging market countries, Mr. Szczuka suggested. First, the link between local and foreign markets was important as the significant participation of foreign investors in domestic financial markets could possibly create greater financial volatility. Second, in most cases, governments would not be able to fulfill their need for foreign exchange by issuing bonds only in the domestic market. Finally, as local investors were usually better informed than foreign investors, they would often react quicker to problems in the domestic market and be the first ones to withdraw their investments.

Mr. Mirakhor agreed with Ms. Lundsager that the Report could have paid greater attention to emerging markets, and supported her proposal that the staff either resumed producing a quarterly report on emerging markets, or, at the minimum, increase the coverage on emerging markets in the *GFSR*.

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

> Let me first thank Directors—the staff appreciates your continued interest in our work. It is not a surprise that the level of interest increases when the Report points to some specific weaknesses in various segments of the markets. It continues to be the staff's objective to deliver an evenhanded Report to the extent possible. However, at the same time, there are limits to what the staff knows and feels comfortable in publishing.
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> There were suggestions by a few Directors that the Report may have been too sanguine in its general tone, and may have prematurely assessed that the international financial system was still resilient. But looking back, the two previous *GFSRs* were less optimistic than much of the then available macroeconomic analysis—the staff had pointed to the issues of indebtedness and lack of corporate profitability as weighing on the global recovery at that time. We know now that corporate profitability turned out to be lower and did not entirely match earlier expectations in the spring. The equity slump over the early part of the summer, which was fueled by accounting irregularities, had also been mentioned in the previous two reports.
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> As for the current Report, while on the one hand the erosion of confidence in some markets—especially the equity markets—continued throughout the second quarter, since the Report was compiled, there has been some improvements in the markets, which should not be overlooked. Equity markets are currently more in line with fundamentals than before. Furthermore, after August 14, which was the deadline for the CEOs and CFOs of major U.S. companies to certify the accuracy of their companies' financial statements with the SEC, previous anxieties in equity markets about accounting issues started to subside. While the majority of the accounting irregularities may have taken place in the United States, there have been other cases elsewhere, and more such incidents may surface in the future. The swift and decisive reaction of the U.S. authorities to the accounting irregularities has impressed the markets and has helped change market sentiment. The EMBI+ has recently shown a slight improvement, while cash positions for emerging market investors have risen.

The correction of financial asset prices that has taken place over the past one to two years is not just cyclical, but also structural, and will continue for quite some time. Given the losses inflicted on many financial institutions and retail investors, the amount of risk aversion will be the dominant issue going forward. For example, Brazil has been affected by the increase in investors' risk aversion, which was partly fueled by events in the region and partly by events elsewhere. However, if this risk aversion rises further, it would affect various asset classes across regions; this may not be fully rational, but it is how markets operate.

Any possible reorientation by financial institutions away from wholesale banking, as mentioned by Ms. Lundsager, would affect lending to emerging markets. Based on anecdotal evidence, there are some initiatives under way on the part of banks to reallocate part of their capital away from wholesale lending, given that it has not yielded higher returns as opposed to consumer lending. Therefore, the shares of banks focused on wholesale lending have not performed well in the equity markets compared to more consumer lending-oriented financial institutions. However, if financial institutions were to significantly reallocate capital away from wholesale banking into more consumer-oriented banking, countervailing forces might set in at a later stage to balance this shift in capital.

The issues of corporate governance and accounting will lead to a more conservative valuation of financial assets, going forward. Investors will have to look to smaller returns on investments and equities, probably in the range of 20 percent before tax. This may benefit emerging markets by lowering the investment benchmark in mature markets. This correction in valuation will significantly affect investment decisions in the future, although the staff is not in a position to predict the specifics. The markets are treading in uncharted waters, and such a significant structural adjustment in so many financial assets has not been witnessed before.

That said, the international financial system is more robust than sometimes anticipated, partly because of the countervailing forces that will start to set in. Financial intermediaries have been rather well capitalized in the past, although some of that cushion has been reduced. The steep yield curve in some of the mature markets, especially the United States, has benefited financial institutions in these difficult times. Most importantly, it has been overlooked that the distribution of risk—through the use of derivatives and the distribution of some of the risks from financial institutions to retail investors, especially in Europe—has helped strengthen the resilience of the global financial system.

Looking ahead, the risk of a sudden reversal of capital flows into the United States and its subsequent impact on the U.S. dollar is not significant in the short run. However, the staff focused on this issue partly because some

Directors had previously asked for such an analysis in the *GFSR*, and partly because—as Ms. Lundsager said—data are more readily available on U.S. financial markets, and it is a culture of the Fund to focus on the United States. In addition, as mentioned by Mr. Mirakhor, the importance of U.S. financial markets for the rest of the world merits particular attention by the Fund, especially under the present circumstances of financial instability. However, going forward, the staff will do its best to shift that focus on the United States and produce a more balanced report.

One of the main downside risks to global financial stability is that—due to the structural changes under way in financial markets—equity prices will remain subdued, while credit provisions by banks will continue to be high in areas of the world where bank lending still plays a significant role in the financial system. Such conditions may bankrupt one or two financial institutions, although a systemic threat is low at this point in time due to the credit provisions. This is why the shares of European banks have not performed well recently.

Regarding Mr. Padoan's question on the Report's analysis on European financial institutions, they operate, to some degree, in a less benign environment, partly because in some areas their markets are far more fragmented, and partly because the credit cycle is affecting them more due to the slower growth rate in Europe.

The increase in risk aversion will continue to affect capital flows to some emerging markets as banks have started to retrench their lending in those markets. Given that bond markets in some emerging economies are volatile, or less reliable as a source of financing, foreign direct investment becomes more important. Attracting FDI hinges on stable macroeconomic and legal frameworks. So far, emerging markets in Asia and Europe have performed quite well in that respect, unlike Latin America. The staff has established a new project focusing on FDI financing, and will work closely together with the World Bank. It is important to try to understand the patterns of FDI flows and how they will be financed, going forward.

Another downside risk that is hardly mentioned publicly, but that is intensely discussed among financial market players is the possibility of a new terrorist attack or a serious military conflict somewhere in the world. The materialization of such a risk will have a significant impact on the risk aversion of investors.

On the format of the Report, it is a work in progress, and the staff will conduct a review after a full year. It is notable that other international institutions, such as the Bank for International Settlements (BIS), have picked up some of the themes and topics that had been mentioned in previous issues of the *GFSR*.

> Concerning the overlap between the *GFSR* with the *WEO*, the staff coordinates closely with the Research Department so as to ensure that the messages in both reports are consistent. The staff also takes great care not to venture into an analysis on the real economy in the Report. In addition, the staff is in the early stages of discussion with the BIS, and will also consult with the Bank of England and the ECB, going forward, on the possible scope for cooperation and creating synergies in the surveillance of the global financial system.
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> On the balance of focus on mature markets versus emerging markets in the *GFSR*, in terms of number of pages, two-thirds of the current Report is devoted to emerging markets, compared to the one-third on mature markets. This may not be the right balance, given the importance of developments in mature markets over the past 3-6 months. Overall, the *GFSR* is shorter in length compared to its predecessor and the previous quarterly reports on emerging markets, but the staff will try to produce an even more concise report, going forward.
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> Mr. Szczuka commented that the Report is of limited value because it did not forecast the crises in Brazil and Uruguay. However, the cause of Brazil's crisis was mostly political. The outcome of elections is an issue for political analysts to forecast, and the staff did not feel comfortable in speculating on that matter. Although the staff did have some anxieties about the political outcome in Brazil, it would not be a good idea to publish them in the Report.

Mr. Szczuka reiterated that the crisis in Brazil had many causes, and was not mostly a political problem. It was still unclear whether the crisis had been primarily driven by Brazil's domestic political uncertainties, or by a more general retrenchment of lending to emerging markets. However, even so, there had been clear indicators of Brazil's vulnerability to a financial crisis, such as the 400 percent debt-to-export ratio, the 100 percent debt service ratio, and the increase in debt from 30 to 60 percent of GDP. Therefore, Brazil's case had implications for the effectiveness of Fund surveillance in general.

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

> First, we are grateful to several Directors who came to the staff bilaterally to offer factual clarifications; we will take their comments into consideration. Second, some of the questions raised in the statements by Directors are detailed and technical, so it would be better for the staff to discuss them bilaterally. Finally, there were also many suggestions on the possible topics that staff could look into in future reports. We welcome those comments as indications of Directors' interests, and will take them into consideration when deciding the issues that future *GFSRs* should focus on.

Turning to the more specific questions, many Directors commented that the Report did not focus enough attention on the issue of corporate profitability. The staff mentioned that issue in Chapter II, but as much analysis on the topic had been provided in previous reports, it was thought that the focus of the current Report should shift to more relevant issues. Disappointment with corporate earnings was less of a concern during the second quarter as expectations had been sharply revised downward throughout the quarter and for the remainder of this year, allowing actual profit performance to more or less match expectations. A new worry—as highlighted in the Report—is that real economic data seems to be showing some slackness in the global recovery.

Several Directors asked whether the strength of the real estate market in the United States, which is key to sustaining consumer spending and, therefore, economic recovery, could be maintained going forward. The staff will continue to study this issue, particularly analyzing the housing market as an asset market in the United States. The preliminary thinking at this point is that the U.S. real estate market has been mainly driven by two factors: interest rates and growth in personal income, both of which have performed well. Interest rates are low, and are expected to remain low for the foreseeable future, while personal income growth has developed quite satisfactorily in recent times. Although the so-called "housing affordability" index for the United States—which measures the capability of an average household to afford an average-priced house—has declined slightly from the high level a year or two ago, it is still relatively high compared with the level throughout the 1990s. The staff believes that the health of the U.S. housing market is not yet a concern that will have a direct, negative impact on financial market stability.

There were many comments on whether the recent U.S. legislations related to corporate governance and accounting and auditing standards have been sufficient in restoring investor confidence and trust. As earlier mentioned, after August 14, the staff noticed that the anxiety and expectations of further revelations of accounting irregularities in the United States have abated. Unless some major and unexpected events happen, the staff feels that the worst of the corporate scandals has occurred, although continued vigilance on the part of policymakers is still required.

On European financial institutions and banks, many of them faced difficulties in the past year. They have suffered losses from their heavy investments in the telecommunications sector in Europe. In addition, their efforts to diversify outside Europe, including in emerging markets, have largely not been profitable. They also invested heavily in many U.S. companies, several of which have ended up in bankruptcy. Therefore, in the context that some of the European banks are facing difficult domestic business opportunities and profitability, the staff feels that the national authorities and the Fund need to monitor these banks more carefully.

On the issue of the potential redirection of international liquidity toward emerging economies, most emerging Asian markets, and many of the emerging European markets, particularly Russia, continue to perform well and attract investments. However, South American countries are undergoing great difficulties. There are some indication of net new funds flowing into emerging market mutual funds, which will exercise some stabilizing influence when market conditions improve.

There was a question on whether there had been any emerging market sovereign bond issued in New York so far this year that contained collective action clauses (CACs). The staff is not aware of any such issue. Given the interest in CACs, had there been such a bond issued, it would have been widely commented upon. In addition to the current Report, the staff had also prepared a separate analysis looking at sovereign bond issues by emerging market countries over the past 10 years in different jurisdictions. This analysis will be included in the next issue of the *GFSR,* but will be made available to Directors soon.

On the chapter on emerging local bond markets, it is part of a series of analysis looking at, first, equity and bond markets, and subsequently—in the next issue of the *GFSR*—on local foreign exchange and derivative markets. The series will conclude with an analysis on policy recommendations for the development of domestic financial markets in emerging economies. Therefore, many of the comments by Directors on emerging local bond markets will be addressed in the next installment of this three-part series. The staff is also planning to issue one or two occasional papers to reflect in full our analysis on these issues.

On the comments that the chapter on local bond markets did not mention many important emerging economies with local bond markets, given time constraint, the staff could not visit all the countries. Therefore, the chapter reflects the actual information from countries that the staff managed to visit. Going forward, the staff will try to visit all countries and update the analysis accordingly.

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

On Box 3.1 in the Report, which discusses the channels of contagion and the potential for the retrenchment in bank lending to emerging markets, the staff's aim was basically to present the observation of the common ownership problem amongst banks. In recent years, with the increasing globalization of financial sector institutions, and of banks in particular, a few of the larger banks have established operations in emerging markets. When risk managers of these institutions assess the risks in their portfolios and balance sheets from operations, they tend to analyze the risk profile on a broad basis and on an asset class basis. In particular, in times of heightened uncertainty, such as during the past couple of months, this unfortunately puts emerging markets at the forefront of a reassessment of risks by those managers, who are inclined to retrench from asset classes as a whole. The particular circumstances and policy regimes in individual emerging markets tend not to be fully taken into account by the risk managers, as the decision to retrench lending is basically undertaken to protect bank capital in times of heightened uncertainty. Banks decide on the basis of cumulative or total exposure when reducing their risk exposure, which implies that they do not discriminate whether an exposure has been created by the local branch offices in the emerging markets or whether it has been created by the global financial centers of New York, London, and Frankfurt. The staff tried to illustrate that phenomenon statistically by using consolidated data from the BIS, which are therefore different from the statistics on external debt.

Trade contagion has not played a major role in the recent capital account crises. The conditions mentioned by the staff in Box 3.1 were merely necessary rather than sufficient for trade contagion to occur. The staff's key concern remains the retrenchment of capital or bank lending from emerging markets.

Regarding the specific contagion from Argentina, as noted in previous reports, and in the current Report, it was initially limited because the crisis had been anticipated by market players well in advance. Therefore, the majority of portfolio investors had time to adjust their positions before the crisis happened. However, subsequently, a number of unfavorable developments occurred and affected neighboring countries through the real sector and banking sector channels. Moreover, the unfortunate concept of "FDI contagion"—which was broadly understood as the possible risk that FDI or contracts underpinning FDI in countries other than Argentina could also be suspended on a unilateral basis—surfaced in the markets. This may be partly related to the fact that investors were, at that time, also beginning to reconsider their exposure to other emerging markets from an FDI perspective.

On the question why there was greater contagion in Brazil, it was basically because investors had early this year priced in a positive political scenario; asset prices reflected a high probability that there would be policy continuity. However, subsequent political and other developments took a large number of investors by surprise, and they therefore reversed their positions fairly quickly as losses mounted. In addition, they shed some positions that were profitable, which ultimately led to this fairly short episode of contagion in June.

> On Mr. Al-Turki's question regarding dollarization, the staff agrees that dollarization of the banking sector is not, per se, a cause of a financial crisis. Rather, dollarization would exacerbate the effects of the crisis and currency mismatches, in particular the impact on banks' balance sheets.

Mr. Oyarzábal reiterated his concern over the vulnerability indicators used by the staff in Box 3.1, and suggested that other indicators be added to provide a fuller analysis on emerging market contagion.

Mr. Bischofberger made the following statement:

> We welcome the third issue of the *Global Financial Stability Report.* Mr. Häusler and his team have again produced a very informative and high-quality analysis of recent developments in the international financial system. We are pleased with the evolution of the Report and we very much appreciate that the staff continuously incorporates proposals that were made in previous discussions. Overall, the Report has, therefore, become more focused and forward looking.
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> Directors who issued statements for today's discussion have made a number of proposals with respect to the format of the Report, which deserve further consideration. With regard to frequency, there seems to be merit in considering a move to a semi-annual cycle, perhaps complemented with short updates in between. But I would caution to take a decision now. The greater public might be confused by a change in the publication frequency so shortly after the introduction of this new publication. Instead, I would recommend to wait until further experience with the current publication cycle has accumulated. Mr. Häusler indicated that a fall publication cycle may be the appropriate time span, and I agree. I also concur with those Directors who see additional scope for a closer coordination between departments in drafting the *GFSR* and the *WEO*. However, a certain overlap of analysis and information in the two publications seems to be unavoidable. Finally, I would like to echo Mr. Andersen's and Mr. Törnqvist's comments concerning the possibility that the Report could draw also on existing stability reports of central banks and supervisory institutions to complement private market sources.
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> That said, I would like to stress that we share the main thrust of the analysis and the policy recommendations. Conditions in global financial markets have deteriorated significantly in recent months, reflecting a sharp erosion of investor confidence and heightened risk aversion. Regarding developments and sources of risk in major financial centers, we note—like others—that the Report has a strong focus on the U.S. economy and U.S. financial markets. Clearly, U.S. markets play a central role for global financial flows. Furthermore, recent revelations of corporate accounting irregularities, abuses and fraud—predominantly but not exclusively in the United States—have been instrumental in driving worldwide asset prices down. In this

respect, I can associate myself with the remarks of Mr. Andersen and Mr. Törnqvist, who encourage more substantiation of some statements concerning Europe. I also agree with Mr. Padoan and Mr. Vittas that the Report's assessment of the exposure of the EU banks and the vulnerability of the predominantly bank-based EU financial system seems overly negative. We think that, all in all, and despite a number of adverse developments in 2001, the euro area banking sector is robust. This is also the conclusion of a recent article in the ECB Monthly Bulletin dealing with current developments and risks in the euro area banking sector. More specifically, while we do not, in general, call into question the analysis in the first paragraph of page 26 on developments of European and German financial institutions, we are concerned that this quite short paragraph could be misinterpreted and raise doubts about the underlying soundness and systemic robustness of the European and the German banking system as a whole. Mr. Häusler and Mr. Tran already addressed this issue, but further comments would be welcome.

On emerging markets development and financing, we welcome the staff's analysis of contagion. While we broadly agree with the staff's detailed analysis, I would like to stress that markets continue to play their very important role to distinguish visibly between different sets of policy choices, including different institutional arrangements. In that regard, I concur with Ms. Lundsager and Mr. Baukol, that credit will flow more readily and on better terms to countries that are able to reduce risks, for instance by strengthening their financial sectors and enforcing the rule of law.

Regarding emerging local bond markets, we agree with the staff on their potential merits. We think, however, that domestic bond markets should be developed primarily with a view to facilitate private sector financing. As noted in the Report, government borrowing in narrow markets often crowds out the private sector and experience shows that excessive public sector activity with a related huge financing requirement is the root of many financial crises. It is, therefore, of utmost importance that the public sector uses, first of all, tax revenues to finance its activities, while using debt financing predominantly to smooth out cyclical fluctuations. The cultivation of local bond markets would prevent contagion from other economies only if accompanied by sound fiscal policies and prudent debt management.

Mr. Callaghan made the following statement:

As others have said, the Report provides a very comprehensive description of developments in global financial markets. A number of Directors have commented on its structure, content, timing, and so forth. It is good that we are focusing on these issues, and Mr. Häusler has said it is work in progress.

In terms of the interaction of the *GFSR* with the *WEO*, I found a clear benefit in reading the *GFSR* and the *WEO*, and looking at some of the statements, I think other Directors found similar benefits. It is good that we are discussing the two reports in close proximity because they are closely related. The two reports should be prepared, presented, and considered as companion volumes. Certainly, there is some cross referencing in the *GFSR* with the *WEO*, for there inevitably has to be significant overlap between the two reports. Mr. Häusler has noted that the *GFSR* does not deliberately venture into the real economy. But this is what we are all interested in—the impact of financial market developments. Some readers may not know that the *GFSR* is deliberately staying away from references to the real economy, so there will have to be close cross-references with the *WEO* on this issue. It is work in progress, and as Mr. Shaalan and others note, there is scope for improvement in terms of greater coordination with the *WEO*. On the timing of publication, there would seem merit in the *GFSR* being a biennial publication, but taking a different view from Ms. Lundsager, perhaps the best value would come from the *GFSR* being issued in conjunction with the *WEO*.

While we appreciate the policy references in the *GFSR*, we would echo previous comments and say that there should be more discussion on policy implications of market developments. As it stands, the policy discussion is somewhat limited and we should always remember that we are essentially policy advisers.

The Report notes that the financial system remains resilient and market adjustments have been orderly in that they have stopped short of a widespread withdrawal from risk taking that could derail the global recovery. This may be a fair assessment and some have taken a good deal of comfort from it, but it is a very broad assessment and many readers may find it difficult to equate recent financial market developments as representing orderly adjustments. However, it is worth noting that the most recent slide in U.S. equity prices is part of what has been a very prolonged adjustment. This is the third year in a row that broad indices of share prices have fallen—it is proving to be an unusually drawn-out decline. It is also worth noting the magnitude of the decline, for on some stock indices we have seen a nearly 50 percent fall from peaks. We seem to forget this at times.

The real value of the Report is not in describing what has happened, but in looking ahead. We look at what has happened as a guide to what might happen. The focus of the Report should clearly be on the risks and shocks that could see a widespread withdrawal from the markets, and importantly, if there is anything policymakers can do to minimize the chances of such disruptive developments. The downside risks identified in the Report have the potential of being very disruptive—as Mr. Padoan and Mr. Vittas have stated in the first heading of their statement, 'A Worrying Global Scenario.'

The Report highlights that a key to whether future value erosions in U.S. financial markets will derail even further the global recovery will depend on the behavior of retail investors, particularly U.S. retail investors. If retail investors lose confidence and dump their equity investments, this could see a sharp fall in values, significant wealth effects, and an adverse impact on what has been the bulwark of the U.S. economy, namely, private consumption.

As the Report notes, the fact that financial risk is more widely spread through the economy means that there is a less direct effect on the condition of financial institutions, but it also means that retail investors are more exposed than ever before to movements in equity prices.

Whether there will be a withdrawal en masse from financial markets and risk taking seems to depend, in large part, on whether further corporate governance problems are exposed.

But this should mean for policy that it is simply a case of wait-and-see—hold our breath, hope the market continues to recover and that no further bad news comes along, which could significantly derail confidence?

There is clearly a role for pre-emptive policy to help bolster confidence, particularly among retail investors, in the face of any future shocks.

The three dot points on page 11 refer to the need for increased vigilance by those in charge of financial stability, and that "additional efforts to improve corporate governance, accounting, disclosure and transparency will most likely be needed..." I think we could drop the "will most likely" and say "will be needed".

The Report should expand on these policy issues. An appropriate regulatory and self-regulatory response to promoting corporate governance is essential. The material in Box 2.1 is a start, but it needs to be expanded, including the importance of ensuring that a balance is maintained, and that there is not a knee-jerk regulatory response, which limits necessary risk taking and entrepreneurial activities. Mr. Häusler and Mr. Tran have made a few brief comments on the adequacy of policy response—it would be good to see more on this in the Report. But there is an issue whether the regulatory response to date is adequate, has it gone far enough, or is it adding to uncertainty. In short, the policy issue should be covered.

While not wishing in anyway to downplay the risk imposed by further evidence of corporate governance problems, we wonder how much of the slide in U.S. equity prices in July was the result of disappointing earnings numbers for the second quarter (expectations were for 30 percent growth and they came in flat) and how much was it concern over corporate governance.

The incorporation of more conservative earnings expectations could be a major positive for the future stability of equity markets.

A key risk is whether there may be a sudden change in sentiment by international portfolio managers towards U.S. dollar assets.

It is appropriate that this be a focus of both the *GFSR* and the *WEO*, but this is a specific area where I think there could be a closer link between the coverage in the two reports.

For example, the *GFSR* appears somewhat more complacent than the *WEO* as to the prospect of a benign adjustment to the current account imbalance. To quote from the *GFSR*: "Given the historical experience with U.S. capital account adjustments, there would seem to be a small likelihood of a sudden market shift in investor sentiment against U.S. assets ..." I hope this is right, but the issue is how much comfort should we draw from the historical experience of corrections to major payments imbalances?

The prospect of a disruptive adjustment cannot be dismissed. The disturbing aspect is that while we continue to identify that a major risk facing global economic and financial stability is that foreign investors may lose their appetite for U.S. financial assets, the *WEO* forecasts imply that U.S. net liabilities will continue to grow to unprecedented levels. This is, as the *WEO* notes, an unsustainable position. The exchange rate has to be part of the adjustment, and the issue is whether or not it will be orderly.

The *WEO* has a brief discussion on how policy should respond to the assessment that existing current account imbalances are unlikely to be viable over the medium term. Some policy discussion should also be included in the *GFSR*, particularly given that one of the conclusions in the *WEO* is that reforms of accounting rules and enforcement procedures are important in maintaining investor confidence in U.S. assets.

The increasingly obvious weakness in parts of the European banking and insurance sectors are also of concern, not least because of the impact on emerging market financing flows. Barriers to cross-border consolidation may exacerbate the weakness evident in sectors of the European banking system and prevent the speedy resolution of problem banks. Efforts to address barriers to consolidation should be accelerated with an eye to improving the stability of the financial sector.

In terms of emerging markets, we should be particularly concerned about the assessment in the Report that there are growing signs of contagion.

The defense against contagion which the Fund has advocated is the adoption of good policy and appropriate risk assessments by investors, so that they discriminate among emerging markets and recognize good policy.

We have already seen a number of comments on the issue of contagion coming from events in Brazil.

With an eye on the policy message, it is important to highlight that investors still recognize good policies, and that this is evident in the generally positive investor sentiment towards the emerging markets in Asia and Eastern Europe. This point should be brought out more in the Report. We support Ms. Lundsager's comments in that we should also outline why some countries are performing well.

The Report rightly highlights the connection between mature and emerging markets, and that volatility in mature markets can have a destabilizing impact on emerging markets. In fact, the risk aversion which is impacting on emerging markets may have at its source the financial turbulence in the mature markets, as it does in the events in Brazil.

A sharp further downturn in mature equity markets would have an adverse impact on global growth prospects. This is particularly relevant for the emerging markets, for the factors which the report says may mitigate the vulnerability of the emerging markets to further volatility in the mature markets seems to depend on an improvement in the global economy. Here there seems to be some circularity in the argument in the Report.

Another key point raised is that while many emerging market sovereigns have been insulated from recent market turbulence because of pre-funding, the same does not apply to corporates. Moreover, sovereign pre-funding is running out, and if markets are closed, the obvious question is the implication for demand for Fund resources. Perhaps this is an issue that should at least get a mention in the Report.

Finally, the selected topic on emerging local bond markets is particularly important and, like Mr. Shaalan, we think it should be a subject of ongoing study and technical assistance.

Mr. Brooke made the following statement:

Like other Directors, I would like to thank the staff for the latest edition of the *GFSR*. We are in broad agreement with its main messages.

Despite the clearly adverse developments in financial markets, we feel that the financial system has thus far shown somewhat greater resilience than at previous points of turbulence. Looking ahead, while we are concerned that downside risks predominate, we tend to agree with the staff that the most likely outcome is that global financial stability will be maintained. Our main reasons for reaching this conclusion are:

- Our agreement with the *WEO's* projection for a gradual recovery in global activity.

- The sound macroeconomic policy frameworks in most advanced economies and the scope for further monetary policy easing, should it be required.

- Improvements in risk diversification and the generally good health of the large financial institutions in advanced economies.

- The fact that equity prices are now closer to the levels suggested by underlying fundamentals.

Turning to the risks, we agree with the staff's concern that the sharp declines in the prices of securities could lead to strains in a number of the large and complex financial institutions and that, if realized, this would facilitate the transmission of shocks between the major financial centers. Given the related weaknesses in the insurance and pension sectors identified in the previous *GFSR*, we concur with the staff about the importance of central banks and regulators closely monitoring such developments for any early signs of stress. We hope that the staff will continue to be kept informed of these assessments through their participation in Financial Stability Forum meetings.

Second, the Report rightly highlights the adverse effects on investor sentiment arising from recent misreporting of corporate profits. The main risks here arise from the fact that it is not yet clear what the true origins of the problem are, in terms of whether the fault lies with the U.S. accounting standards, or a more general deterioration in corporate governance. The latter would clearly have wider reaching implications for firms operating outside of the United States. We hope the issue relates more to U.S. accounting standards and that the new legislation introduced in the United States under the Public Company Accounting Reform and Investor Protection Act will be sufficient to restore investor confidence. In the absence of a clear understanding of the nature of the problem, we tend to agree with the staff that additional efforts should be made to improve corporate governance, accounting, disclosure, and transparency. In this regard, the text could have included an explicit encouragement for more countries to undertake the ROSC on corporate governance and sign up for the OECD's code of good corporate governance.

The third risk highlighted by the staff is the potential for a rapid and disorderly change in the direction of capital flows away from the United States and the knock-on implication that this would have for exchange rates.

Here, we tend to agree with Ms Lundsager and Messrs Portugal and Tombini that an orderly adjustment of global imbalances and exchange rates is the most likely scenario. Furthermore, it is important to recognize that a reduction in current account imbalances and a depreciation of the dollar are appropriate developments. The key for policy makers will be to ensure that such developments happen in an orderly fashion.

As staff note, another channel that could result in a sharp adjustment of capital flows would be a rise in household savings rates in the countries where consumption growth has been strongest over the past year. While such an adjustment is also more likely to be gradual, household behavior could change quite quickly if debt servicing costs were to rise. It would be helpful, therefore, if the staff could make a fuller assessment of personal and corporate income and capital gearing ratios in advanced economies, and the associated linkages with banks and other credit institutions. In this regard, I agree with Mr. Callaghan that it is very difficult to separate financial and real economy issues. I would be wary of trying to push this separation very far.

Overall, we broadly agree with the Report's policy recommendations for the advanced economies, as set out on page 11. We would, however, place less stress on the need for financial companies and large corporations to reduce their reliance on income sources from non-core business activities. Diversification has an important role to play in reducing risks and in lowering the volatility of firms' revenues.

Turning to developments in emerging markets, the Overview chapter rightly notes that indicators of risk aversion and contagion have increased, but remain well below the peaks observed in the 1997 and 1998 crises. Helpfully, there are also other signs of continued investor discrimination between different countries. The draft *WEO* rightly adopts the same line. However, as others have highlighted, some of the text in Chapter III of the *GFSR* places a little more weight on the role of contagion, especially emanating from Brazil. Given the need for the Fund to promote greater discrimination among investors, it would be helpful to ensure that the *GFSR* presents a consistent message about this issue. Like Mr. Oyarzábal and Ms. Lundsager, we would also like the text to include a stronger policy recommendation about the need for authorities in emerging market economies to do more to promote greater transparency, thereby facilitating better investor risk assessments and market discrimination.

Another area where we felt the analysis of the *GFSR* could helpfully have been expanded somewhat is in the role played by vulnerable debt positions. The first sentence in Box 3.1 rightly highlights that adverse debt dynamics have been paramount in determining which countries have been the most likely to be affected by the recent wave of crises. Given this fact, it would have been helpful to have presented a fuller discussion of which countries are currently considered to have the most vulnerable debt positions, taking account of debt levels and their currency and maturity compositions. Similarly, it would be helpful to emphasize more strongly the importance for countries to implement policies to reduce vulnerable debt positions and to undertake their own comprehensive DSAs. In this regard, I would be interested to hear from the staff whether their work on identifying vulnerability thresholds for debt positions has progressed and would also like to know what strategy is being pursued towards the adoption of the agreed comprehensive format for DSAs in Article IVs and program documents.

The growing divergence between the experiences of emerging Asia and Latin American countries is particularly interesting in this context. Does the staff feel that these developments are justified by assessments about debt positions, growth prospects, and progress made on structural reforms?

We found Chapter IV very useful. In particular, we agree with the staff that the development of local bond markets will help to reduce external vulnerabilities. For example, greater issuance of inflation-indexed debt would remove uncertainty about the real cost of borrowing and would limit the authorities' incentives to erode the value of government debt through inflation. However, we accept that developing such markets is not a simple task and considerations of demand and liquidity, as well as the institutional, regulatory and macroeconomic environment, need to be taken into account. Like Ms Lundsager, we encourage Bank and Fund staff to do more to assist countries to develop their own local bond and equity markets.

Linkages and substitution effects between different forms of financing, as the staff highlighted, need to be considered fully in the final installment.

Finally, we welcome the way the *GFSR* is evolving. While there is scope to shorten it, we agree with Mr. Yagi that the current unsettled market conditions underscore the usefulness of a thorough examination of global financial markets on a quarterly basis. As on previous occasions, we have a number of more detailed comments, which we will pass directly to the staff.

We welcome the press conference to be held at the Bank of England on 12 September to launch this edition of the *GFSR*.

Mr. Kiekens made the following statement:

The third *Global Financial Stability Report* is the outcome of good hard work delivered—it should be noted—by a rather small staff team from the International Capital Markets Department. I also give high marks to the staff for the straightforward, well-structured oral comments presented at the outset of the meeting. The Report's analysis and policy recommendations are sensible. The report could be improved by streamlining and eliminating repetitions. Descriptions, analyses, and policy recommendations should be more clearly labeled. Additional statistical data would better document and justify the Report's analysis, conclusions, and recommendations. I would like to give one example. The staff points to the somewhat weakened financial condition of some European banks caused by their exposure to the telecommunications sector, the emerging markets, and several large U.S. corporations now facing financial difficulties. Some European Directors found this assessment unjustified. More precise documentation could have clarified this issue, but I can understand that detailed information may not yet be available. More generally, cooperation of the staff with the BIS and other authorities in Europe and elsewhere can be most helpful in improving the descriptive part of the report and providing statistical documentation. I am well aware that all this would require additional work, and it therefore might be better to produce only two reports a year.

The first and second Reports arrived at relatively positive conclusions, though more cautious than the general optimism of the markets at that time. The third Report is definitely more pessimistic. As Mr. Häusler rightly recalled at the outset of the meeting, early this year, the Fund was warning that the financial markets could be pricing in an unrealistically robust recovery of economic activity and earnings, creating the possibility of a disappointment. In fact, this scenario has become reality. It is now expected that the global recovery will be weaker than initially projected, and equity prices have undergone a significant downward correction. This correction of equity prices seems larger than can be explained solely by the moderation of the recovery projections. Indeed, what we have seen in the second quarter was not simply the markets' adjustment to a less robust recovery, but also an increase in risk aversion. Lower financial market confidence may result in further damage to economic activity from falling equity prices, tighter credit conditions, and even lost market access for less creditworthy borrowers.

On a more cheerful note, the staff observes that, until now, the global financial system has proved resilient to effects of the significant correction in the financial markets, partly because the risks are now more widely spread. But this does not mean that the correction will have no effect on the global economy. Households have become important holders of financial assets. Even if the effects of the correction are be less for the balance sheets of financial institutions, and thus for credit flows, they will be greater for households' balance sheets, and thus for consumer demand. Subdued consumer demand in the United States and elsewhere might become a principal cause of a prolonged period of weak growth and even deflation that could increase the stress in the financial markets and institutions.

Although the wider dispersion of financial risks is seen as one of the reasons for global financial market resilience, one may wonder whether this transfer of risk to non-bank financial institutions and households does not have some undesirable side-effects for the financial markets. The staff argues that the portfolio behavior of households is important in determining the future direction of stock prices, but their past behavior, as documented in paragraph 1 on page 28, suggest that households have typically shown pro-cyclical rather than contrarian investment behavior. Indeed, net monthly inflows into equity mutual funds peaked in February 2000, one month before the start of the equity market downturn. Likewise, the increased exposure of insurance companies and other nonbank financial institutions to market and credit risks may have reduced their willingness or ability to act as "contrarian" investors, who step into low markets or provide liquidity in times of stress. From this standpoint, some of the less desirable side-effects of the increased dispersion of financial risks may lead to higher volatility and lower liquidity in times of stress.

Uncertainty about global financial developments remains great. If there are no further negative shocks, and signs appear that the global recovery is strengthening, the situation in thc financial markets could stabilize and begin to improve. Many observers hope that such a stabilization may already have begun, but I am rather skeptical. The downside risks are indeed considerable, and have many triggers. These include a further weakening of economic activity in the major industrial countries, a further abrupt deterioration of the situation in the emerging markets, or the revelation of further corporate scandals.

The staff makes some interesting observations about the risk that investors will try to rebalance their portfolios away from U.S. assets. The bottom line seems to be that while U.S. prospects are not as good as formerly supposed, they are still better than those of other countries: investors therefore have no reason to leave U.S. assets en masse. And even if investors would like to, the question is whether alternative markets are sufficiently liquid and resistant to accommodate large inflows without excessive price movements.

A few comments on developments in the emerging markets. It is disturbing to see the effects of the Argentine crisis spreading to neighboring countries, especially Brazil. Even though Brazil's economic fundamentals have changed little for some time, its creditworthiness has plunged, solely due to market jitters about possible policy changes after the presidential election. Detailed analysis might reveal the lessons of this episode. The staff points in the right direction by stressing the need for both public and private sectors to avoid overdependence on inflows of external borrowed capital, and also the need to protect foreign direct investment by policies and institutions that guarantee continued macro and legal stability. Erosion of legal stability has recently become a source of contagion, particularly in Latin America. The breaches of obligations have gone far beyond those connected with borrowings, especially in Argentina. When economies become more and more private-sector driven, adequate protection of property and contracts also becomes more important. Unfortunately, this principal has not been respected. I would like to point to the asymmetrical "peso-ization" of bank assets and liabilities, and the freezing of the tariffs of privatized utilities in Argentina. Those measures amount to arbitrary expropriations, without compensation, that seriously undermine foreign investors' confidence with respect to Argentina, and—whether justified or not—with respect to other countries in the region. Given the significant worsening of Brazil's financial indicators even though its economic fundamentals remained relatively strong, the decision to increase official financial assistance was an appropriate response, as was Monday's meeting of Brazilian officials with creditor banks to secure the continuation of trade financing.

I find the analysis of the role of local bond markets very useful. I agree that local bond markets can provide a welcome alternative source of financing and reduce a country's dependence and vulnerability to shifts in external environment. We might study, in more detail, the conditions and policies that promote the development of local bond markets, and how economies with well developed local bond markets perform during time of increased turbulence in the international capital markets. It appears that the countries of Asia and Central Europe, which rely less on external and more on domestic borrowing, are clearly less affected by such turbulences than the countries of Latin America.

Finally, one comment on recent sovereign bond issues and the inclusion of collective action clauses. The staff observes that most of the international bonds issued by emerging market sovereign borrowers during 2002 do not include collective action clauses. During the present period of turbulence and heightened risk aversion among investors, it appears that issuers are especially careful to avoid any steps (such as CACs) that might further weaken investors' confidence. I wonder whether the staff shares this interpretation.

The Chairman asked whether Mr. Kiekens was recommending that the Fund should not continue to pursue its work on CACs.

Mr. Kiekens clarified that he was rather advising the Fund to be realistic and not expect that it could persuade emerging market countries—under the present financial market conditions—to change their policies to include CACs in their sovereign bond issues.

The Chairman agreed with Mr. Kiekens, and also supported his comment that safeguarding the legal environment for investment was an important next step in limiting the spread of contagion in Latin America.

Mr. O'Murchú made the following statement:

We welcome this latest Report and would like to compliment the staff on the improvements they are continuing to make. However, we still have a question about its value added in relation to the resources devoted to it, given particularly the other periodic analyses, such as the *WEO* and *WEMD*, which cover a lot of the same area, though not necessarily in the same depth. In this context, we too note the degree of overlap of the present *GFSR* and *WEO*. Perhaps, when the next *GFSR* is being considered by the Board, it would be useful to review experience with it, as Mr. Andersen suggests.

We would endorse the *GFSR's* objective of identifying fault lines in the global financial system and thereby helping to obviate crises. However, this raises the familiar dilemma between frankness and running the risk of precipitating the very problem we wish to avoid. This is a very difficult balance to strike and, in the present instance, I feel that the staff may have come to a conclusion about continuing market resilience without sufficient analytic justification. It would certainly be more comforting if that conclusion were supported by an analysis which showed that recent market volatility and rising risk spreads were not having a significant impact on players in the goods and services markets.

But even in the context of market sentiment, the pre-conditions for further financial turbulence are certainly there, particularly the flight to quality, concerns about the outlook for the real economy and the current fraught geopolitical situation. Adding to investor nervousness are worries about further unpleasant surprises relating to corporate governance, about the balance sheets of financial institutions, about how rough the process of resolving the payments imbalances between major economic blocs is likely to be, and about the sustainability of debt in important emerging market countries. Against this background, the contagion most to be feared is that of fear itself, i.e., that the nervousness of markets might for no specific reason descend into generalized panic. These factors underline the importance of the policy prescriptions set out on page 11. Though these recommendations may not be new, they certainly bear repeating. However, I would have one caveat relating to the recommendation that financial institutions rely less on income from non-core businesses—this suggests that these institutions should become less innovative and it also seems to mix up the issue of risk diversification with that of prudential risk management, which is the theme of the particular overall recommendation.

A number of Directors have referred to the possibility of a burst in the real estate bubble. I would be grateful for the staff's views on the possible linkages between the equity and property markets. Specifically, is the real estate market being buoyed by the movement of investors out of equities and what does history tell us about the sustainability of divergences in price trends in both markets over the cycle?

Finally, I agree with others who have commended the section in the Report dealing with emerging local bond markets. The development of such markets is certainly to be encouraged. However, I would caution that these markets are not necessarily a panacea, especially in a situation in which, to use the words of the Report, they attract the interest of global fixed-interest investors. Past experience in Ireland shows that a significant involvement of foreign investors in the domestic bond market can give rise to difficulties in terms of funding and exchange rate management at times of economic or financial stress.

Mr. Couillault made the following statement:

Like others, I would like to thank Mr. Häusler and his staff for the third issuance of this new publication. Progressively, the team has been refining the initial model and is still looking for an appropriate balance between market development monitoring and prospective issues. However, the format of the Report is still a source of debate, and I believe that Mr. Andersen's and Mr. Törnqvist's proposal to have a review of the experience makes a lot of sense, and it should largely benefit from the feedback from external readers. It is probably premature to have a definitive stance on the periodicity, but at first sight, I have the impression that two reports per year looks very attractive.

Since our last discussion, financial markets have had to face new shocks. As pointed out by Mr. Callaghan, after two years of decline in the stock market, the recent movements have amplified the fall. After the burst of the technology bubble, markets have had to absorb a loss of investor confidence following the Enron case. Doubts surrounding the accuracy of the accounting principles and the integrity of the reporting system have provoked a sharp reappreciation of profit expectations. I think that Mr. Callaghan and Mr. Brooke have made very valuable comments on this issue.

We share the staff's view that the markets have so far demonstrated some resilience. Panic movements have been avoided and in a certain sense developments in the stock markets have not been totally unwelcome since they have participated in reducing excessive valuations. However, these corrections, combined with doubts on the strength of the recovery, are a source of additional uncertainties with regard to the nature and the size of the wealth effects. As noted by the staff, the increase in retail ownership for financial assets in major countries can explain part of the resilience of the markets since risks are more widely spread throughout the economy. But, as rightly emphasized by Mr. Kiekens, this could lead to a greater impact of market fluctuations on household consumption.

While we agree that we should not overestimate the strength of the wealth effect on the stock market, we wonder, however, how the severe corrections will affect consumption behavior. True, in the United States, the wealth effect to the real estate market has contributed to counterbalance in part of financial market losses, but, as rightly stressed by Mr. Yagi and Mr. Toyama, uncertainties exist on the sustainability of the evolution.

Turning to the evolution of the financing of the U.S. current account, we welcome the staff analysis. We note that the staff is relatively confident on an orderly financial adjustment, and indeed the appreciation of the euro is a positive movement in the right direction. Given the existence of a "where-to-go" syndrome weighing on the capital flows and the positive impact expected from the dollar depreciation on U.S. exports, we tend to share the staff's confidence, but we still believe that we should not underestimate the risk of more abrupt adjustments and, in any case, we remain convinced that this is an important issue which must be kept under review.

Concerning emerging market financing, the recent evolution has confirmed the concerns we have expressed on the potential risk associated with the lasting crisis in Argentina. We note the staff's acknowledgment that developments in Argentina continued to sour investors' sentiment toward the region and that elements of contagion are at play. However, we share Mr. Padoan's and Mr. Vittas's interrogation on the limited role attributed to the Argentine crisis. In particular, we remain persuaded that we should devote more attention to the evolution of FDI. Here, I would like to associate myself with Ms. Lundsager's remark. I welcome Mr. Häusler's comments, and I look forward to his analysis. I also believe that Mr. Kiekens has a very valid point on this problem of legal stability, which is part of the problem and which could have an impact on FDI evolution.

While the situation in Brazil remains uncertain and weighs on market sentiment, we find the analysis developed in Box 3.1 particularly interesting, and we would like to thank the staff for this presentation. I would see no problem in developing this analysis to have maybe more balanced views. So far, we are still facing developments having a regional dimension, but like Mr. Szczuka and Mr. Moser, we have some concerns for the coming months, in particular given the unusual accumulation of political uncertainties in a very limited period of time not only in Brazil and Turkey, but I refer also to the potential terrorist attacks and the risk of war in the Middle East.

Finally, let me say a couple of words on the situation of financial institutions in Europe. The staff stresses the potential risk clouding the European banks and insurance companies. While we welcome the attention given to Europe in a report largely focused on the United States, we would appreciate it if the staff could develop their assessments in future reports. No doubt, the staff has interesting arguments and stimulating analysis; but given the sensitivity of the topics and the influence of any IMF report, we believe that we should remain careful and provide well-documented and precise qualification of the assessments.

Concerning the situation of the French institutions, for example, my authorities remain relatively confident vis-à-vis the potential risk identified by the staff. The relatively low exposure of French insurance companies in stocks, plus the high level of previous unrealized capital gains, provide enough cushion to absorb the recent fall in the stock market. Banks also, so far, do not indicate a major problem. This being said, my authorities will continue to monitor very closely market developments and their impact on the financial soundness of French institutions.

Mr. Palei made the following statement:

I welcome this opportunity to discuss the *Global Financial Stability Report* and thank the staff for their work. On the mature markets, I agree with the staff that despite recent breathtaking swings in the market indices and gloomier economic outlook, the financial markets continue to demonstrate their resilience and continue to play their essential role in financial intermediation. At the same time, I agree with the staff's insights on the sources of risks in the mature economies. In particular, the behavior of retail investors in the United States is a major source of uncertainty and has to be monitored closely. Major declines in equity prices sustained over a rather lengthy period of time are, indeed, testing the retail investors' devotion to the asset class. Investors have to deal with higher uncertainty due to confluence of many factors, including the burst of the bubble in the technology sector, the slowdown of the economy after a very long period of growth, the recent revelations about the accounting irregularities, and also the serious structural adjustment in transportation, travel, and other industries as a result of the September 11 events. All of these shocks complicate proper valuations of the companies and create difficulties in estimating future earnings. However, there are also positive signs in the markets. Recent recovery in the stock markets coupled with heightened activity among institutional investors may provide the needed support for the markets and mitigate some of the retail investors' fears.

I also agree with Directors emphasizing the importance of housing market in affecting the behavior of consumers in general and retail investors in particular. The staff have looked into the risks of the real estate being overvalued and they seem to share the in-depth analysis of Federal Reserve that while some metropolitan areas may suffer temporary declines in housing prices, the broader market is characterized by rather strong fundamentals. Moreover, the risks here, as in other financial markets, are broadly dispersed through a well-developed market for mortgage-backed securities, and thanks to an active role of the real estate investment trusts (REITs). In addition, in the United States, the interest rates on mortgages are now sufficiently low to lead to yet another round of refinancing, which may support the level of consumption in the economy, similar to the previous episodes during the last two years. Refinancing would allow homeowners to further decrease their liabilities. Still, like Mr. Shaalan and some other Directors, I think the Report would benefit from highlighting the financial issues related to housing market, and I look forward to the more detailed analysis of these issues promised by the staff today.

On the emerging markets, it seems to me that the gravity of the recent pressures on emerging markets, as a group, is somewhat exaggerated in the Report. At least I have such an impression from the introductory section. Under current circumstances, it is difficult to treat the emerging markets as a homogeneous group. The recent deterioration in regions other than South America was rather mild, and it can hardly be attributed to contagion from Brazil. More likely, the increases in bond spreads and moderation or volatility in equity prices resulted from the increase in risk aversion of investors in mature markets. Increases in spreads for most of the emerging market countries were in tandem with the spread widening for other similarly graded investment instruments, which is evidenced by the correlation between the EMBI+ (without Brazil) and Merrill Lunch high yield index.

In South America, as the staff correctly pointed out in Box 3.2, country-specific developments dominated market sentiments, such as IMF program delay in Ecuador or security concerns in Colombia. At the same time, there are few, if any, signs of contagion from Brazil beyond the region. To see the effects of worsening investment sentiments towards Brazil on other emerging markets, it is instructive to compare second quarter financial flows with the first quarter. From Figure 3.6, we see that primary bond issuance declined only for Western Hemisphere borrowers, while access remained unrestricted for sovereign and, more importantly, for corporate borrowers from others regions, so there was no market closure for countries outside South America and investment grade borrowers. Equity placements depicted in Figure 3.12 also show no difficulties. Figure 3.13 shows marginal decline in syndicated lending in the emerging markets, from $10.9 billion in the first quarter to $9.4 billion in the second. As I have already mentioned, generalized widening of spreads on sovereign and corporate bonds can probably be attributed to lower tolerance for risk in the mature markets across various assets classes, not just with respect to the emerging market bonds. In our view, most of the emerging markets still remain relatively immune to financial pressures in Brazil. The introductory section of the report would benefit from some editing to reflect the differences between emerging markets, so that it better corresponds to the main chapter on the emerging markets.

I found the discussion of potential retrenchment of cross-border lending in Box 3.1 to be illuminating. Today I have heard many Directors' questions about the assumptions in this analysis, and I hope that they can be clarified before the publication of the Report. If the analysis is correct, heavy reliance of several countries on Spanish banks, which suffered from economic collapse in Argentina and are also exposed to Brazilian risks, could be a problem for some of the countries in Latin America. Potential role of the Spanish and other banks in contagion is yet one more argument to monitor the health of the financial sectors in advanced economies. In this respect, I support Mr. Mirakhor and other Directors in their call for closer surveillance in this area, and FSAP should be one of the vehicles to achieve this goal.

I welcome the paper on emerging local debt markets. As the staff emphasized, these markets are not only a potential alternative source of financing, but in many countries, they already play an essential role easily comparable to external financing. This chair encourages the staff to further develop this work and go beyond the description of the main features of local bond markets in emerging countries. The staff should aim at continuous monitoring of the developments in these markets; they should highlight and address the data limitations and, hopefully, come up with analysis of implications for current policy issues.

I appreciate the inclusion of information on the use of CACs in newly issues bonds and call on the staff to provide even more country-specific information in the future reports. I also agree with Mr. Kiekens that it would be premature to rush into conclusions about the lack of progress with the use of CACs. It is too early to see whether the pace of the progress within the contractual approach to the SDRM can be increased.

Finally, I tend to share the opinion of Ms. Lundsager about the possible revisions of the periodicity and format of the *GFSR*. Semi-annual publications of a comprehensive report supplemented by quarterly focused reports on emerging markets financial stability could relieve some of the pressure on staff resources and could also enrich the Board discussions.

Mr. Wei made the following statement:

At the outset, let me commend the staff for presenting another excellent report on global financial stability for today's discussion. I would also like to associate myself with Mr. Mirakhor and others in emphasizing how useful and important an instrument the *GFSR* has become in the Fund's multilateral surveillance endeavor. Like Mr. Reddy and others, I also support Mr. Mirakhor's view that given the incidence of irregularities in accounting and auditing practices in the United States and the latest developments in some European financial institutions, FSAP and other ROSCs as tools for the Fund's surveillance of financial markets should be conducted in industrial countries as well. We generally endorse the staff's views in the Report. We agree that the overall international financial situation has deteriorated in the past quarter. This is reflected in the decline in the major equity market indices, reduced lending by institutional investors to high-risk borrowers, the continued depreciation of the dollar against major currencies, increased fragility in emerging bond and equity markets, and signs of emerging contagion from the recent development in some Latin American countries.

The Report correctly points out three major risks to international financial market stability, namely, the possible continued erosion of investor trust and confidence, the accumulated losses experienced by financial institutions that could impair the capital positions of key institutions, and the possible rapid slowdown of net capital flows into the United States, but concludes that the most likely outcome is that financial resilience and stability will be maintained. At this stage, this general judgment has important implications for policy makers around the world and, therefore, deserves careful examination.

First, the Report argues that the global economy still appears to be improving, although at a slower pace than expected. Implicitly, this implies that the international financial market will get support from a still relatively solid real economy. While we understand this analysis, the real economy and the financial market are interacting with each other. The continued absorption of the equity bubble could generate lasting effects on consumption and also affect the capital adequacy and cost of financing in the banking and corporate sectors.

In this regard, the staff argues that the recent market corrections have worn off some of the unrealistically high equity valuations that were once a direct source of risk. Does this mean the equity price has already reached its bottom and will start to recover? Not necessary. As pointed out in the Report, great uncertainty surrounds the behavior of retail investors. The reduced inflow and even outflow of money from mutual funds in recent months are ominous signs of money withdrawal by retail investors. This means that an overshooting in equity price still exists. Thus, we believe the national authorities, as well as the IFIs, should continue to be vigilant in closely monitoring equity market developments.

Second, as mentioned in the recent *WEO*, productivity in the United States may be revised downwards due to the recent revision in the national account. Although the exact result of this revision is still unclear, its potential impact on the market could not be ignored. The higher productivity in the United States has been the major explanation for the new economy, the large sustained capital inflow to the United States, and the high valuation of the equity market. As pointed out in the Report, there may be no other place in the world that is more attractive to investors than the United States, however, the exchange rate movements between major currencies may become more volatile in future and this will have a destabilizing effect on the global market—especially for some emerging markets.

Third, the contagion which recurred in some Latin American countries may spread to other emerging markets through many channels including the retrenchment of major institutional investors across the entire class of high-risk assets. In this context, I join Mr. Rustomjee and others in welcoming management's announcement of a new $30 billion Stand-By Arrangement with Brazil, which has helped stabilize the market not only in Brazil, but also the Latin American continent. We hope a Fund-supported program with Argentina could be agreed upon—the sooner the better.

A technical issue concerns Box 3.1 in which the common credit index measures the similarity of sovereigns' borrowing patterns relative to those of Brazil. Although we are glad to see that Hong Kong SAR has the lowest index in the graph, we would like to emphasize that the Hong Kong SAR government does not borrow. We thus wonder where the borrowing patterns information comes from.

In sum, although the cautiously optimistic tone expressed in the Report is reasonable in many aspects, we would rather give greater weight to the risks that may lead the world toward a less pleasant scenario. In light of these risks, the Fund should be alert to the higher-than-usual fragility in the international financial market at this particular juncture and be ready to take more active measures to prevent crises in specific countries from spilling over to the rest of the world. Should the downside risks become a reality, we believe further stimulus is necessary. Therefore, member country authorities, especially those of the major industrial countries, may need to consider taking further actions in assisting the already weakened recovery.

Mr. Yakusha made the following statement:

The current Report provides a rather interesting insight into recent developments in important financial markets and, as such, is a valuable addition to the *WEO* exercise. This Report appropriately concentrates on the downside risks to global financial stability. In addition to the continuous reduction of risk appetites in mature markets, there seems to be a growing import of contagion, which has started to spread among many emerging market economies. This should not be surprising as investors will continue to behave cautiously in light of the uncertain U.S. and European recovery, following the somewhat shaken confidence in corporate governance, the continuous downsizing in the technology, media, and telecommunications sectors, as well as difficulties in most of South America. The staff correctly highlights, while not overdramatizing, the additional risks stemming from possible movements in the major exchange rates, reduced profitability of banks, and further reduction in financial flows to emerging markets. I generally agree with the staff's analysis, and would just like to make a few points for emphasis.

First, the staff argues that the abrupt reversal of capital flows into U.S. financial markets, which could lead to a substantial depreciation of the dollar, is unlikely. I would be somewhat more concerned, however, as all three factors mentioned on pages 35 and 36 of the Report, which have triggered an appreciation of the dollar in the past, have a risky flip side. The most important of those factors is that a large share of dollars in total international foreign reserves implies that a small average global portfolio adjustment could trigger a relatively large sell-off of the dollar; and markets may behave irrationally in this regard. Like other Directors, I would also mention that the fact that the U.S. housing market has never experienced a serious sustained price depression before does not render it immune from abrupt price corrections. A fragile housing market in the United States may eventually increase the likelihood of exchange rate volatility and endanger consumer confidence.

On emerging markets, given the most recent developments, the Report could pay somewhat more attention to the probability of sustained higher energy prices and its consequences. If oil prices remain at the current levels for a longer period of time, or increase even further, this could pose a new shock to some of the already weakened emerging market economies, raising new doubts about debt sustainability and causing the already high bond spreads to rise further. High energy prices may also cause a fall in both consumer and market confidence in many industrialized countries, thus limiting the possibilities for emerging markets to export themselves out of the current difficulties.

The increasing risk aversion, which is signaled in the Report, might last longer than earlier crises. With Argentina in default and market participants wondering whether other large emerging market countries could go the same way, banks and other investors might eventually alter their emerging market credit strategies. This would lead to less available emerging market financing and structurally high spreads. Although one might argue that investors seemed to have forgotten the Russian crisis quickly, there is a substantial difference in the speed of reforms and the willingness of governments to take decisive actions among emerging market countries, at least at the beginning of the transition. There is a continuous stream of oil revenues flowing into Russia, something which other non-oil producing emerging markets are lacking in. Adding to the possible increased structural risk perception of emerging markets is the announced Fund-supported program for Brazil. If it fails to restore confidence, that would be a blow to the credibility of the Fund, and market participants would probably increase their risk perception of emerging market lending.

On financial sector stability, over the past 12 months, financial institutions in continental Europe and some other countries have had to cope with lower growth, reduced profit forecasts, and increased risks due to such events as accounting scandals and market turbulence. The focus in the Report is somewhat skewed, in our view, against banks in Europe. Although risks to the profitability of these banks exist, their solvency seems to be intact, partly as a result of the relatively mild economic downturn. Moreover, the IT sector boom of the late 1990s was to a great extent financed in other markets, such as through corporate stock and bond issues, as well as venture capital. Furthermore, some structural changes during the last decade have had a positive effect on the resilience of banks—for example, solvency ratios have increased worldwide. Due to financial innovations such as credit derivatives, risks are now more evenly spread, and financial institutions themselves have facilitated greater diversification. The staff notes that European banks' market valuation has been strongly affected by the market turbulence in the United States, but this is partly also due to the fact that European banks historically had a bigger role in financing new businesses.

As the staff rightly notes, the development of local bond markets in emerging market countries could soften the impact of disruptions in international markets or bank credit. But, like other Directors, we would caution against treating local bond markets as a panacea. We would welcome continuous staff attention to this matter, especially on the issues of the interaction between corporate and government bond markets, and on the subject of crowding out.

Mr. Guetat made the following statement:

We would like to thank the staff for producing this insightful and comprehensive update on the global financial market stability since our last meeting. While we are reassured by the staff's comments on the resilience of financial markets, we would like to call for more vigilance in light of the slow recovery in the world economy along with major developments in other markets. We are still concerned by the impact on developing countries' economies, given the uncertainties surrounding the economic outlook for the second half of 2002. We expect that the discussion of the *WEO* will give us more details.

On the manipulation of corporate earnings that has impacted equities market worldwide, we call for the reinforcement of corporate governance, accounting, and transparency laws, and their stricter implementation, as these are critical conditions for the efficient functioning of free markets. While we are in favor of the steps taken by the U.S. authorities, we also share the view that an appropriate official response should be brought not just in the United States, but also in global markets, and that the regulations governing the accounting and auditing profession should be further tightened. Here, we welcome the OECD's code on corporate governance.

In this respect, let me mention that the privatization of electricity companies in the major countries of my constituency—a major component in Fund-supported programs—has suffered greatly from the recent developments in Enron and Vivendi, which are the key players in the international energy markets.

Finally, as many Directors have noted, we also appreciate the topic on emerging economies' bond markets. Like Mr. Shaalan and Mr. Mirakhor, we expect further studies on the provision of technical assistance to emerging market countries to establish strong local institutions and develop the infrastructure that could support these activities.

Mr. Djojosubroto made the following statement:

Like other Directors, we thank the staff for the informative issue of the Fund's *Global Financial Stability Report (GFSR)*. The Report has a very clear presentation of the economic policy developments and their implications in the financial market, and has become an important tool for the Fund's multilateral surveillance mechanism. Given the importance of this Report, we look forward to deeper and broader analyses in the future issues.

The report presents current challenges and vulnerabilities to the financial markets. As highlighted by the staff, overall conditions in the present global financial markets have deteriorated further, reflecting a slow pace of global economic recovery, rapid erosion of investor confidence, and a heightened tendency of risk aversion. Investors have a tendency to reallocate their resources towards less risky and higher quality assets. In the mature market, particularly in the United States, uncertainties about the outlook for corporate earnings, along with heightened concern of corporate governance, transparency, and accounting practices following the collapses of several big companies have contributed to the risk of equity price corrections and adverse implications for commercial bank profitability. As such, the advanced economies have to play a significant role in restoring confidence and preventing crises for the global financial stability.

If the weaknesses and volatilities in the United States, as well as other mature financial markets continue, it can trigger a further retrenchment of capital flows to the emerging markets and, in turn, cause a further downward global financial condition. Similarly, signs of contagion as seen in some Latin American countries can further aggravate the situation. As such, although the staff is optimistic regarding the recent 'orderly' and 'contained' market adjustment and the aversion of risks due to greater participation of retail investors in the equity markets, we are concerned about the weak corporate performance in advanced economies, as well as the macroeconomic and financial instability in a number of emerging market economies.

We concur with the staff's suggestion that there is a greater need for coordination among countries for the safety and soundness of the global financial system. While the advanced economies need stronger fiscal coordination, deeper structural reforms, and improved corporate governance, the emerging market economies also need to ensure greater macroeconomic and financial stability through appropriate policy measures. Emerging market countries need to encourage the mobilization of their domestic resources by encouraging local securities markets and diversifying their financial systems.

Developments in advanced economies are significantly affecting emerging market's access to international capital markets. The weakening position of the banking sector in the mature market, particularly in Japan, has reduced capital flow to many emerging market countries. The cross-over investors are likely to avoid or reduce their investment or holdings in emerging markets assets if the outlook of economic recovery and adjustment deteriorates further. Similarly, capital flows to emerging markets will remain subdued if investors' tendency is to risk aversion. The result can cause an abrupt loss of market access for emerging market borrowers. Therefore, we agree with the staff that emerging market economies should continue pursuing consistent policies aimed at bolstering macroeconomic and financial stability. In this respect, we would like to underscore the need for stronger adjustment policies by the Latin American emerging market countries, mainly by the Argentine authorities, with the support of the IFIs and other creditors. This will help to deter contagion effects to other countries in the region.

We also welcome the analysis relating to emerging market developments and financing in Chapter III of the Report. Although emerging local bond markets are alternative source of funding in many emerging market economies, there still remains much to be done to deepen and widen the market. Since, in many cases, the bond market is basically concentrated in government bonds and as there is still limited foreign participation in local emerging bond markets, the countries need to improve basic market conditions by promoting secondary markets, reducing cost of issuances, and eliminating other hurdles so as to attract more investors. We are glad to find in the Report that Asian emerging markets are doing well in securing investors confidence and have higher accumulation of exchange reserves.

Lastly, there are suggestions from one of my constituency country's to rephrase the sentences relating to the country in the report, which I have conveyed to the staff separately.

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

> Some Directors commented on the staff's analysis on European banks on page 26 in the Report. However, that relatively short paragraph on European banks focused mainly on German banks. There is only one sentence in the paragraph that is devoted to European financial institutions, which includes insurance companies. Going forward, European insurance companies, especially life insurance firms, may encounter greater difficulties. European financial institutions have to cope with a worse economic environment than U.S. financial institutions—they are more exposed to equity, operate in a fragmented market, and will, in some cases, experience problems with profitability should the operating environment become worse. The staff was hesitant to add much analysis and data to the paragraph as that might give even more emphasis to the issue. However, the paragraph could be broadened and strengthened, if Directors wished, but it would draw greater attention to the weaknesses of European financial institutions, which could trigger an adverse market reaction.
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> On the issue of contagion, Ms. Lundsager and others said that the staff should look into ways of facilitating the markets' ability to differentiate among emerging market countries. However, the issue, such as in the case of Brazil, is not so much whether investors recognize prudent policies—they do—but whether they believe that such policies will be maintained over time, which has implications for FDI. Therefore, it is not a clear-cut case that good policies are automatically rewarded by investors. But over the past few years, the Fund has made substantial progress helping markets discriminate among emerging economies.
>
> Mr. Bennett commented that the staff's conclusion that the global financial system is by and large resilient is not underpinned by sufficient analysis, especially with regards to the goods and services sector. This was because the staff consciously tried to avoid venturing into the non-financial, real sector of the economy, so as to minimize duplication with the *WEO*. However, the staff realizes that the relationship between the financial and real sectors may be crucial going forward, and will, in the review process, coordinate with the Research Department to minimize overlaps, as well as to ensure that critical issues are not overlooked.
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> Regarding the comments that the staff should draw clearer policy conclusions in the Report, this requires venturing into the realm of making judgments. Although judgments should be underpinned by analysis, there will be gray areas in which the judgments can only be made to the best of the staff's knowledge and professional experience, and whereby the outcomes will be uncertain. Therefore, if the staff provides clear-cut policy

recommendations, they run the risk of sometimes providing the wrong answers.

The chapter on local bond markets is the second piece of a three-part series. An overall analysis and assessment on local financial markets will be provided after the publication of the third piece in the series.

Mr. Brooke asked about the staff's work on debt sustainability analysis. This a joint project by the Research Department and the Policy Development and Review Department, to which the International Capital Markets Department is a contribute. The project has been broadened to include all countries that have access to financial markets, and is still a work in progress.

On the Report's discussion on European banks, the staff can add a sentence in clarifying that the problems faced by the banks do not pose any systemic risks, partly due to their ownership structure.

Mr. Beauregard stated that FDI flows were more affected by the management of economic policies by governments, whereas financial contagion was more driven by herd behavior. As the staff had earlier explained, risk managers tended to withdraw funds from a group of countries as a whole without differentiating the individual emerging market country's economic policies or institutional framework. On the other hand, FDI flows were governed by long-term decisions. Therefore, the staff's analysis should try to draw a clearer distinction between the factors driving contagion and those affecting FDI.

Mr. Beauregard also supported the comment by Mr. Brooke on the need for the Fund to play a more important role in helping markets to differentiate among emerging market economies. As risk managers make investment decisions on a day-to-day basis, it would be important for the Fund to provide them with greater information and analysis on the different economic policies and institutional frameworks in emerging market economies, so that they would be more discriminatory in their decision-making process.

The Chairman added that while differentiation of economic policies by investors was needed to limit financial contagion, the main responsibility to facilitate that process laid with the authorities, such as through improving policy transparency and building up good investor relations.

Mr. O'Murchú clarified that he was not suggesting that the *GFSR* should include analysis on the real sector; it was more an aspiration for the future. Rather, he supported the view that the Report should have minimum overlap with the *WEO*.

The Chairman said that the issue of the interaction between the real economy and the financial sector was interesting. On the one hand, as many Directors noted, there should be a clear differentiation between the *GFSR* and the *WEO*. On the other hand, financial markets had a clear impact on the real economy. One of the motives for establishing the International

Capital Markets Department was to analyze whether the financial sector had decoupled too much from the real economy, and the extent to which financial market turbulences could have a negative impact on the real economy. Greater coordination between the Research Department and the International Capital Markets Department would be needed to study the interaction between the real economy and the financial sector, but a certain amount of overlap in their work would be unavoidable.

Mr. Szczuka remarked that, on the issue of the channels for contagion, the staff did not devote sufficient attention to loan markets compared to bond markets. The Report had about 5 pages on emerging bond markets, but only one page on local loan markets even though loan markets in emerging economies suffered a more pronounced decline of more than 40 percent in the second quarter of 2002. Could the staff explain why the spreads for Latin American loan markets had been more or less unchanged during the recent period of financial instability, in contrast to the decline in the volume of loans and the shortening of maturities?

The Counsellor and Director of the International Capital Markets Department (Mr. Häusler) clarified that the staff was aware of the different factors driving financial contagion and FDI flows. During the recent contagion, bond investors differentiated among emerging market countries, as evidenced by the fact that Chile and Mexico were basically unaffected by the crisis in Argentina. However, the reaction lag for an FDI investor in response to contagion was much longer. Unlike a bondholder who could rebalance his portfolio quickly, it was difficult for an FDI investor to hedge his business in other countries against potential exposure to contagion.

Mr. Beauregard reiterated that while he agreed that the national authorities had the main responsibility to promote the differentiation of economic policies by investors, the Fund also had an important role to play by providing market participants with a balanced view of the policy performance in each country.

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

> On Mr. Kiekens's comment that the sovereign bond issues so far do not contain collective action clauses, the staff feels that the fact that most of them have been issued under New York law, rather than under U.K. or Japanese law, was more related to the drying up of retail investors' appetite for bond issues in Europe and Japan, rather than any conscious decision by the sovereign issuers not to include CACs in their bonds. In addition, in the secondary market, there are no divergences between the bonds issued in New York and those issued in London. The price behavior of bonds has not changed since the discussion on CACs and Sovereign Debt Restructuring Mechanism (SDRM).
>
> On Mr. Bischofberger's comment that the development of emerging local bond markets should target mainly private sector borrowers, and not be

overused by sovereign borrowers, the staff concurs, and would revise the Report to make that point more explicit.

The staff also agrees that the risk of an abrupt adjustment of capital flows into the United States cannot be ignored. Although the Report tried to provide a balanced analysis on the issue, going forward, if many downside risks materialize, the potential for a significant adjustment clearly exists.

Mr. Brooke and some other Directors mentioned that the Report should highlight the impact on household behavior of the recent decline in equity markets, given the constraint of the already leveraged balance sheets of consumers. This is a topic that the staff intends to look into, going forward, because the balance sheets of the household and corporate sectors in the United States, Europe, and other countries are all highly leveraged. This balance sheet constraint will have an impact not only on financial market behavior, but also on the real economy. The staff will work closely with the Research Department to further analyze the interaction between financial sector developments and the real economy.

Mr. Kiekens stated that, in addition to the positive effects of risk dispersion, there are also undesirable side effects in that risks are being transferred to institutions and households that may not be well positioned to manage those risks. In this regard, the staff will continue to analyze, as in the previous reports, the potential problems posed by the financial investments of insurance and reinsurance companies.

On the Report's recommendation that financial institutions should focus more on their core activities and avoid diversifying into areas where they can easily be exposed to risks which they cannot manage, Mr. Brooke suggested that the staff should clarify that while diversification in itself is a net positive, financial institutions should only diversify if they are fully qualified, competent, and able to manage the risks of the new businesses that they venture into. However, not all financial institutions properly assess the risks before they enter into new areas of business, and the Report should reflect this nuance.

The staff also agrees with Directors' comments that emerging market countries should not be treated as a homogeneous group, and will revise the Report to show greater differentiation among different credit quality sovereign borrowers.

On Mr. Wei's question on whether equity prices have bottomed out, it is difficult to make a forecast. However, based on observation, it is fair to say that equity valuation today is less excessive and perhaps closer to the underlying fundamentals than they have been in the past. Looking at the price/earning ratios of the S&P 500 index, they are now below the ten-year averages and the ten-year U.S. Treasury bond yields. This does not prevent overshooting on the downside, but the potential for sharp adjustment today is less compared to six months ago. The staff will also take into account the comment on the nomenclature of Hong Kong in the Report.

On the provision of technical assistance to emerging market member countries, there have been many staff missions to help them increase their access to international capital markets, and design investor relations programs.

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

On the comments on the discussion of the loan market in Chapter III, the staff placed the emphasis on the bond market rather than on the loan market primarily because bond markets are the primary channel of financial contagion. Although another channel is through the retrenchment of bank lending, the first immediate reaction to contagion tends to take place in bond and foreign exchange markets.

On why the volume of lending to emerging economies has declined more significantly than the increase in loan spreads, there are basically two answers. First, there is still a large number of banks competing for a smaller pool of high quality borrowers and that competition has helped to keep the spreads low. Second, the responses of banks to the financial instability in emerging markets have differed: some banks have retrenched their lending, while others have remained more fully in the loan market. However, these observations are still anecdotal, and greater country-by-country lending data is needed to underpin a fuller analysis.

On syndicated loan markets, some market participants view the assets as being fundamentally mispriced. For instance, there could be syndicated loan spreads of 50 basis points over LIBOR for countries that have experienced a banking crisis, whereas collateralized repo operations would yield 500-600 basis points. However, both transactions would be carried out within the same bank, only by different departments.

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

As we can broadly agree with the staff's assessment outlined in Chapter II, we would just like to make a few comments from the perspective of the euro area.

First, regarding the European banking sector, it is crucial to highlight the diversity of European banks and their markets in order to draw an accurate picture of the stability of the sector as a whole. As underlined by Mr. Andersen and Mr. Bischofberger, the overall assessment of the European banking sector's fragility is probably still fairly reassuring, even if increased vigilance is needed. In this respect, we are grateful for the latest comments by the staff in this regard. Concerning the possible unbundling of debt burdens by firms and consumers in the euro area, data from the financial account statistics show that no major imbalances seem to exist at the present juncture.

Second, it seems clear that after having invested heavily into market-related activities, European banks have started to reorientate their activities, as outlined in the Report. However, whether this is a long-term trend, as suggested by the Report, is by no means clear. Volatility in investment banking activities is rather natural, and only an extended market slowdown could trigger a sustained strategic reorientation by banks.

Third, in the context of Chapter III on emerging market financing, some eastern European countries negotiating accession to the European Union have recently seen their sovereign spreads rise and have experienced exchange rate and equity price volatility. It seems that the difficulties in some of these countries may not be solely explained by developments in mature markets or Latin America, but are mainly due to domestic economic vulnerabilities. A somewhat more extended discussion of eastern European countries may, therefore, be desirable.

Finally, I would like to point out the associated risks of developing local bond markets in emerging market economies, in addition to the advantages that are discussed in Chapter IV. By risks, I mean especially those stemming from the possibility of a sudden withdrawal of capital outflows from local bond markets by foreign investors. In this regard, I would like to associate myself with the remarks of Mr. Szczuka and Mr. O'Murchú. For example, from 1997 to 2001, the larger EU accession countries have expanded secondary market bond trading by more than 200 percent, or $77 billion, and foreign banks have consistently been major players in those markets. Consequently, swings in portfolio investment balances have been large and usually coincided with sharp movements in the nominal exchange rates. In this context, more emphasis should be put on addressing in parallel the development of both a transparent policy framework, and more liquid and sophisticated local bond markets.

Let me conclude by welcoming the forthcoming synergies in the field of financial stability surveillance between the Fund and other central banks, including the ECB, as announced by the staff.

The Chairman made the following concluding remarks:

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

Key Developments and Sources of Financial Markets Risks

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

Looking ahead, Directors assessed several potential sources of risk to international financial stability in both mature and emerging markets. In mature markets, a risk remains that investor trust and confidence could erode to a point where investors withdraw en–masse from risk taking, triggering further corrections in corporate securities markets and a greater cutback of lending, especially to high–risk borrowers. Relatedly, accumulated losses could impair the capital positions of financial institutions, exacerbating a withdrawal of risk taking and lending, including to emerging market countries. Some Directors also warned that a fall in housing prices in the United States could impair the economic recovery and feed back onto financial markets. Some others, however, felt that real estate prices fundamentally reflected strong demand and low interest rates. In addition, Directors considered the potential for further changes in the pattern of international capital flows as foreign purchases of U.S. financial assets slow and the dollar weakens. There remains a risk that if international investors reappraise the risk–adjusted return on investments in the United States relative to other countries, a rapid slowdown of net capital flows into the United States could result, potentially triggering increased volatility in the major currencies and disorderly adjustments in financial markets.

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

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

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

Emerging Local Bond Markets

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

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

2. DOMINICA—2002 ARTICLE IV CONSULTATION; AND STAND-BY ARRANGEMENT

Documents: Staff Report for the 2002 Article IV Consultation and Request for Stand-By Arrangement (EBS/02/152, 8/15/02; and Cor. 1, 8/27/02); and Statistical Appendix (SM/02/261, 8/15/02)

Staff: Salehizadeh, WHD; Kincaid, PDR

Length: 35 minutes

Mr. O'Murchú submitted the following statement:

I would like to convey the appreciation of my authorities to Mr. Salehizadeh and his colleagues for their balanced report on the economy of Dominica and for their assistance in addressing its present difficulties. My authorities would also emphasize the importance they attach to the annual Article IV reviews, which are of inestimable value to small countries with limited independent analytical capacity.

Background: Following three years of modest, though flagging, growth, the economy of Dominica contracted by over 4 percent in 2001. This was largely the result of a sharp fall in banana production, due mainly to drought, and the combined effect on tourism of the global slowdown and the events of September 11. These developments contributed to a marked deterioration in the public finances, with the current budget moving from a small surplus in FY1998/99 to a deficit of almost 7 percent of GDP in FY2001/02. Moreover, in each of the last three calendar years, the current external deficit was in excess of 14 percent of GDP. Recognizing that these internal and external imbalances are unsustainable, the government resolved to take remedial action which, at the same time, would create a solid foundation for future economic and social progress. To this end, it has drawn up a stabilization program aimed at fiscal consolidation and structural reform, which will be supported by the proposed Stand-By Arrangement with the Fund.

Fiscal Program FY 2002/03: The government's immediate aim is to restore order to the public finances. For the reasons set out in the staff report, the government's fiscal program for FY 2002/03 is, of necessity, concentrated on revenue enhancement, mainly through a stabilization levy of 4 percent on all payroll income, curtailment of tax concessions, and increasing the tax on petroleum products. On the current expenditure side, the government has introduced a freeze on wages and salaries, and on public sector recruitment, except for teachers and health workers. However, the savings from these measures will be offset by an increase in actual outgoings on goods and services, reflecting the government's intention to remain current in meeting its obligations to domestic suppliers from October, 2002. As regards capital expenditure, the public sector investment program will be limited to fixed investment of 6 percent of GDP in FY 2002/03. Within this expenditure limit, capital spending will be restricted to projects largely financed by grants or concessional loans. As a result of these measures, the overall deficit of central government is targeted to fall from 10 percent of GDP in FY 2001/02, to about 5¾ percent of GDP in FY 2002/03.

Structural Reforms: Over the medium term, fiscal consolidation will be underpinned by strong structural adjustment measures. The structural reform agenda includes the elimination of remaining price controls; a comprehensive reform of the tax system to broaden the tax base and improve revenue collection; a public expenditure review and civil service reform to rationalize and increase the efficiency of public spending and service delivery; banana sector restructuring to enhance productivity and provide alternative activity; privatization to improve overall economic efficiency; and the strengthening of the financial system.

The first privatization will be the Dominica Banana Marketing Corporation, to be accomplished by end-September, 2002. To manage any proceeds from privatization, the government will establish a special privatization fund that will hold the proceeds of all privatizations. Only the yield from this fund's investments will be used for budgetary support. The government also proposes to examine (i) the feasibility of abolishing the Dominica Export Import Agency's monopoly on the importation of sugar and bulk rice, and (ii) the scope for turning the National Development Corporation into a self-financing agency.

The government is very much alive to the risks to which the program is subject but is firmly resolved to ensure that it is fully implemented. In particular, the government is ready to take any additional action that may be needed to ensure that the fiscal targets are met.

Financial Sector Issues: The government is conscious of the risks which the exposure of the Dominica National Bank to the public sector entails. Consequently, it is determined to move quickly to reduce its indebtedness to the bank. Beyond that, the government proposes pro-actively to examine the question of the privatization of this and the other state bank. Moreover, as noted in the staff report, the government intends to strengthen the regulatory and supervisory framework of the offshore financial sector and to place under the supervision of the Ministry of Finance domestic non-bank financial institutions not supervised by the ECCB.

The authorities appreciate the acknowledgment in the staff report of the major steps they have taken since June 2000, when the Financial Action Task Force (FATF) listed Dominica as non-cooperative, to bring their legislation, procedures and implementation capacity into compliance with the anti-money laundering initiatives of the international community. In this, the strengthened legislative provisions and the establishment of a Financial Intelligence Unit and a Money Laundering Supervisory Authority are of particular note. Only two issues, both relating to mutual assistance, are outstanding and the necessary measures to deal with them will be implemented shortly.

Conclusion: My Dominican authorities are firmly committed to their stabilization program which, they are confident, will achieve the objective of creating a sound base for renewed growth in output and employment. They welcome the recognition in the staff report that the successful implementation of this program would serve as a basis for a three-year arrangement under the Poverty Reduction and Growth Facility. Consequently, they intend soon to start discussions with the Fund and other institutions, and with representatives of economic sectors and civil society in Dominica, with a view to formulating an Interim Poverty Reduction Strategy Paper by end-March, 2003.

Mr. Mirakhor submitted the following statement:

Key points

We welcome the authorities' stabilization program and support their request for a one-year Stand-By Arrangement.

Fiscal consolidation is necessary to reduce high debt ratios, as well as generate savings for growth-enhancing investments.

The rising level of NPLs, and the rapid increase in NBFIs, argue for strengthened financial sector supervision.

Dominica's future prosperity rests on its capacity to facilitate the diversification of its economic base through structural reforms.

We join Mr. O'Murchú in his appreciation of a well-written and balanced staff report, and thank him for his helpful statement. Over the past few years, Dominica's economy has been characterized by declining output growth, increasing budget and external deficits, growing debt ratios, and rising poverty. The real economy contracted in 2001 reflecting sharp retrenchment of the key banana industry due to weak export prices, the progressive elimination of preferential access to the EU, and adverse weather conditions as well as sluggish activity in other sectors. Fiscal and external current account deficits remained very high, central government dissaving intensified, domestic arrears accumulated further, and public debt to GDP ratio exceeded 90 percent.

Given the fragility of fiscal position and the risks posed to economic stability and growth, we welcome the authorities' stabilization program, and concur with the thrust of the staff appraisal. Considering the substantial upfront fiscal adjustment in the recently enacted budget, and the consistency of the stabilization program with sustained output and employment growth objective, we support the authorities' request for a one-year Stand-By Arrangement. We look forward to development of a medium-term program, which upon the successful completion of the Stand-By Arrangement, could be supported by a three-year PRGF arrangement in 2003 and welcome the authorities' resolve to formulate an Interim Poverty Reduction Strategy Paper by end-March 2003.

Attaining a sustainable fiscal position, and generating public savings needed for growth-enhancing investments, will require fiscal consolidation over the medium term. The recent enactment of the FY 2002/03 budget, targeting an overall deficit below 6 percent of GDP, while protecting essential economic and social outlays, constitutes an important first step. On the revenue side, measures announced in this year's budget should prove sufficient to reverse the downtrend in tax revenue. Looking ahead, however, we see merit in plans for a comprehensive tax reform aimed at broadening the tax base, strengthening tax administration, simplifying indirect taxation, and introducing a VAT, possibly in the context of a region-wide agreement. Quarterly adjustment of domestic fuel prices should also pave the way for an eventual switch to an automatic market-based mechanism that would permit these prices to reflect import costs. On the expenditure side, given the high and rising ratio of the wage bill to GDP, we welcome this year's restraint on wage increases and freeze on hiring as well as the authorities' commitment to civil service reform to reduce the wage bill and enhance the efficiency of public service delivery. In light of low productivity of past investments, capital expenditure, to be largely financed by concessional external resources, should focus on projects aimed at enhancing growth and reducing poverty. In this context, the priority accorded to social expenditures and better targeting of social programs is praiseworthy. Moreover, strengthening the budget execution and the monitoring system should facilitate implementation of the fiscal program.

Dominica continues to benefit from a prudent regional monetary policy, and the resulting low inflation. With no scope for independent monetary and exchange rate policies, the fiscal program should provide the room for expansion of credit for private sector investment. On the financial sector, we are pleased to note that the banking system remains basically sound. However, given the rising level of NPLs, we welcome efforts to reduce government indebtedness to the large state-owned commercial bank, regularize government payments under the program, as well as strengthen ECCB's supervisory and enforcement powers. The rapid increase in nonbank financial institutions (NBFIs) in recent years also argues for their enhanced supervision to ensure the stability of the domestic financial system. We therefore welcome planned placement of NBFIs under the ministry of finance supervision, with support from the ECCB, and look forward to Dominica's participation in a region-wide FSAP in 2003.

Perseverance with structural reforms, geared toward economic diversification, is essential in promoting growth and reducing external vulnerability. Restructuring the banana sector, while facilitating the absorption of displaced farmers in other activities, should help the sector become viable in an increasingly competitive international market. We welcome the privatization of DBMC, which has absorbed large fiscal transfers and has significantly contributed to the accumulation of public debt in recent years. Plans to privatize the two state-owned banks, divest government shares in the telephone company, abolish the monopoly on the importation of sugar and bulk rice, and eliminate all remaining price controls promise to enhance economic efficiency and increase private sector participation in the economy. We also see merit in the staff's suggestion to further advance trade liberalization by removing remaining import licenses and establishing a low and uniform tariff rate.

Finally, given the deficiencies in Dominica's statistical database, the authorities are encouraged to enhance data coverage, frequency, quality, and timeliness, for a more effective economic analysis.

Mr. Reddy and Mr. Jayatissa submitted the following statement:

We thank the staff for the well-written report and Mr. O'Murchú for the helpful statement. The authorities are trying to address the problems of unsustainable domestic and external imbalances accompanied with a contraction of the economy, caused largely due to external shocks, with a program for economic stabilization and structural reforms. It is clear that authorities need Fund support for their economic program, which aims at establishing a solid foundation for sustainable economic and social progress in the medium-term. Despite the risks mentioned, given the authorities' commitment to a strong program and actions taken, we support their request for a Stand-By Arrangement.

We are pleased that the government has recognized the urgent need to arrest the deterioration of fiscal position as a priority for restoring macroeconomic stability and building the foundation for sustainable growth. We welcome the announced revenue raising measures. We note that authorities and staff share the same view that greater focus on expenditure restraint in fiscal adjustment is not possible at this stage. However, given the sharp decline in GDP last year and the projected further decline this year, we are somewhat concerned how realistic are the revenue projections for the current fiscal year. We share the staff view that authorities need to be forceful in improving tax administration and tax reforms aimed at improving revenue buoyancy of the tax system. Given the risks in the revenue side, it would be critical to strictly contain the growth of current expenditure as planned to avoid the possibility of a fiscal slippage compared to the program expectations.

We share the view that fiscal deficit reduction should be achieved while protecting spending on essential economic and social services and infrastructure and that essential capital expenditures needs to be met through concessional financing. We note the authorities' commitment to strict fiscal discipline in the capital budget by limiting expenditures to available financing.

We endorse the staff's suggestions for improving the soundness of the banking system. As the authorities have clearly recognized, fiscal discipline is also necessary to reduce baking system exposure to the public sector and enhance the banks' ability to finance productive private sector investment. We welcome the authorities resolve to further strengthen the financial sector regulatory and supervisory framework including the non-bank as well as the offshore financial sectors. We welcome the authorities' actions planned in this area, including their commitment to a FSAP in 2003.

Progress towards sustainable growth and poverty reduction would also depend on the success of the authorities on going restructuring of the banana sector to enhance efficiency and labor productivity and efforts towards improving gainful employment opportunities elsewhere for displaced farmers. Could the staff elaborate on the progress being made in this area? We also endorse the staff recommendations in the trade policy area, to complete the phasing out of remaining import licenses and move on to a low and uniform tariff rate.

With these brief comments we wish the authorities success in their economic program.

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

We thank staff for the report and Mr. O'Murchú for an informative statement.

Dominica is facing a serious economic and financial situation. Real GDP growth has been sluggish over the last few years mainly due to the difficult restructuring of the key banana sector in response to the phasing out of preferential access to the EU market. A series of adverse external shocks, including the global slowdown and the September 11 events, have dampened demand for stay-over tourism, worsening the situation. As a result, there has been a marked deterioration in fiscal performance. Sizable budget deficits, in the presence of declining flows of concessional aid, have been increasingly financed by external commercial borrowing, pushing public debt to very high levels, and to a rapid buildup of domestic arrears. The contraction of the traditional banana industry has led to persistently high unemployment and widespread rural poverty.

The authorities' commitment to implement a program, supported by the Fund, to help regain macroeconomic stability, renew confidence, and lay the foundations for sustainable growth is an important step to start reversing this situation. We welcome and support this program and find its objectives for 2002/03 ambitious but realistic and appropriate, especially in the context of a less favorable global outlook that could further soften tourism demand.

The recently enacted 2002/03 budget, if implemented forcefully, is a step in the right direction towards fiscal consolidation. It aims at a significant front-loaded adjustment based mainly on revenue measures, while at the same time clearing all domestic arrears and undertaking significant structural reforms. In light of the weak state of the Dominican economy, however, the authorities would need to closely monitor revenue collections and execution of the expenditure program to permit the early prevention of deviations from the fiscal target.

We welcome the plans to broaden the tax base over the medium term, possibly through the introduction of a VAT, and to raise the efficiency of tax administration. It seems, however, that action would also be needed sooner rather than later on the expenditure front. Fiscal sustainability will require strong moderation in the wage bill, which accounts for more than half of current revenue, and better control of spending on non-priority goods and services. Greater fiscal discipline would facilitate the Dominican authorities' ability to take advantage of grants and concessional financing for budgetary support rather than commercial borrowing and help to lower the interest bill in relation to GDP.

Close surveillance over the generally sound local banking system should remain a priority. Potential systemic risks arising from the exposure of the large state-owned National Commercial Bank (NCB) to the government and the distressed banana industry should be carefully monitored. Recessionary conditions could lead to a further deterioration in loan quality. We welcome the reassurances in Mr. O'Murchú's Statement of the authorities' intention to lower their indebtedness to the bank so that it can comply with prudential regulations, and encourage them to further reduce the bank's exposure to the government. We also stress the importance of strengthening the supervision of nonbanks (mainly insurance companies and credit unions) under the aegis of the ECCB, and of improving the regulatory framework for offshore financial institutions. We welcome the plans to participate in a region-wide FSAP.

Even with a substantial upfront fiscal adjustment and Fund support, Dominica still faces a very large residual financing gap of close to 7 percent of GDP. We, therefore, call on the international community to further support Dominica's reform effort, especially the multilateral lending agencies and donors to secure adequate and timely external assistance. In this connection, the authorities should use the technical assistance recently offered by CARICOM to help implement actions that would trigger the release of financial assistance.

We encourage the authorities to continue modernizing the banana industry, introducing safety nets as appropriate, and to maintain the diversification thrust into "sunrise" industries such as tourism, communications, and offshore financial services. We welcome their determination to press ahead with privatization and deregulation, and encourage them to consider the possible sale of shares on the new Eastern Caribbean Securities Exchange. This would facilitate a wider ownership base and help to broaden the regional capital market.

Dominica has made progress in the provision of economic statistics. We look forward to the authorities improving the coverage and quality of data on national accounts, public finances and labor markets, including through technical assistance from CARTAC.

Like many of its Eastern Caribbean neighbors, Dominica faces the development challenges of a small, open economy subject to the vagaries of natural disasters and other negative external shocks. A successor program that could be supported by a PRGF arrangement could foster policies to promote growth, reduce poverty, and lessen Dominica's external vulnerability, while catalyzing additional support from the international community.

In conclusion, we support the proposed decision and wish the authorities success in their endeavors ahead.

The staff representative from the Western Hemisphere Department (Mr. Salehizadeh) made the following statement:

Since the staff report was issued, the following information has become available, although this information does not alter the thrust of the staff appraisal.

On August 23, the CARICOM heads of state issued a communiqué calling on member states to provide financial support to Dominica. Thus far, two member countries of CARICOM—Barbados and Trinidad and Tobago—have pledged U.S.$8.7 million for Dominica. The member governments of the Eastern Caribbean Currency Union have also agreed to provide financial support to Dominica through a drawdown of $1.8 million from the Eastern Caribbean Central Bank's (ECCB) reserves, from a pool of retained profits of member countries, which is available to members experiencing economic imbalances. These contributions, combined with support from the World Bank and the European Union, will be sufficient to close the residual financing gap.

In addition, the ECCB will reduce the minimum rate of interest on passbook savings from four to three percent per annum, effective September 1, 2002.

Mr. Ralyea made the following statement:

Weak economic management and external shocks leave the authorities with little choice other than to undertake significant reforms to avoid major economic dislocations. This situation may have been avoided. During last year's Article IV consultation, Directors identified a number of measures that, if the authorities had implemented them, would have strengthened the fiscal situation and reduced Dominica's vulnerability to shocks. For example, Directors pointed to phasing out of the extensive array of tax concessions, strengthening tax administration, and restraining public sector wage increases as crucial reforms that should be undertaken immediately. Alas, that was not to be the case.

Nonetheless, we can support the proposed program. It correctly focuses on stabilization measures and lays the groundwork for extensive structural reforms. We recommend that any structural measure listed in Table 9 not completed within the specified time period should be treated as a prior action for any follow-on program. We also welcome the authorities' consent to publication of the staff report. Before commenting on specific program measures, I would like to say a word about Dominica's efforts to combat money laundering and terrorist financing.

Dominica has made considerable progress in the past year in enacting a new anti-money laundering regime. Looking ahead, it is vital that Dominica fully implement this new regime, including through expeditious international judicial cooperation and effective regulation of its offshore financial institutions. Also, Dominica has expressed support for the global fight against terrorist financing, but the government does not have a blocking order in place on terrorist assets. We urge Dominica to take the steps necessary to implement fully all UN counter-terrorism instruments.

Turning to the program, we note that the substantial fiscal adjustment this year relies solely on revenue measures, including raising tax rates. Going forward, we urge the authorities to cut expenditures instead. Specifically, a civil service wage bill equal to 15 percent of GDP seems unsustainable. Past statistical discrepancies approaching three percent of GDP, as well as undocumented arrears, are unacceptable under Fund-supported programs.

Based on the limited information available on the banking system, we are not as sanguine about its health as the ECCB. In particular, the level and trend in non-performing loans relative to total loans and provisions is worrisome. We strongly urge the government to follow through on its intention to regularize payments on its borrowings from commercial banks.

In that vein, we welcome the ECCB's proposed legislation to strengthen its hand in dealing with non-performing loans in Dominica and other ECCB member countries and the ECCB Monetary Council's agreement to amend banking legislation to permit the disclosure of individual bank soundness indicators. If possible, this legislation should be passed and implemented by early 2003 at the latest. Also, we expect the safeguards assessment to be completed fully by the time of the first review of this program.

Finally, depositing future privatization proceeds in a special account and using the yield from those proceeds for budgetary support is clearly preferable to using privatization proceeds to cover current expenditures. However, paying down public debt with the proceeds may also be worth considering. For starters, it would likely lower the government's net interest bill and avoid the administrative complexity of managing financial assets.

Ms. Stuart made the following statement:

I welcome Dominica's engagement with the IMF, which coincides with the authorities' recognition of the severe fiscal problems that the country currently faces. I support the Stand-By Arrangement, and hope that swift progress can be made on the I-PRSP, and toward a future PRGF-supported program. The staff has done an excellent job of highlighting the risks facing Dominica, its volatility to shocks, and the need for fiscal consolidation and structural reform. I agree with the thrust of the staff report, and would like to make a few comments.

The magnitude of the fiscal consolidation envisioned over the next year is quite ambitious—amounting to 4.75 percent of GDP. While I think that significant fiscal consolidation is necessary, I am concerned that revenue-raising measures may not be as successful as envisioned, as they might generate less revenue than expected, as fiscal tightening might suppress the economy more than expected, or the country might suffer from another shock. Could the staff comment on any contingency plans that might have been discussed with the authorities in this regard?

The planning of public investment projects must be improved. Though I realize that this falls under the purview of the World Bank, I wonder if any currently envisioned projects might be rationalized or cancelled before the beginning of the next financial year.

Regarding expenditures, I welcome the staff's emphasis on the maintenance of social spending, as set out in paragraph 37 of the staff report. Though the World Bank is looking at this issue in the context of the PSIP review, I wonder whether anything can be done prior to the completion of this review in order to improve the social safety net.

Radical changes to public wage policies in the budget demonstrate the importance of communicating the extent of the associated problems to the public, and the need for measures to ensure the viability of the economy over the medium term. Since this policy change, the authorities seem to have focused more energy on communications efforts, although more progress on this front is still required—publishing the staff report would be a step in the right direction. I also hope that the authorities choose to publish the I-PRSP.

Like Mr. Ralyea, I share the staff's concerns about the need for the government to cease borrowing from the NCB, and the impact that government arrears have on NPLs. I also support strengthening the ECCB's supervisory and enforcement powers.

I also agree with Mr. Ralyea about the need for stronger anti-money laundering and terrorist financing measures in Dominica.

Finally, I welcome the close collaboration between the World Bank, the CDB, and other donors, and hope that such efforts are sustained as the government works toward a PRGF-supported program. I would also like to note that the trade issues set out in the *WEO* were very relevant to Dominica.

Mr. di Maio made the following statement:

Dominica made a series of poor policy decisions in the past. In fairness to the authorities, recent external developments and the repeal of long-standing preferential trade agreements have created various economic difficulties. Faced with these problems, the authorities have taken steps toward an economic stabilization program that includes a large upfront fiscal adjustment. We support the program and think that it stands a reasonable chance of putting Dominica on a more sustainable economic footing.

It is clear that Dominica is only beginning the long process of reform. Could the staff elaborate on the current level of political commitment to the measures that underpin this program?

Though we agree with the staff that the fiscal consolidation plan should ideally have put more emphasis on scaling back expenditures, we concede that this might not have been feasible given the current circumstances in Dominica. Furthermore, the proposal to reduce wages by 10 percent may result in a reduction of capacity.

Comprehensive and sustainable civil service reforms may require the authorities to exercise some degree of pragmatism in the short term, and refrain from insisting on immediate reductions in the size of the civil service.

As has been the case for a number of small countries in my constituency, public sector reform requires a strategy that aims to fill the void that such reforms create by focusing on employment measures—this may not be a significant issue in the context of large or developed economies, but it is a critical concern for small island economies such as Dominica. Given the repeal of trade preferences in the banana sector, and infrastructure bottlenecks for tourist development, what are Dominica's options for promoting inward investment and output growth?

Once Dominica's domestic economic situation has stabilized, the authorities will need to focus their efforts on reducing barriers to private investment. However, I believe that there may be a risk that economic activity will fall short of the program's projections because of the large envisioned fiscal contraction, and as a result, economic reforms may lose some momentum.

Tax reforms should be implemented quickly, with a focus on generating resources and addressing the inadequacies of the tax system, which have been exacerbated by ad hoc tax exemptions and the absence of adequate property taxation.

Privatization of the Banana Marketing Corporation is crucial because of its high costs and subsequent drag on the fiscal position. Furthermore, the government should use the proceeds from the sale of this enterprise to reduce its debt—a point also made by Mr. Ralyea.

While we agree that the banana sector will require public investment in irrigation and related infrastructure, we would like to point out our concern about Dominica's long-term prospects for competitiveness in the banana industry in the absence of preferential access to the European market.

Fiscal consolidation is essential to efforts aimed at strengthening the banking sector, and for reducing government arrears. We believe that a reduction of the NCB's exposure to the government will strengthen its position, and encourage the government to consider the privatization of state banks in order to promote the stability of the financial system.

Finally, we welcome efforts to strengthen AML provisions, and the decision to participate in the FSAP.

We wish the authorities success.

Mr. Sipko made the following statement:

After three years of slow growth, the greatest of the many challenges Dominica faces is to devise and implement sound macroeconomic policies that will create the conditions for sustainable economic growth, the first prerequisite for poverty reduction. The present high public debt, the twin deficits, and the large stock of nonperforming loans are the principal obstacles to be overcome. I will discuss some major aspects of these issues.

The authorities are committed to lowering the fiscal deficit to a more manageable level. This will require, in the first place, a comprehensive tax reform. We learn from the staff paper that Dominica has the highest wage bill in the region. We also learn that the fiscal adjustment agreed by the staff and the authorities, involving an expenditure reduction based largely on lowering the nominal wage paid to civil servants, was opposed by the labor union, the business community, and civil society. Mr. O'Murchú's statement notes that the government has reacted by freezing wages and salaries and halting public sector hiring, except for teachers and health workers. Does the staff have any ideas about ways for the authorities to keep their commitment to reduce expenditures, and in particular the wage bill, to levels similar to those elsewhere in the region?

We welcome the measures proposed by the authorities to reduce the central government deficit to about 5.75 percent of GDP next year. However, this target is based on a projected real GDP growth of 1.5 percent in 2003, depending mainly on a recovery in banana production. How realistic is this target in case the recovery of banana production is slower?

Concerning bananas, we welcome the decision to privatize the Dominica Banana Marketing Corporation by the end of September. The decision to establish a special privatization fund to receive the proceeds of this and all other privatizations and invest them to generate resources to support the budget is a wise one. Could the staff venture a prediction about the yield to be expected from this fund in terms of GDP? Do the authorities intend to use any of the privatization proceeds toward retiring the public debt, which is also high?

We are also concerned about the large stock of nonperforming loans. We learn from the staff paper that the Eastern Caribbean Central Bank (ECCB) is expected to adopt amendments to the Uniform Banking Act to strengthen ECCB supervision and enhance prudential banking standards. But the amendment will not be passed until the beginning of next year. Meanwhile, what will be the impact of non-performing loans on Dominica's budget this year and next?

The balance of the current account depends greatly on the level of capital inflows, which at present does not lead to a sustainable current account deficit. We encourage the authorities to accelerate the reforms in the banana sector and improve its export competitiveness. In addition, we join the staff in urging the authorities to continue the liberalization of trade by narrowing the wide variation in tariff rates and import licensing fees and reducing present customs duties to conform with the requirements of the WTO.

Finally, we support the proposed decision, but would like to stress that it is crucial for Dominica to make a strong fiscal adjustment and continue its structural reforms and privatizations, in order to create favorable starting conditions for a three-year PRGF-supported program, which should follow the one-year Stand-By Arrangement.

The staff representative from the Western Hemisphere Department (Mr. Salehizadeh) made the following statement in response to comments from Directors:

In response to questions about the scale of fiscal consolidation, preliminary data indicates that the stabilization levy—the main revenue measure—seems to be performing well. We continue to monitor the situation, with a focus on the possible need for additional expenditure measures in the future, which might be discussed in the context of a program review. The issue of wages might also be the subject of future discussions with the authorities.

Regarding questions about social spending, the PSIP review is now underway with the help of the World Bank. We hope that new procedures will be in place for the PSIP before a new investment program is initiated next year, in order to assist the authorities in meeting the program targets.

Regarding expenditure controls and civil service reforms, the World Bank will send a mission to Dominica next week, aimed at promoting the initiation of civil service reforms before the end of the fiscal year.

In response to concerns over the long-term viability of the banana industry, last year, banana output was down about 35 percent, partly because of a severe drought that affected many countries in the region. Looking forward, it may be realistic to assume an 8 to 15 percent increase in banana production this year, particularly in light of favorable weather conditions.

Regarding privatization proceeds, it is not likely that such proceeds can be expected in the near future, as privatization of the Banana Marketing

Corporation is not expected to generate significant funds for the government. However, the authorities may soon consider privatization of the two state-owned banks—in this context, I agree that using privatization proceeds for debt reduction is a promising strategy.

Regarding nonperforming loans, several reforms aimed at reducing this problem are currently envisioned or underway. The ECCB is looking into strengthening supervision and regulation of the banking sector, and the government of Dominica will soon begin repaying its debt to the banking system. Furthermore, these nonperforming loans are concentrated in the state-owned banks, which increases the likelihood of these reforms being successful.

Mr. O'Murchú made the following concluding statement:

First, I would like to thank the staff for their report—particularly Messrs. Guzman and Salehizadeh, who agreed to be interviewed on Dominican television, and succeeded in projecting a positive image of the Fund's involvement in the country. I would also like to thank Directors for their comments, which will be reported to the authorities, and for their approval of the Stand-By Arrangement. I would also like to assure the Board that the government of Dominica is determined to implement the stabilization program, despite resistance from affected groups within the country. To this end, the government has included several tough measures in the recent budget, and is aware of the measures required over the medium term. As was outlined in the letter of intent, the authorities are eager to take advantage of technical assistance from a number of institutions in order to help them implement structural reforms.

Finally, I would like to inform the Board that today the authorities made another advance in the PRSP process, as they are holding a two-day consultation focusing on the issue of economic growth in Dominica.

The Acting Chair (Mr. Aninat) made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They regretted Dominica's sluggish recent economic performance, a result of the retrenchment of the banana industry and slowdown in tourism receipts. Further diversification and enhancements to competitiveness will be needed to improve long-term growth prospects and reduce external vulnerability. This calls for perseverance with structural reforms to improve economic efficiency, and raise national savings and investment.

Directors expressed particular concern that the overall deficit of the consolidated nonfinancial public sector—after nearly doubling in 1999/2000—remained at an unsustainable level in 2001/02. The public sector's serious cash shortage is the main impediment to output and employment growth, and poses a threat to economic stability. In this context, Directors welcomed the authorities' program for 2002/03, which aims to put the public finances on a path consistent with public debt sustainability and lay the foundation for sustained economic growth.

Directors commended the authorities for the strong measures already taken in the context of the 2002/03 budget. While noting that the decision to focus in the budget on revenue-raising measures had been taken with the objective of securing public support for the program and strengthening social and labor harmony, they would have preferred more emphasis to be placed on expenditure containment, which they saw as a surer path to regaining growth momentum. It was broadly agreed that government spending should be reduced in the medium term, including through structural reforms in the civil service, government financial management, and public investment. A comprehensive reform of the tax system and tax administration will also be important.

Directors agreed that a tight public expenditure policy will be crucial to support fiscal consolidation. They emphasized the need to implement the prudent government wage policy envisaged in the program and, in the medium term, to put in place a wage policy based on performance and productivity gains. Directors welcomed the authorities' intention to implement a comprehensive civil service reform. Reducing public employment through attrition would help increase efficiency in the provision of public services.

Directors advised the authorities to implement only those public investment projects that are aimed at redressing the main impediments to growth, and that can be financed largely with external resources on concessional terms. They welcomed the authorities' ongoing review of the public investment program and their planned review of public expenditure.

Directors were encouraged that the banking system is considered by the Eastern Caribbean Central Bank (ECCB) to be generally sound. However, they noted the risks to the large state-owned commercial bank stemming from its heavy exposure to the financially weak public sector and the distressed banana industry. The authorities' commitment to reduce the level of government indebtedness to this bank was therefore welcomed, as was the commitment to eliminate government domestic arrears.

Directors welcomed the Dominican authorities' intention to support fully the ECCB's efforts to strengthen financial sector regulation and supervision in the region, and their plans to strengthen the oversight of the financial system, with support from the ECCB, and to review the offshore financial sector. They commended the authorities' intention to participate in the Financial Sector Assessment Program of ECCB member countries in

2003. Directors noted the steps the authorities had taken on anti-money laundering, and encouraged them to address the few outstanding issues on an urgent basis.

Directors concurred with the authorities' decision to accelerate the ongoing restructuring of the banana sector. They also welcomed the progress made toward privatization of public enterprises, and noted that consideration might be given to using the proceeds from privatization to reduce Dominica's public debt. They urged the completion of the process of phasing out import licenses and moving toward establishing low and uniform tariff rates.

Directors noted that improvements in Dominica's statistical database are needed for effective economic analysis and surveillance, and encouraged the authorities to accelerate the planned enhancements of economic statistics in the context of the Fund's General Data Dissemination System.

It is expected that the next Article IV consultation with Dominica will be held on the 24-month cycle, subject to the provisions of the decision on consultation cycles approved on July 15, 2002.

Additional UFR Issues

Directors welcomed the authorities' stabilization program and supported their request for a one-year Stand-By Arrangement. While noting that the program's up-front fiscal adjustment was substantial, they underscored the importance of attaining a sustainable fiscal position soon, and generating public savings needed for growth-enhancing investment.

Directors stressed the importance of the program's structural reforms in the areas of tax policy and administration, public expenditure management, civil service reform, agricultural diversification, and privatization. These reforms should improve the financial position of the public sector, help the country attract private investment, achieve higher growth, and alleviate poverty over the medium term.

Directors considered that successful implementation of the program, and progress in developing a poverty reduction strategy, could establish the basis for medium-term financial support from the Fund under the Poverty Reduction and Growth Facility, perhaps as early as next year.

The Executive Board took the following decision:

1. The Government of Dominica has requested a Stand-By Arrangement in the amount equivalent to SDR 3.28 million for a period of 12 months from August 28, 2002 through August 27, 2003.

2. The Fund approves the Stand-By Arrangement for Dominica set forth in EBS/02/152, 8/15/02 and decides that purchases may be made under the arrangement on the condition that the information provided by Dominica on the measures specified as prior action on paragraph 7 of the letter dated August 13, 2002, is accurate.

Decision No. 12834-(02/89), adopted
August 28, 2002

3. ROMANIA—STAND-BY ARRANGEMENT—REVIEWS, MODIFICATION, AND WAIVER OF PERFORMANCE CRITERIA

Document: First and Second Reviews Under the Stand-By Arrangement and Request for Waiver and Modification of Performance Criterion (EBS/02/150, 8/13/02)

Staff: Mates, EU1; Kincaid, PDR

Length: 1 hour, 25 minutes

The staff representative from the European I Department (Mr. Mates) submitted the following statement:

> This statement provides information that has become available since the issuance of the staff report for the first and second reviews under the Stand-By Arrangement and request for waiver and modification of performance criterion for Romania (EBS/02/150). The statement does not change the appraisal in the staff report.
>
> The July inflation outcome was favorable, with the 12-month inflation rate falling to 23 percent (19.3 percent for CPI excluding administered prices). The end-year inflation is thus very likely to be lower than the program target of 22 percent and could even fall below the authorities' revised forecast of 21 percent. Indicators for the second quarter of 2002 show a continuing pick-up in economic activity, with industrial production rising by 4.1 percent relative to the same period of 2001, and exports increasing by 17.5 percent, in U.S. dollar terms. The current account deficit for the first half of 2002 was 2.3 percent of projected annual GDP, somewhat higher than estimated in the staff report, owing to lower transfer receipts and somewhat higher dividend payments. The staff believes that these deviations are transitory and that there is no need to revise the annual program target of 5.1 percent of GDP.
>
> As of August 18, gross foreign reserves of the National Bank of Romania (NBR) totaled US$6.3 billion (3.9 months of prospective annual imports), compared with US$4.9 billion at end-2001. The expansion of credit to the nongovernment sector slowed somewhat in July, to about 28 percent in real terms, inter alia reflecting the effects of enhanced supervision.

The June indicative targets on the ceiling on the issuance of domestic guarantees and assumption of enterprise debt to banks by the government was met. The target on the overall wage bill of the monitored group of state-owned companies was exceeded by 2.1 percent, as projected in the staff report, despite reducing employment by about 0.75 percent more than envisaged under the program. On the structural side, the authorities have privatized two large companies since end-June and expect to sell another five such companies by end-September.

Mr. Wijnholds submitted the following statement:

As usual, the staff report presents a candid and fair assessment of recent economic developments. The Romanian authorities wish to express their appreciation for the continued policy dialogue and advice aimed at consolidation of macroeconomic stability.

From its inception, the program has required consistent, comprehensive and front-loaded measures. Reflecting the determined implementation by the authorities of the policy measures, the macroeconomic performance has been fully in line with program targets. All the prior actions and additional measures for correcting the slippages on some structural areas were observed by mid-August 2002. At the same time, Romania has made substantial progress towards its goal of EU accession. By August 2002 the country provisionally closed 14 negotiating chapters out of 27 officially opened, aiming at catching up with the other candidate countries for EU accession. Despite the encouraging macroeconomic achievements, the authorities are fully aware of the remaining weaknesses and the challenging reform agenda, mainly in areas of restructuring and privatization.

Recent Developments and Outlook

Since the approval of the Fund-supported program in October 2001, macroeconomic conditions have continued to improve, in line with the program targets. After a strong GDP growth of 5.3 percent in 2001, one of the highest in the region, growth in 2002 is estimated at 4-4.5 percent, due to a lower contribution of agriculture and some impact of the slowdown in demand of Romania's trading partners. A growth rate close to 5 percent could be reached again starting in 2003, in line with the strengthening of economic activity, mainly in Europe. The 12-month headline inflation rate fell to 23 percent in July 2002, in spite of continuing adjustment in energy prices, and it might fall below the end-December program target of 22 percent. The disinflation efforts will be continued and a 15 percent target is considered for next year. The current account deficit was contained below 6 percent in 2001 and the authorities intention is to keep it at 5 percent of GDP in 2002, which is fully achievable having in view the favorable developments for the first half of the year. The increase in international reserves was significantly stronger than initially estimated under the program and the 2002 end-December target for the reserves level in terms of import coverage has already been reached. Romania's position on the international capital markets has continued to become stronger and a 10-year euro bond issue was successfully concluded in May 2002. The good performance on the macroeconomic front and in implementing further market-oriented reforms has let both Standard&Poor's and Fitch to upgrade again Romania's sovereign risk in April and June, respectively.

Fiscal Policy

The Romanian authorities are fully committed to continue the fiscal consolidation and to meet the 2.9 percent fiscal target for 2002, being ready to avoid any slippages from these goals. Due to a weaker than expected revenue performance and the downward revision of estimated GDP growth the government decided to eliminate excise reductions for cigarette producers using domestic tobacco as well as to increase excise taxes for gasoline and alcohol products, in order to offset the revenue shortfall. In the same vein, the government intends to broaden the tax base of the pension and unemployment funds. The reform of the tax system has continued and new VAT and profit tax law were approved recently, the main objectives of which are to enforce elimination of tax exemptions and holidays as well as any distortionary tax incentives. Nevertheless, corrective measures on the expenditure side to offset the revenue shortfall have been taken and a prudent supplementary budget was approved in July in close consultation with Fund staff. The authorities are carefully monitoring expenditure developments and stand ready to identify additional steps, if the fiscal target is put in danger. Tax administration reform has been initiated in line with the recommendations of the Fiscal Affairs Department technical assistance missions. A Government Decision has already been drafted for setting up a unified tax administration department within the Ministry of Public Finance and a large taxpayer directorate in Bucharest. It is expected that the Cabinet will approve this decision soon.

Consistent with the fiscal consolidation commitment and to continue the disinflation efforts and containing the current account deficit, the Romanian authorities have already agreed with the Fund to reduce the general consolidated budget deficit to 2.65 percent of GDP in 2003. In this respect the draft of 2003 budget, which is under preparation, has already taken into consideration significant decisions, such as limiting the annual average increase of net wage bill in the budgetary sector to 3 percent in real terms, incorporating other special funds within the state budget, refraining from any other tax cuts. A social program for 2002-2003 was approved in late July in order to soften the impact of higher utility prices on low-income categories of the population and to further improve the social safety net.

Wage Policy

In order to ensure public sector wage discipline, which was one of the main weaknesses of the past programs, by the end of 2001 the authorities had approved almost all the 2002 budgets of state-owned companies and regies autonomes. Unfortunately, higher than expected wage increases in the third quarter of 2001 moved this burden to the next quarters. Additional measures proved to be insufficient to offset this trend and the end-December 2001 and end March 2002 targets for the wage bill of state companies were missed. To improve the wage control mechanism quarterly ceilings for wage bills and employment were approved for the 82 monitored companies and bonus payments were further limited. At the same time, in the last months employment reduction in these companies have been accelerated, the net reductions during January-June reaching 12,900 positions (excluding outsourcing), out of which 8,300 layoffs, meeting the prior action.

In June, a convention was concluded with two large trade unions regarding the minimum wage hike and other social measures, starting with January 1, 2003. The authorities are confident that this agreement should ensure the necessary social stability for further implementation of all measures under the economic program. At the same time it could reduce tax evasion and offset the effects of large energy price adjustments on low-income population. The recent Fund mission, which visited Bucharest early July, reviewed the impact of this convention on 2002-2003 macroeconomic targets and the authorities agreed upon measures to reduce its risk to the program. Also the authorities expressed their strong commitment not to increase again the minimum wage during 2003 and not to index it either to CPI or foreign currencies. At the same time, the Government is confident that the collective contracts at enterprise level, signed in May for one year, no longer include automatic adjustments in the wage scale linked to the higher minimum wage.

Energy Sector and Privatization

Since the Board discussion last year several measures were implemented for improving the energy sector: significant energy price adjustments to cost-efficiency levels in line with the agreed time table, disconnections to the largest non-payers, and transfer of Termoelectrica's heat producing units to local municipalities. As a result, in June and July collection rates were slightly higher than in previous months. For a better monitoring of daily cash collections, the established system of escrow accounts will be continued and monitored by the Ministry of Public Finance. The authorities have agreed to accelerate competition within the sector by expressing the intention to open it to the private sector, starting preparation for full privatization of 2 electricity and 2 gas distribution companies After successful privatization of Sidex-a steel mill with more than 27,000 employees- the oil company Petrom, the largest enterprise in state portfolio is prepared for privatization and could be considered another milestone in the country's program. The short list for selection of a privatization advisor has been published and the Government has expressed its determination to approve the privatization strategy by end-December 2002.

The authorities are giving due consideration to acceleration of the privatization process. To speed up the privatization and increase the attractiveness of the Romanian companies, a new law was passed in April which allows partial or full write-off of outstanding debts to the budget for companies which are ready to be privatized and other steps have been taken into consideration, as mentioned in the SMEFP, which could facilitate progress in this area. Following the 5 large companies privatized in the first half of the year, privatization was concluded for 2 others in July and additional 10 are under different stages of negotiations (five of them are expected to be privatized by end-September). The performance in this area is a steady concern of the authorities. They are also confident that the approval of the World Bank's PSAL II program will support Romania's efforts to further restructuring and privatization.

Monetary Policy

Inflation has been monitored carefully as a central objective of the economic program. During 2001-2002 (August) prudent monetary policy together with fiscal consolidation have moderated inflationary demand pressures, bringing inflationary expectations on a downward trend. The success of reducing inflation has strengthened the authorities' credibility and built up a sound basis for a further successful disinflation process. The inflation rate is projected to decrease further (according with Romania's Medium term Economic strategy submitted to the European Commission) down to one digit by 2004. An acceleration of structural adjustment in the real sector, a stronger financial discipline and improved corporate governance as well as a wage policy consistent with macroeconomic developments will support this process. The declining trend of inflation and stronger demand for lei assets has allowed the NBR to gradually reduce interest rates. The most recent data shows that the average interest rate for sterilization operations declined to 25.9 percent and the NBR's 3 month-deposit rate has been lowered by 3 percentage points to 25 percent. Since August 20, the central bank reduced also the yield on deposit and credit facilities extended to commercial banks to 5 percent and 45 percent respectively. At the same time, the average 3-month T-bill rate declined in July-August by 2.6 percentage points.

The NBR continues to conduct monetary policy in the framework of a managed float and to monitor the exchange rate against a euro/dollar basket. The euro is expected to become the reference currency for the leu exchange rate during 2003-2004. A gradual monthly real appreciation of the currency remains the intention within the target, supporting disinflation and the NBR has reduced the frequency of its interventions on the foreign exchange market. The minimum reserve requirements rate on the lei deposits has been lowered again to 22 percent, while the foreign exchange one was set at the same level. Furthermore, lower inflation and tamed inflationary expectations have allowed the NBR to increase the maturity of its sterilization instruments.

A further strengthening of supervisory capacity of the NBR has been and still is one of the main objectives. To reach this goal the central bank steadily implemented measures aimed at increasing competitiveness and stability as well as developing banks' capacity to ensure an efficient financial intermediation. The new regulations approved recently regarding the reserve requirements and loan provisioning is fully in line with international best practices. At the same time, the central bank is ready to act further to reduce any risks related to development of foreign currency denomination lending.

The share of state-owned banks in total capital and total assets has decreased over the past few years and with the privatization of BCR, the largest commercial bank, by early 2003, the process is entering in its final stage. Preparations for privatizing BCR are under way. The privatization advisor has been appointed and short list has been finalized. The authorities expressed their intention to sell the majority stake to a foreign strategic investor.

The Romanian authorities consider that an in-depth assessment of the financial sector at this time would help to identify its strengths, risks and weaknesses. In this vein, in order to strengthen the financial sector stability and soundness and to avoid any disturbances, the Romanian authorities expressed in April this year the interest to participate in the IMF/World Bank Financial Sector Assessment Program (FSAP).

The Romanian policy in combating money laundering and financing of terrorism is strongly linked to international efforts in this area. The authorities in coordination with international bodies are working on further legal amendments with the view to bring Romania in full compliance with U.N. and EU recommendations.

In view of the above I wish to ask for Directors' support for the completion of the first and second reviews, request for waiver and modification of the performance criterion. I would also want to convey the Romanian authorities' strong commitment to continue the reform process, leading to a sound and sustainable economic development.

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

Romania's macroeconomic performance has been broadly in line with the program. Disinflation has continued somewhat faster than programmed, while GDP growth declined only moderately from its relatively high level in 2001 despite the significant slowdown in trading partners. On the other hand, progress in structural reforms has been slow and many performance criteria have been missed. The main slippages that occurred at the beginning of the year relate to the sharp increase in public wages as well as employment reduction in the state-owned enterprises most of which, we understand, are all loss making. These slippages contributed to pressures on the budget, which have also been aggravated by excessive social transfers and the widening of the quasi-fiscal deficit. The authorities have, however, renewed their commitment to the reform program and implemented a number of corrective measures as prior actions. It is now important to spare no effort in implementing these commitments. In view of these determined actions, we support the proposed decision.

In order to achieve the program's objectives in the period ahead, the authorities need to strictly adhere to their reform agenda in the fiscal and structural areas, particularly with regard to wage policy, privatization, and the crucial reform of the energy sector. The rest of our statement will focus on these areas as well as issues related to improving the regulatory framework of the banking sector.

While the budget deficit has been on track in 2001 and thus far in 2002, this was achieved through less than envisaged expenditures as revenues fell somewhat below target. Such a revenue shortfall, if continued, could pose a threat to achieving the overall fiscal targets in the period ahead, and could thus hinder the ongoing progress on the inflation front. This is all the more important as a continuation of expenditure cuts to attain the targeted deficit may not be possible and may not also be the most efficient option. It would, therefore, be important to strengthen the effort to improve revenue collection. In this connection, we welcome the recent steps taken to eliminate exemptions and tax holidays and the government's decision to establish a large taxpayer directorate. The integration of the different administrations that currently deal with social security contributions will also go a long way in improving collection.

In order to meet the expenditure targets for 2002 and 2003, the authorities need to exercise strict control over public wages, especially after the substantial increase in the minimum wage approved last June. It is therefore encouraging to note the authorities' commitment to enforce strict quarterly wage ceilings, to effectively enforce wage control at the enterprise level, and to end the practice of using the minimum wage as a benchmark for determining other wages. Adherence to these commitments would also help moderate wage increases in the whole economy and prevent a spillover of wage increases from the public to the private sector, and would thus contribute to safeguarding external competitiveness.

While some reduction of the quasi-fiscal deficit has been achieved, it fell short of the program's objective and remained above 5 percent of GDP at end-2001. This large deficit arises mostly from the substantial implicit subsidies and losses in the energy sector. In this connection, we welcome the significant increases in energy prices introduced since June of 2001. We note however, that overall collection rates failed to improve over the last two years. We look forward to continued focus on this issue in the period ahead and hope the improvements reported in the electricity sector in recent quarters will be maintained. We urge the authorities to continue their efforts to strengthen payment discipline, including by cutting supplies to non-payers and decentralizing the heating system which still suffers from deteriorating collection rates. We also urge the authorities to accelerate their efforts to privatize the energy sector in order to further limit the quasi-fiscal losses.

It is encouraging to note the increased confidence in the lei, which along with progress in disinflation, has paved the way to reducing interest rates to about half their very high level two years ago. Notwithstanding this increased confidence and the concurrent reverse dollarization, bank credit denominated in foreign currencies has been expanding rapidly. This trend is exposing the banking sector to higher credit risk especially in view of the existing deficiencies in the regulation on loan provisioning. Although the recent interest rate cuts are likely to help moderate this trend, the central bank has prudently acted by tightening supervision over banks with the highest credit expansion. It is also encouraging to note the central bank's intention to increase the frequency of on-site inspections of these banks and to enhance the loan provisioning regulation. These intensions should be vigorously carried out. In addition to these steps, we find merit in the staff's advice to consider raising the capital requirements for heavily exposed banks.

Finally, we encourage the authorities to accelerate their privatization efforts which should help improve the investment climate as well as reduce public employment and the budgetary costs of covering the losses made by most public enterprises. In this connection, we would urge that privatization decisions be mainly based on price considerations and take less account of non-price factors such as employment or new investment commitments.

With these remarks, we wish the authorities success in implementing their reform agenda.

Mr. Andersen submitted the following statement:

When the current Stand-By Arrangement for Romania was approved almost a year ago, this Board emphasized the need for strong policy implementation. While macroeconomic performance has been somewhat better than projected in the program in a number of areas, I find it regrettable to note that during the first part of the program, several of the performance criteria and structural benchmarks were not observed and that progress in reducing the quasi-fiscal deficit fell short of the target.

As emphasized also by the OECD in its recent assessment, macroeconomic stabilization in Romania cannot be durable without sufficient progress in the restructuring of the financial and enterprise sectors and in promoting a more business-friendly environment. Accordingly, I welcome that the authorities have confirmed their commitment to the program by addressing the slippages in structural policies in the Supplementary Memorandum on Economic and Financial Policies (SMEFP), including by implementing a number of corrective measures as prior actions. In view of these efforts, I support the proposed decision.

With the government's strong commitment to put Romania firmly on track for EU membership, the authorities would be well advised to make full use of the still available window of opportunity and implement sustained stability-oriented macroeconomic policies together with an acceleration of the structural reform process. Obviously, it remains essential to guard against the risk that the gradualist approach of the early years of transition, during which precious time was lost, is gaining foothold once more.

Structural Reforms

As already mentioned, macroeconomic stabilization cannot be durable without sufficient progress in the restructuring of the financial and enterprise sectors. Albeit incomplete, past reforms have established a sounder basis for economic development, as reflected by the resurgence of growth, the expansion of exports, and improved access to international financial markets. Nevertheless, there is no room for complacency and as noted by staff the macroeconomic stability needs to be consolidated and sustained. Also, the financial sector remains weak. In order to achieve a comprehensive restructuring of the economy, an acceleration of structural reforms is urgently needed. This also means that the speed and transparency of privatization need to be improved, as rightly pointed out by staff.

Although progress in financial sector reform has been achieved in recent years through privatization, restructuring or liquidation of large state-owned banks, the banking system still cannot provide effective intermediation. The financial restructuring is a cornerstone for both improving the effectiveness of monetary policy and for enforcing hard budget constraints in the economy. The development of financial intermediation includes a strengthening of the health of the banking sector and the creation of a more favorable environment for financial institutions. This again requires privatization of the remaining state-owned banks and the enhancement of the regulatory, prudential and supervisory framework. I welcome the emphasis given in the SMEFP to the privatization of the largest bank, BCR, which will be a test case for the government as it tries to improve the investment climate.

Restructuring and privatization of other state-owned enterprises is not of lesser importance, as the levels of negative value-added in some of the non-restructured companies are staggering. It is regrettable that the performance criteria regarding the collection rates of the main utilities were missed, as the energy sector has been the primary element in the chain of inter-enterprise indebtedness. While the authorities have made progress in adjusting energy prices, the payment discipline needs to be enforced more vigorously.

Fiscal Policy

It is encouraging that the fiscal deficit targets of the program have been met, especially in view of the significant shortfall in revenues, which has forced the authorities to reduce subsidies and transfers. On the other hand, the development is less encouraging regarding the quasi-fiscal deficits arising from state-owned enterprises. This is still an issue of major concern, since one of the reasons why all five Fund programs during 1990-2000 went off-track was lack of fiscal discipline in state-owned enterprises. I concur with staff that it is of utmost importance to improve the financial discipline in the state-owned enterprise sector e.g. with regard to wages.

Despite several years of generally successful fiscal adjustment, the authorities face major challenges in the medium-term. Consolidation will be hard to sustain in the absence of successful reform implementation. Romania's fiscal debt is low, but fiscal vulnerability persists. The limited size of the local financial market and a poor policy-making record leave Romania particularly exposed to fluctuations in the international financial markets' sentiment towards emerging markets, and thus a limited fiscal deficit would reduce the risk of another liquidity crisis. Moreover, continued fiscal consolidation is crucial in order to contain Romania's current account deficit, preserving an equilibrated policy mix and making room for the costs of much needed structural reforms. It is therefore commendable that the authorities have committed themselves to the completion of a tax reform that improves tax collection and the efficiency in tax administration.

Monetary and Exchange Rate Policy

It is commendable that the authorities have been able to secure disinflation somewhat faster than projected. However, it is important to remember that, albeit on a declining trend, inflation is still at a stubbornly high level - significantly above the levels seen in other EU accession countries. In order to create the necessary environment of price stability, it is essential to eliminate the wage-inflation inertia. To this end, the sharp increase in the minimum wage raises concern regarding the authorities' disinflation policy, because in the past minimum wage increases have translated into an increase in the overall wage level. It is reassuring that the authorities this time around promise to prevent a rise of the overall wage level in state-owned enterprises as noted in the SMEFP.

Over the last decade, the objective of price stability has repeatedly been sacrificed to other goals in a policy environment characterized by soft budget constraints, financial fragility, external vulnerability and political instability. All this led to high and volatile inflation rates. The implementation of tighter fiscal and income policies and the acceleration of structural reforms would unburden monetary policy from undue fiscal and external concerns, thus allowing the monetary authorities to target disinflation more aggressively.

At present Romania operates de jure a managing float regime, which is de facto an unannounced crawling peg against a basket of dollar and euro. According to the Pre-Accession Economic Programme, Romania plans to take the euro as the reference currency in 2003-2004. A greater orientation towards the euro would be more in line with Romania's trade pattern and a rather logical step in view of the EU accession process. Over the same period, the capital account will be gradually liberalized, which may create challenges for the conduct of monetary and exchange rate policies.

EU Accession

I note with satisfaction that the government remains committed to the Fund supported program, which is seen as crucial for accelerating the EU accession. Romania has already made considerable progress towards the EU accession, as Mr. Wijnholds notes in his helpful preliminary statement, and I welcome the authorities' aim at catching up with other candidate countries. Romania has recently made progress in complying with the political Copenhagen criteria, but it is still lagging behind in terms of meeting the economic and institutional criteria for EU membership. According to the EU Commission, the Romanian economy will not be able to cope with competitive pressure and markets forces in a foreseeable future. In the work program of the Danish EU-Presidency, it is noted that the forthcoming enlargement should not result in new lines of division in Europe. Therefore, the presidency suggests that Romania's progress towards accession is continued and intensified via a "road map" for further negotiations to ensure that the negotiations continue at a fast pace. A potential speeding up of the EU accession negotiations goes hand in hand with a comprehensive restructuring of the economy, as is also envisaged in the Fund supported economic program.

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

Although the Romanian program seems to be technically on track, we are disappointed that six performance criteria have been missed and the reviews of the program postponed for a substantial period of time. It is also unfortunate that such sidetracking happened at the time when economic situation has been fairly stable, which should have actually allowed for bolder measures both on macroeconomic and structural reform fronts. While some of the postponed actions, such as the delay in approval of SOEs budgets and the announcement of a privatization tender, did not have a substantive impact on policy implementation, other measures, such as the breach of the wage bill agreement and lower than expected utility collection rates, have put a significant strain on the budget and subsequently undermined the main goals of the program. As corrective measures have been taken, we can go along with supporting the completion of the reviews, modification of performance criteria and approval of waivers. We do, nonetheless, expect a much better performance under the program by the next review. This, however, may not be easily achieved given upcoming difficulties in improving the fiscal position, moving on with structural reforms and dealing with the social discontent with the painful economic adjustment.

At the outset, we would welcome a good performance of the external sector and a prudent monetary policy management resulting in the achievement of disinflation objectives and accumulation of foreign reserves. As the staff, we would, however, caution against a rapid growth of foreign currency loans in the system and urge the authorities to improve banking supervision particularly in this area and increase prudential requirements for such credits.

Achieving fiscal consolidation remains one of the priorities under the program. And, while the authorities have adhered to an overall budget deficit target (mainly by implementing additional expenditure cuts), the lackluster performance of revenues is worrisome. Looking forward, on the one hand, resorting to further expenditure reductions may be the authorities' only viable option, given the lags in the effectiveness of new tax laws and tax administration reforms. On the other, greater efforts should be made in limiting the occurrence of policy-induced weaknesses, such as minimum wage increases. While we recognize the importance of the authorities' commitment to lessen the burden of energy price adjustment on low-income households, such abrupt and unplanned action, as a sudden wage increase, does not bode well with the program's objectives to attain macroeconomic stability. We are glad that the authorities after all have agreed to take corrective measures to limit the impact of a minimum wage increase on economy-wide wage developments, private sector employment and growth in some sectors.

While we commend the authorities for following the energy price adjustment schedule, we call for a better targeting of subsidies to the poorest groups of the population. In regards to the weak collection of utility fees, while it is unfortunate, it is not surprising that the results are worse that expected. Discontinuing supplies to large industrial users with bad payment records is not a politically easy step to take. Thus we commend the authorities for taking bolder actions on this front in the first quarter of 2002. Given the significance of utility companies' performance on the budget, we urge the authorities to stay on track with their commitments in this area.

Efforts to speed up several privatization projects will need to be accelerated, especially the sale of the BCR and four large loss-making enterprises. In this regard, it is appropriate that the new law allows for tax arrears write-offs and that the authorities have reduced the price of non-weight factors in the criteria for selecting winners in privatization bids. Steering clear of granting discretionary tax incentives would also be an important commitment to keep.

Finally, we believe that two issues (partly related to the privatization) did not find adequate coverage in the paper while their importance is rather high for the overall economic development and social stability. First, while privatizations are certainly necessary not only for reducing the burden on the fiscal accounts but also for deriving adequate contribution to growth from more efficient enterprises, their impact on the population through labor force shedding is also rather dramatic. This said, even with privatizations behind schedule, we note from Table 1 that the unemployment rate projection has been revised from 8 percent to 11 percent for 2002, which, in our view, is rather significant. We would like to hear from the staff on the reasons for the revised unemployment projection, as well as on the ability of the private sector to absorb extra labor force resulting from future privatizations, and on the government's steps to address this serious issue in the context of World Bank social sector reform program.

Second, the issue of governance, so pertinent to conducting business in Romania, needs a greater attention under this program. While negative precedents of some murky privatizations of 2001 call for greater transparency in the future, the issue of governance does not only relate to the privatization process. In general, according to the recent PriceWaterhouseCoopers' report, a lack of transparency in the legal system is costing Romania billions of dollars in FDI. We have also learned from other external sources that in order to combat corruption a new anti-corruption agency is to begin work in September and will be responsible for cracking down on bribery, money-laundering and tax evasion. However, doubts have already been raised about its likely independence. We would like to hear from the staff on the developments in this area and whether the World Bank is being actively involved.

With this said, we wish the authorities success.

Mr. Wei submitted the following statement:

We welcome this opportunity to discuss Romania's program. We thank staff for the concise and candid paper and Mr. Wijnholds for his comprehensive and helpful preliminary statement.

It is very encouraging to see that so far the Romanian program has been successful with the achievement and continued improvement of the main macroeconomic objectives. Despite the external economic slowdown, the economy has continued on a recovery path with the strong rebound of the real economy and the increasing strength displayed by the export sector. Owing to successful disinflation measures, inflation has come down significantly and the lowering trend is being sustained. As a result, this year's inflation target is within easy reach. The current account situation has further improved. Foreign reserves are growing and have reached a comfortable level. On the structural reform front, the authorities have made some encouraging progress with regard to strengthening the fiscal position, reducing the quasi-fiscal deficit and reforming the state sector. However, progress in the key reform areas is less than satisfying with several quantitative and structural performance criteria not observed for understandable reasons.

We commend the authorities for their strong efforts in keeping the program on track and encourage them to maintain these positive developments. On the other hand, we note that for the program to achieve macroeconomic stability and reduce vulnerability, the authorities need to reinforce their structural reform efforts in key areas.

As we are in broad agreement with the staff appraisal, we wish to confine our comments to the following issues for emphasis.

The prudent macroeconomic policies have served the economy well with inflation significantly reduced and on a downward trend. We share Mr. Wijnholds' view that the success in reigning in inflation has strengthened the authorities' credibility and better positioned them for further disinflation. The authorities have struck a balance between maintaining the disinflation trend and preserving economic growth while allowing for more flexibility of the lei. Nonetheless, fiscal discipline is still crucial to contain inflation pressure.

It is therefore reassuring that the authorities are fully committed to continue the fiscal consolidation in 2002 and beyond. The fiscal targets under the program have been met, but the unexpected shortfall in revenue, the unsuccessful attempt to contain wage increases in the state sector and the persistent quasi-fiscal deficit incurred in the energy sector, point to some uneasy developments, on which the authorities must take resolute action. On addressing the revenue shortfalls, we welcome their decision to eliminate tax exemptions, remove distortive tax incentives, enlarge the tax base and strengthen tax administration.

Wage policy has been the main weakness in past programs. The authorities and staff both agree on the importance of strengthening wage discipline in the state-owned sector. The development so far is mixed. We note that the authorities have put wage increase and employment ceilings in place to improve the situation. We urge the authorities to follow such ceilings strictly. We understand that as part of the social program for 2002-03 approved in late July, the expected minimum wage hike beginning in 2003 aims to reduce the adverse effects of economic reform on the low-income population and ensure social stability. While we support the authorities' intention to take care of these people while implementing difficult reforms, it is important that the minimum wage hike does not translate into an overall wage increase in the public sector.

On reform of the energy sector, we welcome the progress so far in raising energy prices to levels that recover costs, enforcing payment requirements and transferring heating production units to local municipalities. The poor collection rate is a matter of concern and remains an obstacle to reducing the sector's quasi-fiscal deficit. We encourage the authorities to strengthen payment enforcement and punitive measures on noncompliant users. The intention to promote competition through privatization is worth pursuing. On privatization, we share staff's view that progress in privatization will provide an important signal on the authorities' commitment to improving the business environment and contribution to attracting FDIs. We welcome their plan to accelerate the privatization process.

Finally we welcome the authorities' decision to participate in the FSAP which will help them assess the strength of the financial sector and take the necessary measures to address the weaknesses

With these remarks we support the completion of the first and second reviews and waiver and modification of performance criterion. We wish the authorities success in implementing the program.

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

Since October 2001, Romania's performance under the Stand-By Arrangement has been broadly positive on the macroeconomic side. However, as highlighted in Mr. Wijnholds' candid preliminary statement, performance in other areas has been poor. That the first review reaches the Board ten months into an eighteen-month program is indicative of this. We have been concerned about the approach taken by the authorities in attempting to meet the pre-conditions of previously scheduled Board discussions – in particular their attempt to meet the public employment reduction requirement by outsourcing PETROM employment rather than through real reductions. That June's significant minimum wage deal came as an apparent surprise to Staff worryingly suggests that the Government's commitment to a Fund-sponsored program is weak. Going forward, communication between the authorities and Staff must improve.

As noted in the staff report, there has been significant slippage on both structural reform and wage conditions, and the Board is being asked (despite at times an apparent lack of commitment from the authorities) to agree to a large number of waivers. We naturally welcome the Government's new-found commitment to the program and to privatization. In contrast to the recent past, it will be important for these commitments to be realized.

Macroeconomic Performance

On the macroeconomic side there is much to welcome. Supported by a strong agricultural recovery, growth in 2001 was 5.3 percent. Progress with reducing inflation has continued and has been in line with the program. We urge the authorities to be ambitious in bringing down inflation further. Steady depreciation of the Lei has helped to maintain competitiveness and exports have performed well, exceeding targets. Budget deficit targets have been met under the program, though the staff rightly highlights the risks posed by significant revenue shortfalls.

Wage Policy

We are concerned that, despite some moderation, public sector wages are again out-stripping those in the private sector. The performance criteria for end-December, end-March and end-June were all missed. Are we heading down a previous traveled path? As Staff point out, this Fund program was designed to address the loose fiscal policy and rapid rises in household consumption driven by excessive wage settlements in state-owned companies. The new minimum wage deal will see both a 43 percent rise in the minimum wage and cut employees' social security contributions (by 4.7 percent) from January 2003. Whilst it is welcome that the authorities recognize the risk that this deal poses—for inflation, competitiveness and the fiscal position—we are skeptical of their assertion that this will not feed into wage inflation across the public sector and economy as a whole. Given the earlier erratic performance by the authorities we need more than promises to be reassured.

Quasi-Fiscal Deficits

Whilst significant progress has been achieved in raising energy prices, the failure of utilities to improve poor collection rates meant that the program targets for reducing quasi-fiscal deficits in the energy sector were not met. Collection rates for heating deteriorated in Q4 2001 and Q1 2002 as a result of "insufficient efforts" (para18). Overall losses in the energy sector are large at 3 percent of GDP. Implementation of the authorities' plan to enforce payments and disconnect non-payers is crucial in dealing with this issue.

Privatization

Further privatization is badly needed in Romania. This would help to improve the investment climate for the private sector, reduce the costs to the government of covering the losses made by many public enterprises and improve the management of important sectors of the economy. It is therefore worrying that progress on privatization remains slow. With the exception of the SIDEX deal, only six major firms have been privatized against the twelve envisaged under the program. The privatization of the major bank BCR (a structural performance criteria for which a waiver is being requested) has also been repeatedly delayed. That the above mentioned minimum wage deal will give more power to the unions in future privatizations is not an encouraging sign. We would welcome Staff's assessment as to whether the authorities' agreement to reduce the weight of nonprice factors in the criteria for selecting winners in privatization is sufficient mitigation against this risk.

We applaud the government's proposal to "re-invigorate" privatization, but again are keen to see concrete actions back up these words. We strongly endorse Staff's appraisal (para 53) that "it is essential for the government to change its overall attitude towards privatization, and to avoid imposing conditions to preserve employment or rapidly increase investment in privatized companies. The authorities would be well advised to be more decisive in liquidating perennial loss-makers."

Conclusion

In the light of these concerns, we were not wholly convinced by the case for concluding the 1st and 2nd Reviews. A firm message needs to be sent to the authorities regarding our concerns as to the progress of this Stand-By Arrangement. Words alone appear to have had little impact to date and we wonder whether Staff considered further delay to reinforce the need for progress?

At the very least, by the time of the Third Review we would expect to see the authorities demonstrate their professed commitment to the privatization program; and to demonstrate further how they are going to limit the knock-on effects of the proposed minimum wage hike. In light of previous indifferent performance, we expect to see impeccable commitment and performance at the Third Review. At that point we would not expect to see any further waivers.

The staff representative from the European I Department (Mr. Mates) informed Directors that the authorities had met the last prior action for the presentation to the World Bank Board of the Private Sector Adjustment Loan II, which was expected to take place in mid-September 2002.

Mr. Boitreaud made the following statement:

We welcome today's discussion on the first and second reviews under the Stand-By Arrangement with Romania and we thank the staff for a well-written and rather candid report. During our last Board discussion on Romania, many chairs, including ours, stressed the importance of a strong and sustained commitment from the authorities for the program to succeed. The delays and the difficulties experienced over the last months are testimony that such a commitment remains, more than ever, crucial, particularly in the perspective of the accession to the EU. Therefore, like Mr. Andersen in his preliminary statement, we urge the authorities to make full use of the window of opportunity and implement the comprehensive set of structural reforms agreed under the current program.

Romania's macroeconomic performance has been satisfactory so far and the latest data on inflation sends a positive signal since it strengthens the credibility of the ambitious program inflation target for 2002. Indeed, Romania could experience its first year with an inflation rate below the 30 percent threshold of its recent macroeconomic history. We also welcome Romania's export performance, achieved in a context that was not fully supportive. Since we share the thrust of the staff's appraisal, we will focus on three items for emphasis: privatization, wage and fiscal discipline.

First, privatizations remain critical to the overall success of the transition and the EU accession. The program has rightly insisted on this area and its conditionality—in close connection with the World Bank—offers a balanced coverage of the implementation of the privatization process. But, on the ground, progress so far has been mixed at best. We therefore urge the authorities to respect the agreed timetable and proceed as decisively as possible. However, rapidity should not be obtained at the cost of weak quality or poor transparency. The modalities of the privatization process are also central: as pointed out in the staff report, FDI levels continue to be modest in Romania compared with other candidates for the EU and a perceived lack of transparency in the way public companies are sold to the private sector has certainly played a role in this situation. FDI, notably through privatization, will not only provide Romania with financial support but also with technical expertise and management skills. In this context, we believe that a successful and transparent privatization of the BCR will send a very strong and positive signal to investors, particularly if the buyer were to be a foreign group. The rewards could be substantial as the current low level of FDI leaves room for a discernible increase over the next years. At the same time, as underlined in Mr. Mozhin and Ms. Vtyurina's preliminary statements, privatizations will have important social consequences through labor force downsizing and we share the interrogations raised by the Russian chair on the government's intentions to tackle this social issue and on the role of the World Bank in this area.

Second, wage discipline in state-owned enterprises is another cornerstone of the success of the program. Like for privatization, results have been mixed so far. The recent and unexpected agreement on the minimum wage is clearly not a positive step, although it seems that its consequences on the whole wage scale should not be as important as in the past. Anyway, we urge the authorities to closely respect the measures specified in para 19 and 20 of the supplementary memorandum on economic and financial policies to limit as much as possible the effects of this minimum wage increase on the financial situation of the state-owned enterprises and, more generally, on the country's external competitiveness.

Third, the continued weakness of fiscal revenues is a cause for concern. Since the scope of reduction in expenditures appears limited with regard to important needs in the social, health, and education sectors, the weakness in revenues undermines efforts aimed at achieving the overall fiscal targets and could push Romania back into its vicious cycle of soft budgetary constraints, typical of an insufficient transition. As for wage discipline, the importance of financial discipline cannot be overemphasized in the case of Romania. In this connection, we welcome the launching of an ambitious tax reform, encompassing both tax measures and institutional changes, and we urge the authorities to strictly adhere to the agreed agenda. Like wage discipline, weakness in revenue collection does not concern only the state but also extends to state-owned enterprises, notably in the energy sector. We therefore welcome the substantial increases in energy prices and, like Messrs. Brooke and Mellor in their preliminary statements, urge the authorities to continue their efforts to improve payment discipline and disconnect non-payers.

Before concluding, I would like to express some concerns on the rapid expansion of bank credit denominated in foreign currencies. Recent experience has reminded us that currency mismatch in the balance sheet of banking institutions could pose a threat to the stability of the financial system of the whole country. The situation does not appear too worrisome yet, but we join the staff in asking for a strengthening of banking supervision, notably through an increase in capital requirements for heavily exposed banks. In this regard, we welcome the authorities' interest to participate in the FASP, as expressed in Mr. Wijnholds' comprehensive preliminary statement.

Having said that, we support the proposed decision and wish the authorities every success in their challenging endeavors.

Mr. Baukol made the following statement:

The review of Romania's Stand-By Arrangement shows that the structural policy issues that have been at the heart of Romania's last five and unsuccessful programs—namely wage policy, privatization, and the quasi-fiscal financing of state-owned enterprises through the accumulation of arrears—continue to be a problem. The request for multiple waivers for these reviews reinforces the serious difficulties with implementation in these areas. Of course, progress in these structural issues is critical for setting hard budget constraints and reinforcing fiscal sustainability.

Like Messrs. Brooke and Mellor, we think the case for concluding these reviews now is not clear cut. The Fund staff has taken steps to put performance back on track by delaying the reviews and requiring additional prior actions in the areas where reform has lagged. The authorities should have no doubt about what is expected from them going forward, as we will be looking very closely for evidence of exemplary performance in order to support the next review. As Romania is a prolonged and inefficient user of Fund resources, the Board and the staff have the obligation to hold the authorities to high standards.

Enterprise Reform and Privatization

A key weakness in the program so far has been performance with restructuring and privatization of state enterprises. Here the authorities' commitment to the program is questionable. An illustrative example concerns the layoffs at state enterprises that were implemented this summer. Originally, the authorities conducted these layoffs simply by spinning off part of the state-owned enterprises, rather than through actual layoffs. Going forward, the authorities need to show more determined ownership of the program by fulfilling both the letter and spirit of their commitments.

The authorities missed the end-December, end-March, and end-June ceilings on the wage bill in state enterprises. The authorities now plan corrective measures by reducing bonuses and withholding 4 percent of the quarterly wage bill until approved by respective ministers. These corrective measures are not fully convincing as similar commitments by the authorities in the past have had only temporary success. Indeed, it would be more convincing if the Finance Minister could withhold payments from the ministries. The authorities should be ready to take corrective action here in a timely manner if the new procedures do not work.

Another concern is the 43 percent increase in minimum wages slated for January. The authorities provide assurances that this increase will not impact the wage scale more broadly, and we agree with Mr. Boitreaud on the importance of following up on these commitments.

Privatization has remained disappointing. At this stage, let me simply agree with the comprehensive comments of Mr. Boitreaud. We encourage the authorities to over-fulfill their commitments in this area. We also concur with the remarks of Ms. Vtyurina on governance issues.

Fiscal and Quasi-Fiscal

Turning to fiscal and quasi-fiscal issues, we welcome the introduction of the new VAT and profit tax laws, which take some steps to eliminate exemptions. We also welcome the steps taken to reduce the very high payroll tax rates. Further efforts to reduce quasi-fiscal losses, increase compliance, and improve expenditure targeting would free up additional resources that could be used for additional cuts in payroll tax rates.

Some progress is being made in reducing quasi-fiscal deficits in the energy sector, but the government is still short of program commitments. While energy prices have been raised, collection rates remain well below the program targets. The small improvements in collection rates for 2Q 2002 are a helpful sign, and we encourage the authorities to follow through on their nascent steps to cut off delinquent customers.

While we understand the staff's desire to streamline conditionality, we are disappointed that it has removed the element of the program pertaining to tax arrears, downgrading it from an indicative target to ongoing monitoring. In the absence of direct subsidies to loss-making state-owned enterprises, this is one of the more important ways in which quasi-fiscal measures are used to prop up insolvent enterprises. More importantly, these arrears produce an uneven playing field for private enterprises and reduce the incentives for tax compliance.

Monetary/Banking

Monetary policy has performed reasonably well, with inflation falling as anticipated in the program. Nonetheless, we are concerned about the exchange rate intervention, which the staff report says is designed to prevent 'unwarranted real effective appreciation'. We note the comment in

Mr. Wijnholds's statement that intervention has become less frequent. Nonetheless, it is not clear to us how the authorities determine what is 'unwarranted' versus 'warranted' appreciation. In our view, with inflation still over 20 percent, the NBR should focus its efforts on bringing down inflation rather than targeting the exchange rate.

On banking, we concur with the staff's concerns about the rapid expansion of credit denominated in foreign currency. While the growth is from a low base, the authorities should take steps early to help minimize the risks resulting from foreign currency lending, particularly in the context of a largely unreformed state enterprise sector. Here, we note that the indicative targets for bank lending to state enterprises have been repeatedly exceeded and are being revised up for the rest of this year. Also, could the staff provide information on the liability (deposit) side of the bank balance sheets? Are foreign currency loans being fueled by a rise in foreign currency deposits? Given these risks, we welcome the authorities' intention to do an FSAP mission. We also welcome their intention to strengthen the legal infrastructure to fight money laundering and bring this up to EU and U.N. recommendations.

Other

Two other issues. One, we welcome the completion of the safeguards assessment and the staff's intention to include corrective measures in the program going forward. Two, last year the Board welcomed the authorities' intention to subscribe to the SDDS. Can the staff update us on progress in this area? Finally, we welcome the authorities' intention to publish the staff report.

Mr. von Kleist made the following statement:

We commend the Romanian authorities for their successful macroeconomic stabilization efforts and sincerely hope that these reform policies will be maintained and strengthened, to ensure that the current program will be the first one, after a long row of failed attempts, that could be successfully concluded.

Several recent developments and policy decisions are, however, very troubling. Therefore, while we support the conclusion of the first and second reviews, the authorities have to take a number of important steps to make it possible for us to continue our support in the future.

Since I can in general support the preliminary statements by Mr. Brooke and Mr. Mellor and by Mr. Anderson, as well as the remarks of Mr. Boitreau and Mr. Baukol, my own additional comments are quite brief.

Recent decisions concerning income policies are threatening the overall stabilization gains achieved in the past and aimed for in the future. Monetary policy on its own cannot guarantee price stability. To achieve lasting stability, appropriate monetary policy has to be accompanied by matching incomes and fiscal policy. We do not share the authorities' assessment that they will be able to wholly contain second round price effects emanating from the recent wage increase. Experience of other countries has shown that more often than not wage-price spirals result from such policies. There are more efficient and better targeted ways to achieve the aimed for social objectives.

To continue with monetary policy, we regret that domestic price stability is not the sole objective, but that—at least implicitly—monetary policy is burdened by a parallel exchange rate objective. Low domestic inflation is the best defense against unwanted real appreciation, which is not warranted by relative productivity developments.

We strongly regret the necessity for such a large number of waivers, especially those concerning the increase of electricity prices and the revenue goal from improved collection rates. These two factors are the main culprits for missing the performance target concerning quasi-fiscal adjustments. Price increases and improved revenue collection have to be achieved simultaneously to ensure a reduction of quasi-fiscal deficits. Against this background, the sanction mechanisms envisaged in the program seem to be rather toothless. This probably is due to the fact that most of the industrial electricity customers are loss making state owned enterprises. This again illustrates the point that only rapid privatization and restructuring of these loss making SOEs will reduce quasi-fiscal deficits lastingly. Looking forward, we expect decisive progress in this area, otherwise we would find it extremely difficult to support the upcoming third review.

We join staff in warning against the dangers of negative balance sheet effects due to increased foreign denominated indebtedness in case of a sudden and unexpected devaluation. The high growth of credits in the non-publicly owned private sector is generally very welcome. The fact, that much of this growth occurs in foreign currencies is, however, worrisome. In the same vein, the marked reduction of spreads on the capital market is generally welcome, except that it may induce a higher degree of foreign denominated indebtedness than one would usually regard as prudent. A reversal of the increase in investors' confidence, which may occur unanticipated and quite suddenly, would then pose a serious threat to further economic development.

This leads us back to overall stabilization policy: if inflationary expectations can be put on a clear downward path, the current cost advantage of foreign versus domestic credit would be reduced and might even be reversed, thereby minimizing the risk of negative balance sheet effects.

Mr. Vermaeten made the following statement:

As Mr. Wijnholds has pointed in his helpful preliminary statement, the staff report presents a candid and fair assessment of Romania's performance. I think staff should be commended not only for the high quality report, but also for the fact that the staff has worked hard to try to bring the program back on track. I am sure this required not only great skill, but a tremendous amount of flexibility and patience.

Mr. Chairman, 10 month ago the Romanian authorities made a commitment to undertake comprehensive reforms. Some members of the Board—including this Chair—were skeptical as to whether this Stand-By Arrangement could be completed given Romania was 0 for 5 on the completion of past programs. Today, we are somewhat more optimistic, but serious concerns remain. Romania has achieved much, but there have also been noticeable failures in reaching major agreed-upon goals.

On the positive side, and to give credit where credit is due, the Romanian authorities should be commended for the significant progress they have made on the overall fiscal situation and macroeconomic performance. Deficits have been reduced, and the authorities have shown considerable resolve in reforming the tax system—including the implementation of a new VAT law and profit tax law. The improved fiscal situation, a lower current account deficits, and a strengthened official reserve position is starting to pay dividends in terms of recent credit ratings upgrades.

Monetary policy management has also been solid, and the reductions in the inflation rate are encouraging. But like Mr. Mohzin and Ms. Vtyurina, we caution against a rapid growth of foreign currency loans and urge the authorities to act in strengthening supervision and prudential requirements before the growth of foreign currency loans turns into a serious risk.

While these accomplishments and the implementation of many other prior actions should be commended, it is also clear that on other major fronts progress has been slow, and in this respect, I share many of the concerns expressed by Mr. Baukol and Mr. Von Kleist. Let me just touch briefly on only three problem areas: privatization, wage discipline and the corruption.

Both the speed and transparency of privatization need to improve. As the OECD report says, negative value-added in some of the unrestructured companies are simply "staggering". In reading various other external reports, it is obvious that there are many people in government that benefit from the current system of inefficient state owned enterprises, and are doing what they can to slow down the process. Rather than selling state-owned enterprises as quickly as possibly to end the perennial drain on Romanian taxpayers, the process is dragged out by an uninspiring privatization team and by public servants that, in the words of the Oxford Analytical report, "exhibit a chronic lack of professionalism". And even after privatization, inefficiencies drag on because Romanian authorities are still placing too many demands on the buyers of state-owned enterprises, such as prohibiting the firing and laying off of existing staff, regardless of performance. Let me once again urge the authorities to improve performance on privatization—not only because it is absolutely essential if Romania expects to complete this program—but as Mr. Andersen has pointed out, because macroeconomic stabilization cannot be durable without restructuring and privatization.

Second, on wage discipline in state-owned enterprises, I fully agree with Mr. Brooke and Mr. Mellor that the slippages on this front are very disconcerting, and appear to be a continuation of the pattern of broken commitments, rather than the turning over of a new leaf. We see strict adherence to the new targets as necessary for the completion of future reviews.

And third, corruption remains an enormous problem in Romania. It affects the performance of the economy on many levels. It means poor public services, large losses to state owned enterprises, slower privatization, and reluctance by foreigners to provide much needed capital and foreign investment. For 2001, Romania placed 69th out of 91 on the Transparency International Corruption Perception Index. The 2002 report just came out today, and Romania went even further down the list—to 77th place. Their overall score also slipped from 2.8 in the previous report, to 2.6 in this report. The one positive development is Romania's Prime Minister does seem to recognize that the current anti-corruption campaign has not yet been very effective, and he has complained about "inexcusable delays" in addressing corruption. Hopefully, this is a harbinger of a much-needed turnaround on this front and we would look forward to a progress report in the next staff report.

In conclusion, let me once again commend the authorities on their accomplishments, and also encourage them to diligently follow through on their commitments. We cannot hold the current government responsible for the fact that the previous 5 programs were not completed, but the reality is that there have been serious slippages by this government in implementing this program. We'll be viewing the next review through this lens, and we hope to see very positive results.

Mr. Jang made the following statement:

At the outset, we share staff's assessment that the macroeconomic stability in Romania has been notable under the Fund-supported program. Excessive growth in domestic consumption is now under control with a faster reduction in inflation than projected. Meanwhile, industrial production has begun to pick up, helped by a strong export performance. The program now projects that the economy will grow at about 5 percent with a continuing disinflation trend.

This substantial achievement would not have come without the concerted policy efforts of the authorities. Admittedly, there have been some program slippages, but the authorities' quick action to correct them have enabled the program to broadly remain on track. There have been a number of breaches in performance criteria but the authorities' corrective actions, as detailed in the SMEFP, some of which have already been implemented as prior actions, appear to be reassuring. On these grounds, we are prepared to support the completion of this review, while agreeing with the proposed decision regarding the granting waivers and modification of performance criterion.

Nevertheless, we still see a number of downside risks to the program. We will limit ourselves to these issues.

First, given the utmost importance of fiscal prudence in maintaining macro stability, we are uneasy about the way the fiscal deficit target was met. That is, the budget deficit managed to stay on track in 2001 only by expenditure cuts in the fourth quarter following an earlier spending surge and lower-than-expected out-turn of tax revenue. This pattern is likely to continue for some time, given the prospect that revenue performance is not going to improve soon.

In this respect, the authorities' plan of reducing payroll taxes certainly poses a concern, especially because increases in disposable wage income were a driving force in excessive increases in domestic demand in the past.

Nevertheless, we note the authorities' firm intention to proceed with the plan due to their concern about the social safety net, which we sympathize with. We also see its merit in terms of enhancing tax compliance, the lack of which is believed to be the major reason for lower-than-expected performance of tax revenue.

But if the policy benefits of the payroll tax cut are to be better served, we would like to argue that the plan should be structured in a way that would allocate tax cuts more equally between employees and employers. This will not only give employers an incentive to provide more jobs, which will be a sound way of helping the poor, but it will also make it easier for them to comply with their tax liabilities.

The wage policy is another area of concern. While understanding the political reality in Romania and the authorities' firm intention to keep wage rise in the public sector under control despite the increases in the minimum wage, we are still uncomfortable with the possibility of the minimum wage increase spilling over into the private sector. The authorities appear to be confident that this will not increase inflation beyond 15 percent next year. We wonder whether staff is equally as confident. Staff's comments would be welcomed.

Moving on to the exchange rate policy, we note that lei remain competitive despite declining but still high domestic inflation. But this has been achieved by the authorities' periodic intervention in the market with their short-term sterilization instrument. Too frequent interventions, however, are bound to create distortions. A primary example is the increasing trend in foreign-currency-denominated lending by commercial banks facing high interest rate differentials between home and abroad.

The inverted yield curve of T-bills shown in figure 6 may also be another example of such distortions. Of course, they seem to reflect the public's expectation for an increasingly faster trend in disinflation, as staff suggested. But they may also be affected by the central bank's sterilization operations. If the central bank predominantly relies on short-term T-bill instruments, then the increased supply of short-term T-bills is likely to push up short-term rates, resulting in an inverted yield curve. In this regard, we would appreciate more information about the recent composition of T-bills.

This leads us to comment on the staff's concern about the credit risk of financial institutions which have recently increased foreign-currency denominated lending. We welcome the authorities' recent decision to increase the reserve requirement for foreign-currency denominated lending to a level comparable to domestic-currency loans. We also agree with the strengthening of prudential regulations to encourage the banks to enhance their risk management.

Nevertheless, we believe that staff's recommendation to increase the capital adequacy ratio only to those banks with high exposure to foreign-currency denominated lending might be too little. We understand that staff would not recommend this as a longer-term measure. But a more desirable way of reducing the credit risk would be to reduce incentives for banks to rely on this type of lending in the first place. That is, reducing the gap between foreign and domestic interest rates, as indicated by the authorities, would be a better way to deal with this problem. Achieving this goal, however, requires an even stronger determination and commitment by the authorities to prudent fiscal and wage policy and speedier privatization.

With these remarks, we wish the authorities greater success in the program.

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

> Let me start with the important question raised by Mr. Brooke whether the staff has considered the possibility of further delaying the completion of the first and second reviews as an appropriate incentive to improve the performance under the program. As indicated in the staff report, discussions on the completion of the reviews were quite protracted, requiring three staff missions. In addition, there was a long list of thirteen prior actions, which are provided in table 2 of the Supplementary Memorandum of Economic and Financial Policies (SMEFP), including important measures that required parliamentary approval like the VAT and profit tax laws, and other measures like disconnections of worst industrial nonpayers, layoffs in SOEs and the completion of several privatization projects. Once the authorities have completed this long list of prior actions, we consider that the conditions have been met to proceed with the discussion and the completion of the reviews.
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> There was a question on the purpose of interventions in the foreign exchange market by the National Bank of Romania (NBR). Indeed, the NBR was present in the foreign exchange market almost on a daily basis until the end of the 2001. Although no depreciation target was officially announced, market participants clearly recognized what the target for the given month was. The central bank's actions were in effect close to a crawling peg arrangement. We advised the authorities to reduce the frequency of interventions and to allow for larger variability in the exchange rate to reduce incentives for short-term capital inflows, but the central bank continues to operate in the foreign exchange market to prevent inappropriate appreciation of the currency because of a persistent excess supply of foreign exchange. The central bank is basically trying to achieve a targeted depreciation which is consistent with the targeted inflation rate. In some sense, the central bank is using the exchange rate as a soft nominal anchor in its disinflation effort, and this is because the effectiveness of the exchange rate to reduce inflation is much stronger than that of the interest rate channel. This reflects the fact that the degree of monetization in the economy is pretty low, and that domestic financial markets are still fairly underdeveloped. Since the beginning of 2002, the central bank has mainly been intervening to buy foreign exchange, which means that there would have probably been a nominal appreciation of the exchange rate or a lower depreciation if the central bank had refrained from intervening, and as a result inflation could have been brought down even faster than targeted. The authorities consider that undershooting the inflation target would not be appropriate because it would lead to the deterioration in the external current account deficit, given the substantial inertia in wage settlements. There would also be implications for the public budget.
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> A question has also been raised about the factors behind the increase in lending to SOEs by the domestic banking sector, and whether this creates a

risk to the program. The indicative benchmark for domestic bank lending has been revised upwards and actual lending has been even higher. Most of this reflects the change in the financing of the energy sector, which has switched from foreign financing to domestic financing this year. Almost all of these loans are guaranteed by the government, and they do not increase the credit risk for the banking sector. On other hand, the measures that are implemented under the program are providing for improved financial performance of the energy sector. So we hope that these guarantees do not increase fiscal risks either.

We are also concerned about the rapid growth in lending denominated in foreign currencies, although several measures have already been implemented in this area. Reserve requirements have been changed to eliminate the bias in favor of foreign exchange deposits. As indicated in the staff report, the central bank is also intensifying on-site inspections of banks which have been particularly active in this type of lending, and the announcement by the central bank of changes in provisioning regulations might have already had some effect on the behavior of the banking sector.

Several preliminary statements have raised the issue of unemployment. Regarding the increase in the unemployment rate in the beginning of 2002, we should clarify that this should not be seen as a signal that restructuring in the enterprise sector has accelerated. This statistical phenomenon reflects a new social assistance scheme that requires registration as unemployed to be eligible for some benefits. As a result of that, the unemployment rate jumped to 13 percent, but it subsequently declined to less than 10 percent, which is probably not excessively high for a country at this stage of transition. Several programs provide retraining to facilitate reemployment of those who lose jobs in the process of restructuring. Some of these programs are supported by the European Union and the World Bank.

Regarding the question on the establishment of the new anticorruption office, and whether this office is going to enjoy sufficient autonomy, our understanding is that the anticorruption office established by the government after extended discussions with the European Union will be a semiautonomous entity under the ministry of justice. Reportedly there are some obstacles in the constitution that prevent the government from granting full autonomy to this office, but its establishment is certainly a step forward. On the role of the World Bank in the establishment of this office, my understanding is that it has not been directly involved in this, although it has provided assistance on anti-corruption measures on several other occasions. The World Bank also intends to initiate a new lending operation in financial year 2004, which is going to address the issue of anticorruption measures in Romania.

On the question about the structure of T-bills, there are serious restrictions in this market, as nonresidents are not allowed to trade in T-bills. It has been our recommendation to the government not to eliminate this restriction on the capital account at this stage, particularly because we wanted to avoid some of the short-term capital inflows that would otherwise result. The government is selling some one- and two-year T-bills denominated in foreign currencies to residents, but the amounts have been modest and the associated risks are limited. While the staff has not encouraged these operations, it has not tried to restrict them either, given the limited amounts involved.

As regards the possible increase in the power of trade unions to influence privatization projects, the recent agreement with the unions contained a reference to this effect. We have tried to address this issue by including a sentence in the SMEFP, according to which even if there are any amendments to the privatization law, there would need to be a specific provision saying that the consent of the unions would not be a necessary requirement for completing the privatization project. In practice, it remains to be seen how much importance the government, which always consults trade unions in cases of large privatization projects, will attach to the opinion of unions in such cases.

The staff representative from the Policy Development and Review Department (Mr. Kincaid), in response to questions from Directors made the following statement:

I would like to come back to the question that was raised by several Directors concerning whether a convincing case exists for concluding the first and second reviews at this stage.

First, we should bear in mind that it has been ten months since the approval of Romania's Fund-supported program, and that the first and second reviews have already been considerably delayed. During this time, the staff has been working with the authorities to bring the program back on track. The staff's judgment is that the list of prior actions, which is quite lengthy, provides the economic underpinnings to allow the program to go forward.

At the same time, as Directors will recall from Board discussions on conditionality, prior actions are not a very good instrument to gauge commitment of the authorities going forward. Thus, as pointed out by Directors, risks to program implementation remain, especially given the authorities' poor track record. In this context, calls by Directors for exemplary performance are certainly appropriate.

All in all, the authorities' willingness to implement the required prior actions hopefully indicates a new sense of commitment by the authorities, and they now have the chance to demonstrate that they are, as one Director put it, turning over a new leaf. Going forward, they should be held to a high standard of policy to make sure that they implement the agreed program and that they adhere to their commitments. These considerations have provided the basis for the staff's proposal to bring the program reviews to the Board.

Mr. Marques made the following statement:

Romania's macroeconomic performance has been broadly in line with the program's objectives: inflation has been lowered without compromising growth, the current account deficit has been contained, and official reserves have been strengthened. It is regrettable that this good performance has been marred by weak and inconsistent policy implementation in other areas, forcing the authorities to request today a large number of waivers.

Given the authorities' reaffirmation of their commitment to the program as it is laid out in the Supplementary Memorandum on Economic and Financial Policies (SMEFP), and the corrective measures they have taken, I can support the proposed decision, stipulating that by the time of the Third Review all promises must have been kept. It is encouraging to note that the authorities recognize the success of the program as a crucial step toward EU accession.

Since I broadly agree with Mr. Andersen, I can limit my comments to the following issues.

Public sector wage discipline continues to be one of the main weaknesses of the program. Recent wage increases in this sector have again outpaced those in private companies and program objectives are put at risk by the minimum wage hike. Like Mr. Brooke and Mr. Mellor, I fear the new minimum wage may have secondary effects on the overall wage level. At a minimum the authorities must implement strictly the measures described in paragraphs 19 and 20 of the SMEFP.

In the energy sector, there was good progress in adjusting prices to more viable levels, but the collection rates of utility tariffs remain disappointingly low. The large quasi-fiscal deficit will persist and even grow unless the authorities act decisively to strengthen payment discipline. This requires *inter alia* suspensions of service for nonpayment. The authorities' efforts to privatize the sector are welcome, but must be intensified if further quasi-fiscal losses are to be avoided.

Generally speaking, the progress of privatization is still too slow. Romania has already wasted precious time, and must accelerate the progress of structural reform if durable macroeconomic stabilization is ever to be achieved.

In the fiscal area, the weak revenue performance is especially worrisome. Without deeper spending cuts than those currently planned, the negative effects on revenues of slower growth and faster-than-expected disinflation will put the deficit target of 3 percent out of reach.

The difficulty of containing central government expenditures is confirmed by the state budget deficit of 3 percent of GDP for the first half of 2002, and the proposals to increase pensions and welfare payments, and soften the effect of higher energy prices on poor households. New expenditures will also be needed to meet the requirements of NATO and EU accession and to pay for reconstruction following the recent floods. I am somewhat reassured by Mr. Wijnholds's comment that the authorities are carefully monitoring expenditure developments and are ready to identify additional steps to avoid exceeding budgetary targets. The plans to reform the tax administration is a step in the right direction, but the identification of additional potential steps would be welcome.

With these remarks, I wish the authorities every success.

Mr. de los Santos made the following statement:

The adoption of a Stand-By Arrangement in October 2001 by the Romanian authorities has proven effective to discipline the economy and to lay the groundwork for the needed economic and social transformation. Macroeconomic developments during 2001 were encouraging, with positive real GDP growth, lower inflation, lower domestic interest rates, and an improved balance of payments. It should be noted, however, that these results were achieved through an uneven program implementation, typified by fiscal and structural reform slippages that prevented the authorities from meeting several structural and performance criteria to December 2001 and March 2002. Fortunately, the authorities decided to address the slippages by adopting some corrective measures—including prior actions to this review—all of which have been implemented, and the program is being brought back on track.

The fiscal position needs to be further improved. We recognize that the notable fiscal contraction that took place during the last quarter of 2001 and the first half of 2002 was instrumental in lessening consumption and shrinking the overall fiscal deficit. Projections to end-2002 are for a smaller deficit. Accomplishing this goal, however, would be feasible on the condition that the authorities take the necessary measures to improve considerably revenue collection and to further reduce the quasi-fiscal deficit in the energy sector. Improved collection efforts in the energy sector during the second quarter of the current year are promising signs in this direction. Also, the recent implementation of the new VAT and profit tax laws, the elimination of some exemptions and increase in excise taxes, as well as the comprehensive tax administration reform already under way, are expected to enhance collections.

Closely monitoring wage developments is warranted to ensure that wages remain below program targets.

We commend the authorities for their implementation of a prudent monetary policy, which has been effective in reducing inflation and interest rates, and in keeping the exchange rate stable and competitive. They should persevere in maintaining this policy at least until they bring inflation down to the programmed target. It is projected that the CPI to end-2002 will be trimmed down to 22 percent, from 30 percent registered in 2001. (We welcome Mr. Wijnholds's remarks that year-end inflation could be even lower than this target). The authorities also need to monitor closely foreign currency-denominated lending to prevent undue risk exposure that could eventually lead to a deterioration of commercial banks' portfolios. In this regard, we welcome the BCR's introduction of a set of new banking regulations aimed at reducing such risks, by establishing reserve requirements on foreign currency liabilities and imposing currency-specific limits. We also commend them for their actions to enhance regulations to combat money laundering activities.

Recent developments on the external sector have been very helpful in improving notably the balance of payments and strengthening the country's external position. The current account deficit was reduced to only 1.5 percent of GDP as of May 2002, much lower than the program target, and foreign reserves increased to appropriate levels, in terms of coverage of imports, broad money and short-term external debt maturity. To consolidate these gains, the authorities need to maintain export growth, taking advantage of their enhanced external competitiveness. Conditions appear suitable for further growth of Romania's participation in the EU's market. We welcome the improved market sentiment and confidence toward Romania's prospects, which is revealed by the recent upgrade of the sovereign country risk, and by the favorable developments in the external sovereign bond spreads.

We are pleased to note the authorities' definite commitment to the program, and share the staff's claim that they have so far achieved the main macroeconomic objectives of the program supported by the Stand-By Arrangement. We take note of the staff's explanations for recommending the waivers of the missed performance and structural criteria, and therefore support the authorities' request. We also support the proposed decision on the completion of this review and wish the authorities well in their future economic and social endeavors.

Mr. Vogel made the following statement:

I thank staff for a well-written report, and Mr. Wijnholds for his helpful preliminary statement. Since we agree with the thrust of the staff appraisal, I will offer a few comments for emphasis. First of all, we welcome the performance that Romania has shown in macroeconomic terms, in particular the significant progress made in reducing inflation and the improvement in the balance of payments position. However, it is clear that much needs to be done in both the macroeconomic and structural areas if the window of opportunity that EU membership represents is to produce the expected benefits in terms of growth and welfare gains. In this regard, we are encouraged by the awareness of the authorities, noted by Mr. Wijnholds, of the remaining weaknesses and the challenging reform agenda, mainly in areas of restructuring and privatization.

Given the need to preserve external competitiveness and the risks associated with the dollarization process in Romania, we welcome the recent measures taken by the National Bank of Romania. The cut in the interest rates could help to reduce the pressures towards appreciation of the lei, but should be reevaluated in case domestic demand growth accelerates. Similarly, the unification of the reserve requirements should serve to remove the bias in favor of foreign currency deposits.

Notwithstanding the efforts to revert the dollarization process, bank credit denominated in foreign-currency has increased rapidly. While this poses significant risks in the medium term, it does reflect the reality or insufficient credibility in the mechanisms of support for the nature of the domestic currency. In any event, the Central Bank has prudently acted by tightening supervision over banks with the highest credit expansion. In addition, we concur with staff's recommendations to minimize the currency mismatch by imposing, inter alia, higher capital requirements for heavily exposed banks.

In the Romanian context, pre-EU accession, fiscal policy has a significant responsibility to maintain the process of disinflation and preserve external competitiveness. While we are concerned by the risks that weak revenues pose for attaining the fiscal targets, we are encouraged by the tax reform, including the elimination of several exemptions in the case of the VAT and the introduction of the new profit tax law aiming at a uniform investment tax allowance.

The benefits of the tax reform will not be seen immediately. Therefore, wage policy restraint, especially in state-owned enterprises, is paramount. In this regard, we welcome the approval of the quarterly ceilings for the wage bill and the decision to further limit bonus payments. While we understand the authorities' reasons for a minimum wage increase, caution will be necessary in order to avoid feeding wage-inflation inertia.

A more disciplined state-owned wage policy should be supplemented by a strengthening of the utilities' revenues in order to alleviate the quasi-fiscal deficit. The recent adjustment of energy prices to more viable levels is a welcomed step. At the same time, the authorities will need to address, in general, the low collection rates of the utilities and, specifically, the incentives for payment and collection. In this regard, we welcome their decision to strengthen the payment discipline, including in particular discontinuing supplies to the large industrial users with a weak payment record. Similarly, the decentralization of the heating sector should help to improve the deteriorated collection performance. Meanwhile, we welcome the privatization of two large companies since end-June and the announced sale of another five by end-September.

With these comments, we support the proposed decision and wish the authorities every success in their endeavors at this critical juncture of the EU membership process.

Mr. Skurzewski made the following statement:

Like other Directors I welcome the progress in macroeconomic stabilization of the Romania's economy, but I regret the delay of the first review and several waivers requested today. This has happened too often during the previous arrangements to be treated without high concern. However, in view of the corrective actions taken, and a renewed commitment signaled by the authorities in the supplementary memorandum, I support the proposed decisions.

Last year's doubts regarding growth projections have not materialized so far, the external vulnerability has diminished thanks to some reduction of the current account deficit and further increase in the international reserves. Also the inflation rate fell faster than projected, yet it still has a long way to reach the EU required convergence level. Like the staff I would welcome a more ambitious monetary target for 2003 but I understand that it would require modification of the decision on the minimum wages, which could be too difficult to undertake. The real rates, however, remain high, at some 10 percent recently, which encourages the borrowers to look for foreign currency denominated loans. The staff rightly suggests careful monitoring of these developments and higher capital requirements for the heavily exposed banks. This should also diminish with the continuation of the interest cuts, which in turn, as Mr. Andersen noted, will much depend on the ability to keep the tight fiscal and incomes policy, and on progress in the structural area.

On the fiscal side of the program, the authorities rightly decided to increase some tax rates and broaden their base in order to meet the deficit target, while reacting to partly unexpected revenue weakness. The reduction in taxation of labor seems a proper choice, in view of its very high level and the need to facilitate private sector growth and job creation. Other changes, in particular the elimination of several VAT exemptions and distortionary profit tax holidays were also long awaited and are welcome. The benefits of these actions, and of the recently initiated tax administration reform, may take some time to come, so the expenditure restriction will be necessary this year. It may become even more of a challenge in 2003, if it has to be reduced by over 2 percent in real terms, as the staff predicts. In this context the public sector wage discipline becomes one of the focal points among the spending items. The experience of other transition countries may suggest however, that various tax and non-tax instruments of wage control are not perfectly efficient, or sometimes do not work at all. The only viable solution is restructuring and eventual privatization of the state owned companies. Like other speakers I therefore look forward to reinvigoration of this process. Introduction of the law enabling writing off tax arrears burdening the privatized enterprises should eliminate one of the significant obstacles, but others are still in force. One is the overemployment in the public enterprises, which may be difficult to tackle in the environment of significant trade unions' influence. Paragraph 27 of the SMEP envisages, however, the intended downsizing in case of unsuccessful privatization bidding, and then eventual liquidation, and such approach should be forcefully taken by the authorities. Another issue is governance, as noted by Mr. Mozhin and Ms. Vtyurina. Lack of transparency and red tape, reported by various analysts, have obviously played a significant role in discouraging domestic and foreign investors, and must be addressed.

With these remarks I wish the authorities further success in implementing the program.

Mr. Al-Nassar made the following statement:

Romanian macroeconomic performance under the Fund-supported program is encouraging. Growth picked up, inflation declined and the external position improved. However, the progress on structural reforms has been mixed. More effort is needed to reduce inflation further, pursue structural reforms and accelerate the process of accession to the European Union. The corrective measures and the revised program reflect the authorities' commitment to that end. Here, I broadly agree with staff appraisal and will only add a few remarks for emphasis.

The authorities' fiscal stance is appropriate to help reduce domestic demand and inflationary pressures. The measures that have been taken to offset the shortfall in revenue should help achieve the programmed budget deficit. The further deficit reduction set for 2003 will require strengthening the revenue performance and restraining non-priority spending. The new VAT and profit tax laws and the initiative to reform the tax administration should help in this regard.

Containing wage growth in public enterprises is a priority. Here, the quarterly ceilings for the wage bills and employment are a step in the right direction. The authorities should also consider linking wage increases in state-owned enterprises to their financial performance. With regard to the minimum wage increase, I share the staff's concern of its negative impact on wages in public enterprises and private sector employment. While the authorities' reasoning of the minimum wage hike has merit, the impact of the reforms on low-income households can be better accommodated by a well-designed social safety net.

Monetary policy is appropriately focused on lowering inflation further while preventing real effective appreciation of the leu. Here, greater support from fiscal and income policies as well as improved financial discipline in the public sector will be helpful. Turning to the banking sector, the rapid growth in foreign-currency-dominated lending is a concern. Therefore, I welcome the National Bank of Romania's (NBR) decision to tighten supervision over the banks with the highest credit expansion and to impose reserve requirements on foreign currency liabilities. In this connection, the NBR needs to speed up the implementation of the staff recommendations to resolve the weakness identified by the safeguard assessment

Finally, the authorities clearly need to accelerate structural reforms to improve the business environment and enhance competitiveness. In this regard, privatization of state-owned enterprises needs to be implemented on schedule without further delays. Here, I welcome the steps that have been taken to address the factors that have been limiting the progress in the privatization process. The privatization of the largest bank (BCR) is also essential. It is therefore important to meet the new deadline for completing the sale.

With these remarks, I support the proposed decision and wish the authorities success.

Ms. Lanza made the following statement:

At the outset let us thank the staff for their interesting paper and Mr. Wijnholds for his comprehensive statement.

After experiencing a phase of excessive domestic demand growth, stubborn inflation and an unsustainable current account deficit until the first half of 2001, Romania has thereafter made remarkable progress in its macroeconomic performance: inflation has rapidly decelerated from 36 percent in the first half of 2001 to 23 percent in July 2002 and real GDP growth held up reasonably well despite weaker external demand, while the current account deficit declined by almost a percentage point, hitting the target of 6 percent of GDP.

However, three structural performance criteria and two quantitative performance criteria were missed and they all revolve around structural issues with important macroeconomic consequences : privatization, public wages, fiscal targets and the energy sector. We cannot avoid noting that the number of missed conditionality requirements, and thus of requested waivers, is worryingly large, possibly indicating lack of ownership, and should not be considered as acceptable practice in the future.

In our comment we will focus our attention on these four issues and add a brief final remark on monetary policy.

It is very unfortunate that Romanian authorities are proceeding at such a slow speed in the privatization process, particularly in light of their accession to the EU. In this respect we share Mr. Andersen remark that the EU accession criteria would much more easily be met should the program be thoroughly implemented.

Attracting foreign direct investment will be crucial for Romania to maintain its external viability and repayment capacity over the medium term. The country's ability to attract foreign capital will clearly also depend on its competitiveness, which remains vulnerable both to price and wage rise. In this respect we are quite concerned to note that not only the authorities have missed program targets for public enterprise wages but also they again recently ignored the policy conditions by reaching a new agreement on the minimum wage outside the normal cycle of negotiations on collective contracts. We are somehow puzzled by the authorities' claim that this will not provide good ground for a generalized increase in wages, in particular given that at present many sector-wide collective contracts are below the new minimum wage. Indeed there is a risk that wages in sectors more exposed to international competition will face unsustainable increases as a consequence of the new agreements We would be grateful if staff could explore this issue a little further.

Moreover an increased wage bill will further deteriorate the public sector deficit and risk vanishing the NBR efforts of pursuing disinflation without affecting competitiveness. It is imperative that Romanian authorities stick to the program targets from now on and achieve timely implementation of all the agreed measures. We expect staff to be particularly vigilant in this area of the program as it is crucial for all medium term developments.

In the energy sector the authorities should be commended for the progress achieved in adjusting energy prices to sustainable levels. However, collection rates remain limited and the sector is still in need of a comprehensive and coherent plan of privatization. We urge the authorities to proceed promptly in signing the contract with the privatization advisor and in enforcing measures to fruitfully collect energy charges.

Finally, we recommend that the authorities strengthen banking supervision, increasing prudential ratios for foreign currency loans as to address the continuing rapid expansion of foreign-currency-denominated credit which could—in the long run—seriously undermine the banking system soundness, if not adequately backed.

With these remarks we support the waivers, the modification of the performance criterion and the completion of the first and second reviews. We wish the authorities every success in their challenging agenda.

The staff representative from the European I Department (Mr. Mates), in response to questions from Directors on the supply side effects of the minimum wage increase, observed that the authorities considered that the effects on private sector wages would be limited. According to the authorities, one reason for this was that substantial side payments were made in the private sector in addition to officially reported wages, which meant that the role of the minimum wage in determining remunerations was limited. In addition, the minimum wage was still low relative to the average wage level in Romania even after the latest minimum wage rise. In this context, the staff was more concerned about the effect of the minimum wage increase on the overall wage scale in the public sector. Such considerations notwithstanding, the authorities would need to monitor wage developments in the private sector and assess the effects of the minimum wage rise at a later stage.

Mr. Wijnholds made the following concluding statement:

I would like to underline that the staff has made a great effort to bring this program back to the Board and that this is appreciated by the authorities. It is also encouraging that the authorities have been able to make some progress, especially given the difficult environment in which they have to work. Layoffs in SOEs are not easy to achieve, and some progress in privatization has been achieved—another large special steel complex has been privatized at the time of the current discussion—even if it is still far from perfect.

I can certainly understand the disappointment felt by a number of Directors, particularly with regard to the lack of progress in the structural area, and, to some extent, I share some of that sentiment. I appreciate the support given to the completion of the first and second reviews. The message that implementation will have to be exemplary is clear, and I will pass it on to the authorities in an unsanitized version, so that they know where they stand. As Mr. Andersen has indicated in his statement, this is a window of opportunity that the authorities can ill afford to lose, and there should not be a fall back to the gradualist approach of the past. All these messages are most useful, and I will convey them to the authorities.

The Acting Chair (Mr. Aninat) made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They approved the authorities' request for completion of the first and second reviews under the Stand-By Arrangement, and granted waivers for the nonobservance of several performance criteria in light of the corrective policies being put in place and Romania's renewed commitment to stabilization and reform.

Directors welcomed Romania's favorable macroeconomic performance, which has been broadly in line with the program. However, they regretted that slippages had occurred in key structural policy areas, and emphasized the crucial importance of improved policy performance and perseverance in meeting the program objectives. This will require strong fiscal and quasi-fiscal restraint and strict wage discipline, along with a continued prudent monetary policy, to achieve a further lasting reduction in inflation. Far-reaching structural reforms, including stepped up privatizations of state-owned banks and enterprises, will be key to improving economic efficiency and the outlook for sustained growth. Directors stressed that financial discipline among state enterprises, including notably in the energy sector—an objective that had eluded past stabilization attempts—still needs to be established as part of a broad commitment to strengthen governance.

While welcoming the narrowing of the budget deficit in recent years, Directors emphasized that current expenditure, particularly subsidies, will need to be further rationalized to achieve lasting consolidation. Continuing progress will, however, also critically depend on efforts to address expeditiously recent weaknesses in revenues, and improve tax performance over time. In this regard, Directors welcomed the new VAT and profit tax laws as important steps for improving the tax structure and stabilizing the business climate. Looking ahead, the authorities should stand firm against pressures for ad hoc tax incentives and against the accumulation of tax arrears, while pressing ahead with the implementation of the comprehensive tax administration reform that has been designed with Fund assistance.

Directors urged the authorities to make a sustained effort to stem the losses in the energy sector, on which the reduction of the quasi-fiscal deficit will critically hinge. They welcomed the recent adjustment of energy prices to more viable levels, as well as the government's plan to make further quarterly adjustments of electricity prices. Going forward, however, significant further progress remains to be made to improve collection rates in the utilities. The decision to disconnect the worst non-payers is welcome, and Directors strongly encouraged the authorities to keep their resolve in this respect.

Directors emphasized the crucial importance of strengthening financial discipline in state-owned enterprises more widely, in order to safeguard a lasting reduction in inflation, fiscal consolidation, and competitiveness. They regretted, in this regard, that wage increases in the state enterprise sector had again outpaced those in the private sector, and expressed concern about the possible impact on overall wage developments of the substantial increase in the mandatory minimum wage. Noting that eliminating wage-inflation inertia remains an essential task, Directors supported the authorities' determination to keep to the 2002 wage and employment program. Looking ahead, it will be particularly important to contain the feed-through effect of minimum wage increase on the 2003 wage scale, and to stand ready to take immediate corrective measures if needed.

Most Directors considered that the National Bank of Romania's prudent monetary policy is appropriately focusing on supporting the reduction in inflation, while at the same time avoiding an unwarranted real appreciation of the leu. Some Directors, however, cautioned that this should not undermine efforts to reduce inflation. Given faster-than-expected progress in this respect and the excess supply in the foreign exchange market, some Directors saw room for further prudent reductions in interest rates.

Directors urged vigilance regarding the continuing rapid expansion of foreign-currency denominated credit. While the current level of financial intermediation is low and the banking system is well-capitalized, this type of lending exposes the banks to higher credit risk, which requires close monitoring. Directors therefore welcomed the new regulation on loan provisioning, as well as the tightened supervision by the NBR, and they advised the authorities to stand ready to adopt additional prudential measures—for example, by raising capital requirements for heavily exposed banks—should a slowdown in credit growth not materialize. Directors welcomed the authorities' intention to participate in the FSAP-program. They also commended their commitment to continue strengthening the framework for combating money laundering and the financing of terrorism.

Directors noted with concern that numerous large companies still remain under state control and that privatization has progressed much more slowly than expected. They emphasized that the privatization of the large state-owned enterprises, together with the liquidation of unviable enterprises, will be key to a durable strengthening of the public sector financial position and sustaining macroeconomic stabilization. Building on the government's commitment to reinvigorate the privatization process, Directors looked forward to early, significant progress in the forthcoming program period. They also highlighted the importance of putting in place open and transparent procedures capable of attracting foreign investors, and, in this context, cautioned against excessive use of non-price factors in the selection process. Directors also encouraged the authorities to take appropriate and well-targeted action to address the social impact of privatizations.

Directors saw further financial restructuring as a cornerstone for improving intermediation and the effectiveness of monetary policy, and for enforcing hard budget constraints in the economy. Following the regrettably long delay in selecting a new privatization advisor for the largest bank, BCR, the privatization of the bank should now proceed according to the agreed schedule, sending a crucial signal of the government's commitment to reinvigorate privatizations, and to improve the investment climate.

Directors noted the window of opportunity provided by the current favorable macroeconomic performance for pressing ahead with reforms that will significantly improve Romania's economic and financial resilience; create a business climate that will attract higher foreign investment, in a setting of improved transparency and governance; and allow Romania to catch up with other EU accession countries in establishing a stable and fully functioning market economy. Going forward, this will, however, require exemplary policy implementation under the program; close consultation with the Fund; and the readiness, if necessary, to make timely policy adjustments.

The Executive Board took the following decision:

1. Romania has consulted with the Fund in accordance with paragraph 3(d) of the Stand-By Arrangement for Romania (EBS/01/175, Sup. 3, 11/2/01) and the second paragraph of the letter of the Minister of Public Finance and the Governor of the National Bank of Romania, dated October 17, 2001, to review program implementation.

2. The letter of the Minister of Public Finance and the Governor of the National Bank of Romania dated August 12, 2002, together with its attached Supplementary Memorandum on Economic and Financial Policies (the "Supplementary Memorandum") and Technical Memorandum of Understanding (the "TMU"), shall be attached to the Stand-By Arrangement for Romania, and the letter dated October 17, 2001, together with its attachments, shall be read as supplemented and modified by the letter dated August 12, 2002, together with its attachments.

3. Accordingly, the following changes shall be made in the Stand-By Arrangement for Romania:

(a) The remainder of paragraph 2(a) after "May 15, 2002," shall be replaced with "the equivalent of SDR 134.666 until November 15, 2002, the equivalent of SDR 189.777 until February 15, 2003, and the equivalent of SDR 244.888 until April 15, 2003.";

(b) the quantitative performance criteria referred to in paragraphs 3(a)(i) through 3(a)(x) for September 30, 2002 and December 31, 2002 shall be as specified in Table 1 of the Supplementary Memorandum and further specified in the TMU attached to the letter dated August 12, 2002;

(c) the performance criterion set forth in paragraph 3(b)(iii) shall be replaced with the following:

"(iii) after February 28, 2003, if Romania has not completed the sale of BCR to strategic investors (contract signing) as specified in Table 2 and paragraph 28 of the Supplementary Memorandum; or" ;

(d) the following shall be added after paragraph 3(b)(iv):

"(v) after the dates specified in Table 3 of the Supplementary Memorandum, if Romania has not increased end-user electricity prices, electricity producer prices for Termoelectrica, and unified end-user natural gas prices as specified in that Table 3; or

(vi) after December 31, 2002, if Romania has not approved the budgets of the monitored state-owned companies for 2003 in line with the government decision on quarterly ceilings for wage bills and employment as specified in Table 2 and paragraph 20 of the Supplementary Memorandum."; and

(e) in paragraph 3(d) the words "August 14, 2002" shall be deleted.

The Fund decides that

(a) the first and second reviews contemplated in paragraph 3(d) of the Stand-By Arrangement for Romania are completed; and

(b) Romania may make purchases under the arrangement notwithstanding the nonobservance of the end-March 2002 quantitative performance criteria on the ceiling on the aggregate wage bill of monitored state-owned enterprises, on the floor on cumulative aggregate collection rates of Distrigaz Sud and Distrigaz Nord, and on the floor on cumulative collection rates of Termoelectrica, specified in paragraphs 3(a)(iv) through 3(a)(vi) of the arrangement, respectively, and notwithstanding the nonobservance of the end-December 2001 structural performance criterion on the approval of the budgets of regies autonomes and state-owned commercial companies, the end-February 2002 structural performance criterion on the announcement of a tender for BCR, and the March 1, 2002 structural performance criterion on the increase of the end-user electricity price, specified in paragraphs 3(b)(i), 3(b)(ii), and 3(b)(iv) of the arrangement, respectively, on the condition that the information provided by Romania on the performance under these criteria and on the implementation of the measures specified as prior actions in paragraphs 10, 11, 17, 18, 22, 23, 26, 27, 28, 32, and Table 2 of the Supplementary Memorandum attached to the letter dated August 12, 2002 is accurate. (EBS/02/150, 8/13/02)

Decision No. 12835-(02/89), adopted
August 28, 2002

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/02/88 (8/26/02) and EBM/02/89 (8/28/02).

4. EXECUTIVE DIRECTORS' OFFICES—STAFFING

The Executive Board approves the recommendation by the Committee on Executive Board Administrative Matters to amend the staffing entitlements for offices of Executive Directors as set forth in EBAM/02/108 (8/27/02).

Adopted August 27, 2002

5. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 02/53 are approved.

APPROVAL: November 6, 2002

SHAILENDRA J. ANJARIA
Secretary