May 1, 2002
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 02/20

10:00 a.m., February 27, 2002

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

H. Köhler, Chairman
A. Krueger, Acting Chair
S. Sugisaki, Acting Chair

Executive Directors	Alternate Executive Directors
	A.S. Alosaimi
	A.S. Al Azzaz, Temporary
A. Barro Chambrier	D. Ondo Mañe
	A.R. Ismael, Temporary
	P.R. Fenton, Temporary
M.J. Callaghan	D.C. Guinigundo
	W. Szczuka
	T. Skurzewski, Temporary
K. Bischofberger	C. Harzer, Temporary
P.C. Padoan	H. Vittas
	Low K.M.
	M.P. Bhatta, Temporary
	R.A. Jayatissa
	J. Jonáš, Temporary
Ó. Ísleifsson	S. Kropas, Temporary
	M. Lundsager
	A. Baukol, Temporary
	S. Boitreaud
	S. Le Gal, Temporary
	M. Daïri
	A. Monajemi, Temporary
	L. Palei, Temporary
	H. Oyarzábal
T. Scholar	B. Mellor, Temporary
	J. Gallardo, Temporary
	A.A. Tombini, Temporary
C.D.R. Rustomjee	J. Milton, Temporary
A.S. Shaalan	M.B. Chatah
Wei Benhua	Jin Qi
	Wei X., Temporary
J. de Beaufort Wijnholds	Y.G. Yakusha
K. Yagi	H. Toyama
A.G. Zoccali	R. Maino, Temporary

S.J. Anjaria, Secretary
A. Mountford, Acting Secretary
O. Vongthieres, Assistant
J. Puig, Assistant

Also Present

ECB: G. Grisse, B. Kisselevsky. IBRD: K. Peters, Europe and Central Asia Regional Office; P. Suttle, Development Economics Office. African Department: N. Kirmani. European I Department: C. Cottarelli, M. De Broeck, E. Fernandez, T. Feyzioglu, T. Krueger, J. Schiff. External Relations Department: T.C. Dawson, Director; G. Hacche, Deputy Director; J. Hayden, C. Lotze, W. Murray. International Capital Markets Department: G. Hausler, Director; P. Breuer, B. Chadha, M. Edmonds, A. Ilyina, S. Iorgova, R. Johannes, Y.S. Kim, C. Kramer, S. Lall, J.C. Lau, C.H. Lim, D. Mathieson, M. Muhleisen, J. Nystedt, A. Pagtakhan, E. Psalida, J. Roldos, G. Schinasi, S. Seshadri, M. Singh, M. Soueid, K. Srinivasan, A. Sy, H. Tran. Legal Department: W.E. Holder, Deputy General Counsel; I. Mouysset. Monetary and Exchange Affairs Department: G. De Nicolo, J.W. Van Der Vossen. Policy Development and Review Department:T. N. Blancher, L. Ebrill, A. Lehmann, R. Luzio. Research Department: K. Rogoff, Economic Counsellor and Director; A. Husain, M. Kumar, D.J. Robinson. Secretary's Department: P. Ramlogan, T. Turner-Huggins. Western Hemisphere Department: A.M. Jul, D. Lombardo, L. Perez. Office of the Managing Director: C. Salmon, Personal Assistant; R. Moghadam, T. Wolde-Semait. Advisors to Executive Directors: M.A. Ahmed, M. Beauregard, J.A. Costa, B. Couillault, S.S. Farid, K. Kanagasabapathy, Liu F., F. Manno, P.A. Nijsse, E. Pinto Moreira, K. Sakr, P.H. Whitehall. Assistants to Executive Directors: A.A. Al-Nassar, S. Alcaide, G.M. Campos, M. Di Maio, E. González-Sánchez, B. Gulbrandsen, Jin Z., B. Kelmanson, K. Kpetigo, P. Lathouly, P.R.D. Prasad, D. Radev, B. Siegenthaler, A. Stuart, D.B. Waluyo, N. Watanabe, I. Zakharchenkov.

1. GLOBAL FINANCIAL STABILITY REPORT

Documents: Global Financial Stability Report (SM/02/50, 2/14/02)

Staff: Häusler, ICM; Tran, ICM

Length: 3 hours

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

Key Points

The use of history in assessing the current phase of the cycle is welcome and appropriate. To the extent that we are heartened by the encouraging signs from financial markets, we tend to side with the optimists. But elements of concern related to the growing U.S. external debt can hardly be overstated.

The geography of the report is less satisfactory. Europe and, to a lesser extent, Japan seem to be missing from the analysis of the interaction between real and financial variables. Yet, they are important.

It is too early (and perhaps wrong) to say that the risk of contagion from Argentina is behind us.

Regulatory arbitrage is an important (but in some respects worrisome) phenomenon. The policy implications should be examined more carefully.

Early Warning Models are useful if used with judgment.

We congratulate the staff for a very stimulating and insightful document that represents a useful support for policy action. We will concentrate our comments on the perspectives for global recovery, contagion, the role of risk transfers and institutional arbitrage, and Early Warning Systems.

Do financial markets anticipate a recovery? History and Geography

One of the key questions the report asks, and for which no definitive answer is in sight, is to what extent financial markets are right in anticipating and pricing in a recovery in economic activity during 2002. Let us say that we appreciate very much the role history plays in addressing the issue, a bit less the role geography does.

History: While financial markets anticipate a recovery, economic performance continues to lag behind, and the risk of a gap between expectations and outcomes may be large. In trying to assess this point, the report examines the anticipation of economic recovery by equity markets in past recessions. Box 2.1 supports the optimistic view by recalling that in the previous five recessions equity markets had a relatively good record in anticipating the end of the recession, at least in the United States. It also adds that for the present rebound to be validated in accordance with past historical experience, industrial production would need to have reached a turning point between November of last year and February of this year.

Of course, a proper use of history implies learning from it, not just extrapolating from it. So previous lags need not necessarily reproduce themselves in the present situation at least for two factors. First, strong innovation has changed dramatically both the profile of production and productivity growth, so it is still uncertain to what extent past productivity performance follows previous patterns. Structural breaks in this respect cannot (and should not) be ruled out and the cyclical profile would be affected as a consequence. Second, the way financial variables influence economic activity has also changed as the report clearly shows. In this case, too, extrapolating from past dynamics may be at least in part misleading.

A way to restate the issue is to ask how accurate the forecasts of economic activity are. As Box 3.1 of the *World Economic Outlook*, Special Issue (December 2001) shows, U.S. growth forecasts underestimate outcomes when productivity growth is particularly strong. So, if one opts for optimism, financial markets could be right, because they anticipate something that economic activity forecasts miss.

There are downside risks however if financial markets are proved wrong and the recovery does not materialize. In such a case disappointment could prove self-fulfilling, as a fall in financial assets would trigger a fall in demand and economic activity. A proper use of history suggests looking at differences as much as at analogies, some of which may be relevant. We suggest considering the following two:

a) In contrast to the 1990-91 recession, the United States is coming out of the current recession with an expected substantial current account deficit. Such a deficit, expected to widen as the economy rebounds, would put the trajectory of the net external debt on a path that could hardly be considered sustainable. As the report points out, the U.S. dollar has continued to strengthen in the face of a weakening economy. As the economy recovers, the U.S. currency could appreciate further. Since we are discussing a report addressing stability issues, we would like to ask whether the staff has reflected on the implications of a continuously strengthening dollar in the context of a deteriorating U.S. net external position;

b) As Figure 3.5 clearly shows, both the corporate and the household sectors come out of the recession with larger debt-to-asset ratios. Nevertheless, the cost of servicing their debt remains relatively low, given that interest rates are at record-low levels. As the economy recovers, interest rates will start to rise, undermining the ability of these sectors to finance further expenditure plans. An alternative would be foreign financing but, as discussed above, the foreign sector is already heavily exposed and this channel would increase concerns for global stability.

Both these features may have the potential to affect the level and the pace of the forthcoming recovery and we would very much appreciate comments from the staff.

Geography

In reading the report, one has the impression that the world is made up of only two regions, the United States and emerging markets, with other regions, Europe, Japan and the rest of the developing world, making brief appearances now and then at the horizon. Let us elaborate quickly only on the reasons why we think that some more space should have been given to Europe (as we are sure our colleagues will cover the discussion of the other missing regions in their comments).

As the October 2001 edition of the *WEO* describes, new transmission mechanisms between the United States and other regions have emerged during the recent past, including financial market linkages and linkages through expectations. Given the map of the world, the report assumes we are led to think that financial market developments in the United States are transmitted, somewhat mechanically, to Europe. Is this the message the report wishes to deliver?

In this perspective it would have been interesting to know more on the following :

a) Is there any relationship between financial market expectations and economic activity in Europe that confirms the assessment made for U.S. markets? i.e., a possible gap between financial market expectations and economic activity forecasts;

b) Is there any value in repeating the (useful) exercise described in Box 2.1 that reconsiders historic experience, for European markets at least, for some selected country cases?

c) What is the influence of financial variables on economic activity in the European Union? If this influence is less pronounced in Europe the disappointment of market expectations would lead to a smaller negative effect on growth in Europe and this would add to general stability;

d) Among the several (and ignored) implications of the introduction of the euro, an obvious one is that a large number of national currency markets in Europe have disappeared and, with them, several features of pre-euro financial market performance including exchange rate expectation effects and related risk premia. Is this dramatic change producing no relevant effect on the relationship between financial markets and economic activity in Europe?

Contagion. Should we stop worrying?

We are all pleased to learn that the crisis in Argentina has not produced contagion effects so far. The main reason for this being the improved capacity of markets to discriminate between Argentina and other sovereigns, the lack of the element of surprise, and the reduced weight of Argentina in emerging market bond indices. A further reassuring sign is that new issuance by emerging markets has been revived sooner than previously anticipated.

While this is encouraging news, one should not jump to conclusions too quickly. Two points are worth making:

a) What makes the case of Argentina to a large extent unique with respect to other crises is the combination of two elements: markets had anticipated an increasingly unsustainable situation, and international support to Argentina has allowed a part of the investors to move out of the country. This generated a situation that is clearly different from previous contagion episodes. In particular, it is not clear whether markets have learned to discriminate only in the case of Argentina or, more simply, the delayed "event" has given them time to learn. It is also not clear whether or not such a combination of events would replicate itself in the future. Hence it would not be prudent, to say the least, to conclude that the risk of contagion has decreased because markets have learned to discriminate.

b) Even with this caveat in mind can we be sure that contagion from Argentina has been totally ruled out? Box 2.2 discusses the role of the different segments of asset holders of Argentine bonds. Apparently some amount of contagion can be traced within the investor base for euro-denominated emerging market bonds and, as a consequence, after the Argentine crisis the euro denominated market is "in a state of disarray." The yen market also seems to have been affected. Could the staff elaborate on the following points: has there been (or is there) contagion in these segments and, if so, is this related to specific market characteristics, investor behavior, or financial instruments?

c) Finally, we cannot rule out risks of "delayed contagion" as the process of adjustment in Argentina unfolds and further adjustment costs arise in terms of cuts in trade, FDI and financial flows in the region and elsewhere. Recent events in Uruguay and Venezuela could be reassessed in this perspective

Regulatory arbitrage. What are the policy implications?

Importantly, the Report discusses the growing use of instruments to shift credit risk away from the banking system. Obviously, elaborating on the implications of such new instruments is an ongoing learning process. However, one can observe that the transfer of credit risk reduces the informational content of balance sheets, without necessarily providing information regarding where the risk has been transferred. This is not to say that such instruments per se are not useful. On the contrary, they have the potential for improving the stability and the efficiency of the financial system by allowing for greater risk diversification, making possible the separation between credit origination and credit bearing.

Nonetheless there are a few questions that can be raised.

a) There might be significant economies of scale and scope that might in the future orient the market toward increasing risk concentration in the hands of a relatively small number of specialized institutions: is this good or bad for overall financial stability?

b) Especially if this happens, a sensible consequence will be the removal of the phase of credit evaluation farther away from that of credit extension. One might consider replicating the situation of banks, whereby depositors lend to fund users through banks, for interest, and leave the credit risk with the banks, which by their nature are specialized in evaluating them. However, banks operate under the incentive that depositors can withdraw their deposits if they fear that banks do not evaluate their risks adequately (and we very well know what derives from the weakening of this incentive). What is the incentive under which the "protection sellers" operate in the new credit risk-derivative environment?

We are concerned with the regulatory implications, many of which may have not yet been fully understood. By blurring one of the traditional divides between the banking system and the rest of the financial system or even the other sectors of the economy, the new instruments generate a strong incentive for market players to arbitrage the risk away from the regulated banking sector towards other sectors that are not subject to the same prudential supervision or disclosure standards.

As the Report points out, it is important to understand the regulatory implications resulting from the growing use of credit risk instruments both within the domestic economy and among the economies, as markets increasingly exploit regulatory arbitrage. We see two broad issues on which further discussion is needed: 1) to what extent would efforts towards a more broadly shared financial supervision add to global stability? and 2) as distinctions between bank and nonbank financial institutions tend to become blurred, to what extent should competencies of regulatory bodies be revised accordingly?

Early Warning Systems Models. Promising instruments to be used with caution.

This area of research is difficult, challenging and, we believe, promising. We agree with the indication in the Report to further develop it as part of Fund surveillance. We also feel that research must necessarily proceed with caution and through building blocks. At the same time, we see value in taking as broad and integrated a perspective as possible. Research and experience increasingly point to the role of linkages between different variables and markets and different transmission mechanisms. While it is still too early to conceive of a "workable general equilibrium approach to early warning," in the immediate future more attention could be devoted to the analysis of intermarket linkages, starting from existing specialized models.

We have one general observation and one question. The general observation is nothing more than common sense. It would be plain wrong to expect all models, in the foreseeable future, to predict the exact timing of a crisis. However, crises, in most cases, are the final step of a process of deterioration and increasing fragility. Hence, what we can reasonably ask the models to do, even for the foreseeable future, is to improve our understanding of why and how an economy enters a "state of deterioration" that requires special monitoring and alert. In such a case, a specific variable passing a critical threshold might be neither a sufficient nor a necessary condition to identify a state of deterioration. Rather the latter would be identified when the movement of several variables points towards a critical and unsustainable state of the system. We would appreciate staff comments on this.

The question relates to the interpretation of "false alarms" and "missed targets." As footnote 5 on page 65 suggests, sometimes a false alarm may not be necessarily bad if it signals real risks that are eliminated through policy action. This observation points to a more general issue. Policy action (and reaction) is part of the way a system operates, and it could be both a cause and (hopefully) a factor of crisis prevention. To what extent do early warning models incorporate (explicitly or implicitly) policy actions? To what extent is it possible to discriminate between bad policy and market failure as causes for crisis?

Mr. Toyama submitted the following statement:

The first *Global Financial Stability Report* comes at a significant time when the potential impact of developments in the market and the situation of the financial sector on the real economy has become increasingly large and more global in nature. In addition, the interaction between the Fund's activities and the market's reactions have important implications for strengthening the effectiveness of Fund policies; hence it has become increasingly necessary for the Fund to closely monitor developments in the market in order to meet its mandate. We would like to commend the efforts of the staff of the International Capital Markets Department. The components of the report—recent developments in the market and analysis of current topics—are thoughtfully compiled, attracting the interest of readers. Although market movements have gained speed, I believe the frequency of issuance of the report—quarterly—is about right, considering the time it takes to collect data and discover trends, and the Board can be updated by the staff on the occasion of WEMD discussions. We hope the staff will continue to improve the reports, based on discussions at the Executive Board and reactions from outside observers.

It is encouraging that the market has recovered faster from the shock of the events of September 11 than most had expected, providing a comforting sign for the future course of the real economy. It is monetary policy that can be promptly mobilized in response to such external shocks, and, indeed, the U.S. Federal Reserve and other central banks cut interest rates shortly after September 11. While the market responds quickly to changes in monetary policy, the impact on the real economy is delayed. The current divergence between the market and the real economy reflects this. The contrast between the performance of the market and that of the real economy is most pronounced in the United States, but we can observe the same phenomenon in Europe and emerging countries as well. The recovery of the market should be accompanied by some wealth effect and restoration of confidence, which is a good sign for the prospects for the real economy, provided the risks that I will touch upon later do not materialize. Policymakers need to address the possibility that there may need to be an adjustment after the rapid and substantial recovery of the market, depending on the timing and extent of the recovery of the real economy. Such an adjustment would in turn have an adverse impact on the real economy. To avoid this, monetary policy needs to strike a delicate balance between the need to support the recovery of the real economy and the need to contain excessive fluctuations in the market.

Concerning the risks inherent in the market, first, the fact that the recovery has been led by the United States has increased several imbalances that had already reached historical levels. In particular, the need to maintain capital inflow into the United States should be highlighted so that the external imbalances do not result in a rapid adjustment in exchange rates and long-term interest rates. The crucial question would be, how long the IT revolution, through the process of putting it into real use, can continue to pick up productivity. Does the market provide any useful information about this? In the medium run, it is also important for Japan and Europe to advance structural reforms and gradually raise productivity in order to realize an orderly unwinding of the imbalances.

Second, we have to be mindful of the risk that the increased debt ratio in the corporate and household sectors could weaken the financial sector. While past trends make it probable the current debt ratio on average has not reached an untenable level, the increase in corporate bankruptcies, including big ones such as Enron, suggests there is a risk that a number of corporations and households will suddenly find their debts unsustainable, depending on the future course of interest rates. If interest rates rise along with steady recovery of the real economy, the expansion of the economy will possibly absorb the adverse impacts of increased debt burdens on the economy. However, if interest rates pick up because of a sudden adjustment of the imbalances or a rise in inflation expectations, without a recovery of the real economy, this risk could be a serious one.

Third, there is the risk that the functions of the financial and capital markets would be eroded because of the ramifications of the Enron case or materialization of risks associated with credit derivatives. Shocks to confidence stemming from these factors may be smaller than those from the terrorist attack, but can arguably be regarded as more serious since they are related to weaknesses inherent in the market. While it may take some time to fully investigate the Enron case, we hope that measures to restore market confidence, including strengthening disclosure on transactions with affiliates and on conflict of interest of auditors, will be implemented as promptly as possible. The staff's analysis on credit derivatives is timely as we are facing the first increase in corporate bankruptcies since these transactions prevailed in the market. Given the insufficiency of information on whether the non-banking sector conducts appropriate risk management and has the capability to perform contract obligations, we have to be careful that this does not lead to risks to the banking sector.

The Japanese government is actively dealing with a reform agenda in the financial and corporate sectors, as displayed in a series of initiatives taken since last year. The advancement of the reform is reflected in, among other things, the substantial increase in corporate restructurings and liquidations, including through application of the Corporate Rehabilitation Law, as well as public and private sector initiatives to establish corporate restructuring funds, making a strong case that banks and corporations are making use of the new institutional framework. Last fall, in the face of a further deterioration of the economy and the strengthening of supervisory action, major banks raised by a significant amount the estimates for losses that would be incurred by resolving

NPLs in FY 2001 (from 1.9 trillion yen to 6.4 trillion yen) and established an accounting buffer to override the heightened wave of corporate workouts. The series of corporate workouts that have occurred since then have not changed these estimates, and we can safely judge that banks are already prepared for a significant shock. Also, the government is closely monitoring the situation of the financial sector and is equipped with measures to secure the soundness of the financial system, if necessary. For example, in the event of a systemic crisis, the existing law would allow the government to inject 15 trillion yen into the banking sector. In addition, to accelerate the process for structural reform, the government is scheduled to announce a package that will contain deflationary pressures, including by spurring efforts to restructure the banking and corporate sectors on February 27, 2002.

On the Early Warning System, it is appropriate to improve the system in the direction of expanding its scope to include debt crises and banking crises in addition to exchange crises, which the current system addresses, in light of the lessons of Turkey and Argentina. As was discussed in the Executive Board meeting on vulnerability assessment last fall, we should be mindful that the EWS is no more than one consideration among others in assessing vulnerability as long as the system is not immune from errors. Also, as was discussed in the recent Executive Board meetings on Thailand and Korea, diligent care will be required to avoid adverse impacts on the market resulting from publication of the results. However, this should not deprive the Board of regular reporting by the staff of the results of the EWS assessment. We believe that quarterly Board meetings on the *Global Financial Stability Report* should provide the staff with a good opportunity to report to the Board orally on the assessment outcome. We would like to hear the staff's comments on this point.

The analysis of alternative financial instruments deals with the pros and cons as well as policy implications of various new financing tools employed by emerging economies. While we agree that this is a good topic for the Global Financial Stability Report to cover, we believe these tools also need to be looked at from the standpoint of public debt management and private sector involvement. We would like to hear from the staff how the analysis in this paper will be reflected in these other Fund initiatives.

Mr. Alosaimi submitted the following statement:

Key Points

International capital market developments highlight the resiliency as well as the continued vulnerability of the financial system. On balance, I am cautiously optimistic.

While the limited contagion from the Argentine crisis is encouraging, it is important to remain vigilant, as the impact may not have been fully felt yet.

In view of the increased use of credit risk transfer vehicles and the uncertainties regarding the effective functioning of the market for those vehicles, a new look at regulations and regulatory oversights in major financial markets is warranted.

The staff should continue efforts to improve the predictive ability of early warning systems. Meanwhile, given the limitations of these models, caution is needed in interpreting and using the results from these models.

Enhancements to "plain vanilla" debt instruments may play a useful role in facilitating borrowing and reducing interest expense, but they come at a cost.

I thank the staff for their efforts in producing this first quarterly Global Financial Stability report, which is an important innovation that should help keep us abreast of financial market developments and strengthen Fund Surveillance. The report is comprehensive and covers a wide range of relevant and timely issues. Here, I will make a few comments.

First, recent and prospective international capital market developments highlight the resiliency as well as the continued vulnerability of the financial system. On the positive side, financial markets recovered from the aftermath of September 11, and the launching of the euro currency notes proved to be smooth. However, the crisis in Argentina, the continued malaise in Japan, and the increased incidence of bankruptcy in the United States underscore the risks. Against this background, a dichotomy appears to have emerged between bank lending and bond financing. While bank and syndicated lending tightened, the spread on high yield bonds, including those for emerging markets, declined. Staff comments on this divergence will be appreciated.

Second, one of the encouraging developments in financial markets is the so far limited contagion from the Argentine crisis. While the staff provides reasonable explanation for this welcome development, there is no room for complacency, as the impact of the Argentine crisis may not have been fully felt yet. Indeed, as the staff notes, the resulting disarray in the European and Japanese retail investor base have effectively closed those markets to emerging market issues and it is not clear when these will reopen. This could increase pressure on the dollar bond market and lead to higher spreads.

Third, in addition to its direct financial impact, the Enron bankruptcy created uncertainty regarding the reliability of corporate financial data and negatively impacted the U.S. equity markets. Moreover, as detailed in the staff paper, this bankruptcy highlighted uncertainties about the effective functioning of the market for credit risk transfer vehicles. In this regard, I found the analysis of this issue in the paper very useful. Indeed, while the vehicles help in distributing the risks, the implications for counterparty risk and transparency are concerns, especially given the increased involvement by retail investors through hedge funds. As stated in the staff paper, retail hedge fund investments surged from $8 billion in 2000 to $22 billion in 2001. Therefore, I agree that there seems to be a need to review and update regulations as well as strengthen oversight in the industrialized countries to keep pace with the rapid changes and increasing complexity of financial transactions. Accounting and auditing rules also need to be updated. Enhancing transparency of off-balance-sheet risk management structures is a priority.

Fourth, while the increased level of indebtedness could pose a risk to recovery and to the financial sector, this risk is mitigated by the decline in interest payments. In fact, lower interest rates have been also instrumental in the continued buoyancy of the real estate sector in the United States, which largely offset the impact of the fall in equity prices on households and helped sustain consumption.

Fifth, the strength of the U.S. dollar in the face of the large current payments deficit continues to defy economic expectations. Therefore, the staff is right to note the risks of a sharp reversal. However, factors such as the role of the U.S. dollar as a safe haven and the increasing evidence that the U.S. economy has started to rebound minimize those risks in the foreseeable future.

Sixth, the staff touches on an important dichotomy in the major advanced economies. In both the United States and the major economies of Europe, the judgment is that the banking systems are in good financial condition. Indeed, banks in those countries appear to be more robust than in previous downturns and well capitalized to weather credit deterioration. However, increased incidence of bankruptcies and the variations in the financial strength of individual institutions highlight the need for continued vigilance. Japanese banks, however, face a more difficult and complex challenge. The weaknesses that built up in the banking system during the bubble economy are yet to be fully addressed. There are growing risks from the deterioration in the domestic economy and the weakness in the external environment. The Japanese banks' exposure to the equity market further complicates the picture. Addressing these issues in a timely manner is crucial for the Japanese economy to recover.

Seventh, the staff has presented a useful review of developments regarding early warning systems (EWS). Here, I agree that the staff should continue efforts to improve the predictive ability of EWS models. At the same time, it is important to take due account of the lessons from the past.

Specifically, identifying relevant variables at a point in time is clearly easier than combining them into a meaningful model that can retain predictive ability in a world subject to rapid technological and financial innovations. In this regard, the mixed results of these models carry the risk of costly false alarms and missed crises as well as self-fulfilling prophecies. False alarms can also erode a model's credibility, thus negating the benefits of the system by making countries reluctant to act on Fund advice. Moreover, failure of the model to foresee an impending crisis could lull the Fund and the authorities into a false sense of security.

Finally, I found the chapter on alternative financial instruments and access to capital markets very informative. It is important to stress, however, that while enhancement to "plain vanilla" debt instruments may facilitate borrowing and reduce interest expense they are not costless. Indeed, the cost to borrowers could come in the form of greater risk, loss of maneuverability, or higher future borrowing costs. In this regard, the potential benefits and costs of each of the enhancements would need to be evaluated on a case-by-case basis.

Mr. Shaalan submitted the following statement:

Before reacting to some of the specific issues raised by the first quarterly Global Financial Stability Report, a few general comments on the Fund's work on international capital markets are in order. First and foremost, we continue to support the effort that management and the staff are making to improve the institution's understanding of international capital markets—an important and complex subject, which is of increasing relevance to the Fund. Second, we welcome and underscore the fact that this continuing endeavor is not being viewed as an end in itself but rather as a means of enhancing our bilateral and multilateral surveillance process. Third, although we have to wait to see how the new initiative will work out, we support the rationalization of the publication policy by combining the *International Capital Markets Report* with the quarterly *Emerging Markets Financing Report*. We understand that the focus will be on operational contemporary issues; however, we should not relegate the analysis of global macro aspects to a lesser role. Operational aspects can be best analyzed and assessed in a global framework. Finally, we commend the staff on the methodology, which is, in principle, directed at enabling the present quarterly analytical effort to be timely, flexible, and succinct. While we can well appreciate the need for the wide-ranging survey of the literature that characterizes this initial quarterly report, we hope that successive reports will be more focused on issues that are deemed to strengthen Fund surveillance. As such, this report is only a first step in identifying a variety of potentially surveillance-relevant building blocks to better understand the relationship between these building blocks and to distill major issues from this analysis.

By its very nature, the terrain covered by the reports will not be easy as it deals with many moving parts. These relate to the behavior of private markets (in many instances unpredictable), the evolution of market infrastructure, changes in the regulatory and supervisory regimes, and, most importantly, interaction with what is still an unusually fluid global and country-specific macro economic environment. As such, staff efforts will no doubt face continuous challenges, including how best to strike an appropriate balance between analyzing secular/structural shifts and assessing cyclical developments, as well as to distinguish between them at any point in time. On the whole, we believe that the staff paper does a credible job in striking this balance, as evidenced in the attempt to identify short-term cyclical developments in Chapter II, whereas medium-term issues are addressed in Chapters IV and V. We also welcome the identification of major risks to the baseline analysis, including, in particular, the assessment in Chapter III of the implications of a more subdued global recovery.

At the most fundamental level, the staff paper rightly highlights the resilience of the financial system to a series of significant shocks in the recent past. These shocks have varied in both nature and intensity, as the impact on the financial system of the synchronized global slowdown has been accompanied by post-September 11 risk-appetite volatility, large-scale corporate and sovereign defaults, and the ongoing accounting issues in the U.S. corporate sector, which could have serious ramifications on the financial sector. Here, in view of the Enron debacle, we would have liked to see at least a preliminary assessment of the impact of this event on corporate access to banking credit and how this will affect the global economic environment.

In addition to the robust infrastructure of the international financial system, we should note the important role of responsive monetary policies (particularly in the United States and Europe) and a better informed and increasingly discriminating investor base. It is these factors—one cyclical and the other secular—that ex post leads to the staff observation that "in hindsight, financial markets overreacted to the potential impact of the September 11 events" (page 5). Having said that, the paper correctly emphasizes that this overall resilience should not lead to complacency on the part of the various participants in the flow of international capital. In this context, there are a few aspects that warrant further staff comments.

In the mature markets, the combination of the economic slowdown and general accountancy concerns has led to a sharp contraction in the commercial paper (CP) market and an inversion in the bond yield curves for a growing number of corporations. In addition, some corporations have also decided to draw down contingent bank credit facilities, generally at higher costs. To what extent can these elements of greater short-term financial vulnerability and higher credit rationing risk undermine the sustained recovery of liquidity, which is detailed in Chapter II of the report?

Financial institutions are not immune from waves of investor nervousness. This could well continue if their corporate clients face a deteriorating credit environment (the discussion on page 49 highlights the risks here). Only last week the media carried the reports of an increase in the cost of credit default insurance for J.P. Morgan. To what extent do these recent developments impact the generally confident assessment of the balance sheet strength of financial intermediaries? J.P. Morgan may not be the only bank facing these difficulties.

Still on mature markets, various technical factors alluded to in the staff paper have contributed to the persistence of a relatively stable yield curve for government paper, notwithstanding market consensus for a muted immediate and medium-term inflationary outlook. To what extent does this steepness undermine the steps taken to relax monetary policies across the globe?

As regards mature equity markets, we would simply urge greater caution in putting forward statements regarding the outlook for equity prices. We are referring here, in particular, to the assessment in the report that under a recovery scenario, "no widespread adjustment in asset prices or flows would be likely to occur" (page 44). Such a statement incorporates important implicit judgments about "equilibrium" valuations and investor base stability, which are difficult to assess in light of the other aspects detailed in the paper. We would urge caution in this regard.

In the emerging markets, the paper notes the remarkable degree of decoupling and differentiation among countries, especially in the context of the Argentine debt default. To what extent has this decoupling been underpinned by strengthened investor infrastructure and how does the intensified debate on sovereign debt restructuring play into this process? In this connection, we would have liked to see a discussion on sovereign debt restructuring, but we understand that it may be premature to cover the subject at this time. Hopefully, this will be taken up in a subsequent quarterly report.

While noting the overall lack of contagion within emerging markets, the paper suggests that there may well be some recent impact in view of developments in Colombia and Venezuela. Yet the timing and nature of the weakening in spreads from these two countries' sovereign bonds does not support the hypothesis that these countries are contagion recipients; rather, spread movements may well reflect less contagion factors and more investor concerns about countries' specific developments. Is this accurate and what is the risk that these two countries could become a source of contagion pressures going forward?

While the development of a reliable early warning system would be a major achievement in our surveillance arsenal, we would again like to raise a note of caution with regard to interpreting and acting upon the findings of these imperfect indicators, given the state of knowledge of the economic profession in a rapidly changing global economic environment. We very much appreciate the survey of the literature covered in Chapter IV, which, at least to my mind, clearly shows the pitfalls inherent in the scores of models identified in the report. In our understandable zeal to develop such a system, we should exercise extreme caution in the interpretation of the findings of these models. The incidents of false alarms in all the models described are too excessive and warrant careful interpretation. I cannot support the contention by the staff (footnote 5, page 65) that a false alarm may not be necessarily bad if it signals real risks that are addressed through policy adjustments. It should be pointed out, at least in my view, that the large number of false alarms in virtually all models carries a real danger, as countries may be prompted to take unnecessary corrective policy measures with potentially negative effects.

Finally, we would like to note, as the report does, that two of the models (the Fund's DCSD and the KLR) missed the Argentine crisis badly, as reported by the staff (page 66). Again, we cannot overemphasize the importance of the need for extreme caution in identifying crisis cases (or not identifying them) and worse still on publicizing our findings.

Mr. Callaghan submitted the following statement:

Key Points

The report provides a comprehensive assessment of capital market developments, however, the whole is somewhat less than the sum of the parts because the sections in the report do not sit together as well as they could.

The two selected issues chapters give the impression that the document is more a collection of essays than a report.

For the first report, at least, the focus should be on the backbone of future publications, with the selected issues chapters released at a later date.

The inclusion of the selected issues also gives the material a prominence that is not intended.

Macroeconomic indicators of financial stability receive limited treatment, as does the coverage of exchange rates.

Given the prominence of the Enron collapse, it may be appropriate for additional coverage of whether steps are needed to enhance corporate governance and accounting standards.

The report presents a considerable amount of interesting material and provides a thorough analysis of developments in global financial markets. It also takes a step in the right direction by raising the policy implications of the risks identified.

Before focusing on the specific material covered in the report, however, it is appropriate to first comment on its structure and objectives.

General Observations

This is an important report, being one of the first publications of the new International Capital Markets Department. It should provide an indication of the progress the Fund is making in its efforts to increase the understanding of financial markets and financial flows. It will also be important for this report to demonstrate that nothing has been lost with the cessation of the *International Capital Markets Report* and the *Emerging Markets Financing Report* and, in fact, that this report represents a significant advancement.

This is the first of what is to be a quarterly report, and as such it will obviously grow and develop. With an eye on how it may develop, we offer the following observations on the first report.

The report gives the impression of being a series of essays rather than having a unified structure with some common themes. This is particularly highlighted by the inclusion of the chapters on "Early Warning Systems" (EWS) and "Alternative Financial Instruments and Access to Capital Markets." There is little connection between these chapters and the earlier sections of the report. Moreover, even in the earlier sections, the flow sometimes appears disjoint, for example, there is little link between the comparison of imbalances now with the 1990-91 recession and the discussion of the implications for financial market stability going forward.

The inclusion of the two special features (EWS and Alternative Financial Instruments) in the first report gives these topics a particular prominence. Certainly, it would be different if there had been a series of reports covering different special topics each quarter. However, this is not yet the case. The impression may be that, in presenting these topics in the first Global Financial Stability Report, the IMF is suggesting that they are the key issues influencing the stability of international capital markets.

The above point is particularly relevant to the chapter on EWS. As noted, the inclusion of this chapter in the Fund's first Global Financial Stability Report may be seen as conveying the message that the development of EWS is the key response by the Fund in terms of crisis prevention. On October 22, 2001, we discussed Approaches to Vulnerability Assessment for Emerging Market Economies, which covered the use of EWS. In that discussion, it was emphasized that EWS models are an imperfect tool for predicting crises and, at best, only provide a first indication of a possible growing problem and are only one input to the process of assessing vulnerability. The caveats over the use of EWS, which were highlighted in the earlier paper, appear to be missing from this report. The discussion in Chapter IV on the next steps forward on EWS provides some interesting material. However, we would suggest that further thought be given as to whether the *Global Financial Stability Report* is the best vehicle to release this material.

Part of the problem is that this is the first edition and it is not clear to the reader what is the "bread and butter" content and what is more in the nature of 'selected issues' material. We think it may be preferable to have a shorter, more focused and unified report on the financial market developments and publish the special topics separately. In any event, since this is the first edition it might be best to concentrate on what will be the backbone of the publication and leave Chapters IV and V for future editions where the context might be much clearer to the reader.

After describing recent developments in international capital markets, Chapter III focuses on vulnerabilities and discusses the implications for financial markets of a subdued or delayed recovery, the weaknesses of some financial institutions, particularly in Japan, and vulnerabilities with credit risk transfer vehicles. These are interesting and important issues, and while the preface notes that it is not possible to have a comprehensive survey of all potential risks, the fact that they are highlighted in the report may convey the impression that the Fund considers them to currently be the major risks to global financial stability. A balance needs to be achieved and we would suggest that the risk of a recovery that results in rising financial imbalances is as relevant to ongoing financial stability as a weaker-than-anticipated recovery.

Macroeconomic indicators of financial stability receive limited treatment in the analysis. Issues such as a "global flow of funds", imbalances in the household, corporate and banking sectors are either missing or only partially touched in Chapter III. A more structured analysis of these indicators would greatly enhance the understanding of the "big picture". In particular, we would suggest a presentation of global trends in sectoral balance sheets, highlighting regional differences from global trends.

Readers of a report, which covers developments in global financial markets, may find it strange that there is very limited reference to movements in foreign exchange markets.

In raising the above observations, we recognize the caveat in the preface of the report that it is not attempting to be a comprehensive survey and it has to be seen in the context of broader efforts by the Fund, including in particular the *World Economic Outlook*. However, it is important to have selfcontained assessments and it should not be assumed that all readers will be aware of the relationship of this report with the WEO and other Fund work.

Some Additional Comments

In commenting on the resilience of the international financial system in the face of a number of serious challenges, limited recognition appears to be given to the role of policy in helping to promote this resilience. Discriminating investment behavior by market participants is important, but also important is that many of the emerging markets have adopted sound policies, which have contributed to the relative stability of the international financial system (i.e., the markets have had a reason to discriminate). In this regard, we would suggest that a particularly important change has been the move to more flexible exchange rates.

The overview highlights a concern over the financial strength of banks in the industrialized countries that have been lagging behind in the pace of restructuring and/or have diversified into overseas markets or new activities. However, there is little additional discussion on this topic in Chapter III, although there are two paragraphs noting that financial institution weakness is most pronounced in Japan. The implication appears to be that there may be growing concerns over banking institutions in some countries, apart from Japan. As regards the position of the Japanese banks and the implications for international financial stability, while Japanese banks have been cutting back their overseas operations, they still have a major presence in the Southeast Asian region. We would not underestimate the implications for the region or the international financial system of a significant further weakening of the Japanese financial system.

The overview section of the report appears to come to the conclusion that regulatory measures are necessary to respond to concerns that have arisen over the operation of credit risk transfer vehicles. The fact that the report appears to be drawing some policy conclusions rather than merely describing market developments is commendable. However, while some possible problems from developments in markets for credit risk transfers are discussed in Chapter III, there is little elaboration on the nature of any regulatory response, assuming that one is needed. For example, it can be debated whether the answer to regulatory arbitrage is to subject non-bank institutions to the same regulatory requirements as banks, which seems to be the suggestion in the overview section of the report.

Given the prominence of the implications of Enron's collapse and the possible impact this could have on investor confidence in equity markets, it may have been appropriate to include additional coverage of the extent of the shortcomings of existing accounting standards and the need for any enhancement.

We have forwarded direct to the staff some more technical comments on the report.

Mr. Kelkar submitted the following statement:

Key Points

We compliment the staff for the timely release of the excellent Report (paragraph 1).

We feel that the coverage of chapter II is uneven across markets and instruments. Primary market developments, changing financial structure and volumes and turnover data may also be captured (paragraph 4).

The positive aspects of financial developments need to be covered, besides vulnerabilities and downside risks. A SWOT approach may be useful (paragraph 5).

A disaggregated sectoral behavior of market indices may throw more light (paragraph 7).

Evolving standardized contracts may help smooth functioning of OTC derivatives markets. The critical element of risk being leveraging, the question of evolving prudential norms for leveraging needs to be examined (paragraphs 9 and10).

The Enron debacle raises the core problem of market integrity in the context of financial stability. The regulatory arbitrage and present weaknesses in regulation of non-financial corporations underscores the need for extending the scope of PSI beyond crises prevention (paragraph 11).

We fully share the staff views on concerns, challenges ahead and implications of OTC derivatives and highly leveraged institutions and the need to improve transparency and regulatory structure (paragraph 12).

EWS models should link with domestic market crises. National authorities should be encouraged to develop and use their own internal early warning systems. The recent phenomenon of synchronicity and transmission of contagion underscore the need for a coordinated stress testing of major markets. Staff comments are welcome (paragraph 13).

Paper on alternative instruments is a useful addition and links with the new approach to sovereign debt restructuring (paragraph 14).

The report is timely in the context of ensuing UN sponsored Conference on Financing for Development. The Managing Director should consider writing an amplified preface to the publication.

We commend Mr. Gerd Häusler and his staff for the timely release of the excellent first *Global Financial Stability Report*. We welcome the quarterly periodicity of the report enabling more frequent assessments of market developments and the broad scope of the report to address contemporary issues and to incorporate as a special feature, articles on structural and systemic issues relevant to international financial stability. Our comments and suggestions on the report are provided under two broad heads: its scope and coverage, and its analytical content and implications.

Scope and Coverage

The two chapters, following a brief overview with intricate analyses of market developments and indicators along with research findings, bring out in detail the essence of the central theme of the report—the global financial stability. The contents of the other two chapters, one on the ‘Early Warning System Models’ and the other on ‘Alternative Financial Instruments and Access to Capital Markets’, are also very useful and relevant. We welcome the broad objective of incorporating as a special feature, articles on structural and systemic issues. In our view, the staff may explore the scope for further integrating the major findings of such articles into the analyses of the main chapters.

The report replaces the earlier two reports, the annual on *International Capital Markets* and the quarterly on *Emerging Market Financing*. In our view, the significance of the new report lies in its higher frequency, focus on financial vulnerabilities and overall strengthening of global market surveillance assessment besides the reporting of bilateral and regional surveillance assessments and findings. It would therefore be useful to briefly present in the Preface how the new effort improves upon some of the limitations of the earlier reports and the added advantages and strength of the present report as part of improving Fund’s surveillance mechanism.

In Chapter II, the scope and analytical content across markets and regions appear uneven and not balanced. For instance, in the case of equity, the entire focus is upon secondary market developments whereas in the case of bond and syndicated credit, primary markets also have been covered. As the behavior of markets ultimately reflect issuers and investors preferences and shifts, it would be beneficial if such changes are captured through data on primary market and secondary market volumes, turnovers and flows, apart from movements in rates and spreads. This will also bring out the changing financial structure in the international markets, having a significant bearing upon the health of financial institutions and overall financial stability. If there are data limitations in following such an approach, such limitations may be brought out appropriately in the report, and ways and means suggested to improve market information.

The analyses of markets and their resilience to shocks and their signals for the future recovery have been very well brought out. While in the present environment, we appreciate the analytical thrust upon the vulnerabilities and downside risks, the financial market responses in general may have to be viewed as a two-way process: first, its resilience to shocks to withstand adverse developments, both economic and non-economic and second, its ability to respond quickly to support and stimulate growth when the prospects of recovery improve. The behavior of markets as perceived through the analysis in this respect appears asymmetrical. It would be beneficial to study the reasons for this asymmetry in more detail so that the positive aspects of financial developments can also be captured and further strengthened. In brief, a more balanced SWOT approach would be useful. We will welcome staff comments on this possible approach.

Chapter III has an excellent coverage of the stability implications of global financial market conditions. We have two brief comments on the scope of this chapter. First, the comparison of current recession with 1990-91 recession in terms of financial imbalances is quite revealing and interesting; nonetheless, it would be useful to make a similar comparison on the features in particular the sources and underlying factors behind the two recessions. Second, the financial conditions are no doubt an outcome of economic and market developments but, they are not autonomous in as much as the macroeconomic policies particularly the short-term monetary and exchange rate policies have a significant influence in fully explaining market conditions. While we appreciate the fact that such aspects are covered in more detail in the annual *WEO*, the stability report being a quarterly assessment, policy responses and implications for authorities may be briefly touched upon in Chapter III. Staff comments are welcome.

Analytical Content and Implications

We concur with the observation that financial markets ended the year on a positive note reducing uncertainties. The bond market yield spreads particularly of emerging markets have narrowed and the signs of contagion moderated markedly. The Argentine influence on other markets, excepting Venezuela had been limited. But, the general finding that the movements of indices or correlations in adverse market conditions or crisis periods remained more prominent will require a deeper study. This is also closely related to the synchronized growth behavior of many economies following the U.S. slowdown. A disaggregated sectoral behavior of indices, in particular of TMT (telecom, media and technology) stocks may throw more light on the transmission effect of contagion.

We support the cautious view that in spite of widespread optimism, if there is a gap between financial market expectations and economic performance, the adjustments in asset prices could worsen the financial conditions. In this scenario, a desirable policy response would be not to tighten in haste monetary policy stance, which has remained easy and supportive to growth in many countries. Given the intensity of prolonged recession, it is only fair to continue with the soft option, both on monetary and fiscal fronts, for some more time.

The recent experience underscores the need for continued strengthening of banking and financial sectors. In this regard, the paper throws fresh light on the adverse implications of the proliferation of credit transfer instruments. The root of the problem lies in precisely defining where the credit risk rests. There is an inherent conflict between the global reach of markets and instruments through ever evolving innovations and very slow build up of international financial infrastructure in the form of laws and regulations required to support them, which by and large remain national and heterogeneous. In the absence of a homogeneous legal base and insolvency/bankruptcy regimes, evolving standardized contracts on the lines of Repo and interest rate swaps by international securities/swap dealers associations may provide an interim solution to the smooth functioning of such markets. The scope for such standardized contracts remains valid even in sovereign bond markets. We invite staff comments.

While on the subject of credit transfer instruments, it would be useful if the report highlights the experience with Asset Reconstruction mechanisms, supported as a part of banking and financial sector restructuring in some program countries. The critical element of risk, in such cases lies in the ability of institutions to expand their asset base leveraging on such instruments. This raises the question of the need for prescribing prudential norms for leveraging as part of supervisory standards. Staff comments on this are welcome.

The Enron's bankruptcy, well analyzed in the paper, including a box item, is apparently only a tip of the iceberg. This has brought to light, besides the weaknesses of legal, accounting and auditing standards, the inadequate oversight of financial activities of non-financial corporations and ineffective private market discipline, disclosure, corporate governance and auditing. All these have very serious implications and raise the core problem of 'market integrity for financial stability'. This also raises the fundamental question about the responsibility and accountability of private sector participants in safeguarding the soundness of the financial system. The Report could highlight and bring out, therefore, a clear assessment of lessons from the Enron debacle. In the area of implementation of financial standards and codes, the responsibility and accountability of regulated financial sector as also the role of regulatory agencies like government, central bank, securities and insurance regulatory authorities are well defined. The institutional mechanisms for implementation of standards and good practices in areas like corporate governance, OTC markets in particular in derivative instruments remains rather weak. The potential dangers and risks arising out of this situation have been well brought out in the stability report. This underscores the need for tackling this issue with greater attention as part of Fund's ongoing efforts in promoting private sector involvement (PSI). The scope of PSI may therefore need to be extended beyond the boundaries of crises prevention and address the core problem of market integrity in maintaining financial stability. Any neglect of this aspect would only perpetuate the weaknesses associated with regulatory arbitrage opportunities.

Chapter III, discussing the issues relating to credit transfer vehicles and other OTC derivative products like swaps and the risks associated with highly leveraged institutions, has brought out very clearly and elaborately the vulnerabilities to the financial system and the need for evolving better regulatory structures. We fully share the view of the staff on the concerns, challenges ahead and their potential implications.

Early Warning Systems Models

The Early Warning Systems (EWS) models are useful as a tool-kit for strengthening surveillance mechanisms. We like to emphasize, in line with Fund's philosophy, that there is no substitute for prudent macroeconomic policies and management by national authorities themselves. Given this, the early warning systems models should begin at the national level addressing at the first instance domestic market crises. In an integrated global market, experience shows that the element of contagion has its origins in domestic market weaknesses associated with banking, payment systems and fiscal operations. In this regard, the EWS models developed and analyzed in the paper should attempt to percolate down to specific domestic market environments and analyze the scope of how best national authorities can be encouraged to develop their own internal early warning systems. The FSAP exercise and actions taken already in areas like macroprudential indicators, prompt corrective action and internal rating models for assessing domestic financial vulnerabilities and risks should appropriately link with EWS models. In building these models, it may also be necessary to link the policy variables and policy uncertainties apart from the crucial real sector variables. This is in recognition of the fact that financial markets do not function in isolation and there is an interplay between financial and real sectors and also the regulatory authorities have the policy leverage to influence and correct adverse financial market developments.

In carrying out stress tests and assessing vulnerabilities, in our view, the recent phenomenon of synchronicity and the transmission channel of contagion need also to be better reorganized and appreciated. Apart from national level assessments, we feel that there is a greater need for coordinated stress testing of all major markets in an integrated manner. We would welcome staff comments on the feasibility of coordinated stress tests of major markets.

Alternative Financial Instruments and Access to Capital Markets

The paper on alternative financial instruments is a very useful addition to the report. The paper provides a valuable documentation of country experiences and we fully agree with the assessment that issuance of such instruments by governments particularly in times of crises, must be consistent with sound debt management practices and compatible with efforts of the international community to secure private sector involvement and improving the financial architecture more generally. The paper could highlight whether the existence of such instruments promotes ‘ new financing’, besides helping better debt management. This paper has also obvious links with the ongoing discussion on the new approach to sovereign debt restructuring.

In sum, we greatly appreciate the maiden effort of the International Capital Markets Department in producing this document which will be found very useful by the international financial community, financial market participants across the globe as also the entire Fund membership of developed, emerging and developing economies. In particular, we consider this contribution from the Fund as very timely, in the context of ensuing U.N. sponsored International Conference on Financing for Development. The Managing Director should consider writing an amplified Preface to the publication.

Mr. Wijnholds submitted the following statement:

At the outset, I would like to welcome this first *Global Financial Stability Report*, which has turned out to be an informative and inspiring paper. I broadly agree with the views expressed by the staff. As to the format of the report, I have three suggestions that could perhaps make the product even better.

Firstly, the forward looking nature of the report could be further strengthened by replacing the first chapter, the overview, with a shorter summary of the conclusions, which should consist mainly of the expectations expressed by the staff, which are now scattered in the text throughout the report.

Secondly, the primary focus of the report should remain on countries that pose a risk to the stability of the international financial system, i.e., mainly the emerging market countries. I think that the current report has struck the right balance in this respect and I would like to encourage the staff to continue on that path and not shift its attention too much towards the U.S. and EU economies for which much more data are available.

Thirdly, the report should remain relatively short and focused to be an attractive product that will be useful to a wide public after its publication. I would therefore propose to stick to chapters II and III, but to remove chapters IV and V. Although these two chapters are highly interesting, I think that it would increase the focus of the report to include the conclusions of those chapters in the main text, but to present the detailed analysis in separate, specialized papers.

Recent Developments in International Capital Markets

The staff rightly points to the financial stability risks of optimistically valued stock markets. This risk is especially large in the United States, where price-earnings ratios of the Dow Jones and the S&P500 are still above the average for the 1990s. By contrast, Europe's price-earnings ratios (e.g., Eurotop 300) are close to the average for the nineties. Apparently, U.S. financial markets are currently anticipating a sharp rebound in corporate profits, based on expectations of a V-shaped economic recovery. While a sharp rebound of profits during 2002 may appear to be an attractive baseline scenario after the fall prompted by the events of September 11, there are several reasons to question whether this will happen and whether current U.S. stock prices are sustainable. In contrast to the usual pattern in recessions, consumer demand has remained relatively firm. As a result, even though consumer spending is expected to trend up, the potential for a fast and strong recovery is limited, especially given still rising income uncertainty and a barely decreased indebtedness of households.

Consequently, an economic recovery would mainly depend on accelerating private investments. However, external funds to finance an investment boom are costly in present market conditions, while internal funds are scarce on account of the ongoing process of balance sheet restructuring. Moreover, the lack of pricing power in many industries, as well as expectations of rising interest rates in futures markets, cloud the outlook for rising cash flows. This makes a quick resumption of the profits and investment cycle less likely.

In emerging markets, contagion from Argentina has been limited. As the staff observes, this is partly related to diminished positions of crossover and retail investors in emerging markets, reducing leverage in the financial system. At the same time, FDI inflows have held steady in 2001, contributing to reduced susceptibility of recipient countries to contagion. Another reason for lower contagion is that the latest emerging markets crises (e.g., Argentina and Turkey) were well anticipated, which contrasts with earlier periods of turbulence. In addition, macro economic policies have improved in most emerging markets, as reflected in increased flexibility of exchange rates, higher official reserves, lower short-term debt and stronger current account positions. I would therefore draw only limited comfort from the staff's suggestion that the limited contagion reflects investors' increasing differentiation between credit classes. Nonetheless, this factor has undoubtedly provided a positive contribution and work on the implementation of codes and standards should continue unabated.

Stability Implications of Global Financial Market Conditions

The staff makes the important observation that just as asset price adjustments have shaped the United States and the world-wide expansion in the nineties, they are also likely to determine economic conditions in the period ahead. Related to this is the possibility that equity investors count on a quick return of strong asset price growth in 2002, using the nineties as their yardstick for returns. Such optimistic expectations may help explain why private debt levels in absolute terms continue to rise, even during last year's economic downturn. The staff concludes that high private debt levels make households more sensitive to interest rates, especially this year as futures markets point to rising rates. I wonder, however, if last year's refinancing in the U.S. mortgage market has not reduced the interest rate sensitivities considerably, by changing the maturity structure of household loans.

To assess prospects for financial stability on the basis of developments in asset markets, it is useful to gauge the proportion of tradable assets in firms' and households' portfolios. Given low market prices of their asset holdings, many indebted companies are currently hardly able to restructure their balance sheets. Equally important for financial stability is an assessment of economic agents' dependence on tradable liabilities. Not only in the United States, but also in Europe, companies increasingly rely on financial market financing. However, low equity prices and high credit spreads reduce access to these markets, which may increase reliance on bank credit and may heighten the risk of spillovers from capital markets to the banking system.

As the staff rightly observes, the default of Enron did not have systemic financial consequences, partly because exposures to Enron were generally well-diversified across institutions and markets. Another reason is that markets had some time to anticipate such an event, as in the case of Argentina. For policymakers, the Enron case has brought the issue of regulating financial activities of non-financial firms to the fore. This reinforces the impression that although the regulation of financial institutions remains important in safeguarding financial stability, the blurring of distinctions among assets, institutions, and markets leads to a movement in the direction of systemic supervision based on its final objective rather than institutional characteristics. More specifically, emphasis should also lie on financial institutions' assessment of counterpart risks outside their sector.

Financial stability seems to be truly at stake in Japan, where the vicious circle continues of deflation and rising non-performing loans in the banking sector, implying large and growing contingent liabilities for the government. Japan's case clearly shows how muddling-through policies ultimately transfers the costs of financial instability to the sovereign. Given the very high levels of public debt, serious tensions in the JGB market cannot be excluded. Because of relatively large holdings of government bonds by Japanese banks, this scenario primarily presents a threat to domestic financial stability. However, it is also possible that, given Japan's position as a large net creditor country, there is a risk that financial instability resulting from problems in the JGB market could cause a significant market reaction outside Japan.

Early Warning System Models: The Next Steps Forward

Although the extensive treatment could have been separated from the current report, I appreciate the discussion on early warning systems, given the progress on this topic that has been made in the recent empirical literature, with significant contributions by the IMF staff. The main weakness of the methodology, as stressed in the text, is that the models' success in predicting crises is typically accompanied by many false claims as well (type 1 errors). However, the fact that a predicted crisis does not occur is not necessarily a weakness of the model, as it may simply be due to an appropriate policy response based on the information captured by the indicator. Paradoxically, if these models were perfect predictors of financial crises, their ex post prediction performance would deteriorate if governments would use them for policy. In this respect, early warning systems may be more useful than suggested.

That being said, there are several other reasons to be cautious using early warning systems as indicators for policy. First of all, empirical analyses have shown that the out-of-sample performance of early warning indicators is weak and does not seem to add much to standard analysis. Second, in contrast with the staff's conclusion on page 68, a single measure of risk is not necessarily better than a thorough analysis of the underlying data. Indeed, the fact that several variables give different signals complicates the analysis, but this also reflects that we live in a complicated world. Hence, composite indicators are likely to mask important information and may therefore lead to wrong policy decisions. Third, and more fundamentally, early warning systems are designed to capture systematic patterns that precipitate crises. Although this is important, as it helps to avoid systematic policy mistakes, crisis situations are also likely to emerge from new phenomena.

Altogether, early warning indicators are useful tools for analytical purposes, increasing our knowledge of systematic patterns. At the same time, we should be cautious using these indicators for actual policy, as they cannot replace analyses of the underlying data.

Alternative Financial Instruments and Access to Capital Markets

The use of alternative financial instruments by emerging markets to increase their access to capital markets can be beneficial to the countries involved. However, use of these instruments complicates the debt profile of countries, because most instruments have features of off balance sheet obligations. In order for investors and multilateral institutions to get a clear picture of the actual financial position of a country, a high standard of disclosure and transparency is necessary. If there is insufficient reporting on these obligations, investors can become uncertain of the data quality and hence the financial position of emerging markets, which could possibly lead to higher spreads on their debts. Again, progress on the transparency initiatives should remain a surveillance spearhead.

Mr. Isleifsson submitted the following statement:

General Observations

We commend the International Capital Markets Department for an excellent report that gives a comprehensive overview of global financial markets as well as containing an illuminating discussion on specialized topics. Quarterly reporting on developments in the global financial system is appropriate and fully compliant with the need to monitor risks to financial market stability, effects of rapid changes in financial instruments and expansion of financial activities, especially in emerging markets. The report constitutes a valuable addition to the surveillance and monitoring efforts of the Fund.

Increased transparency and better regulatory systems have certainly made the global economy more shock-resistant but progress in this respect has not been uniform as the report underlines. Banks that have not been able to keep up with necessary consolidation and restructuring have often turned to more risky activities. Weak spots in financial structures are likely to surface if the economic slowdown continues.

In this debut issue, analysis and illustrations are to a significant extent drawn from the U.S. market, signifying its importance in the global system. In future publications there will be ample opportunities to turn the spotlight on the euro area and other regions of relative systemic importance.

Implications and Outlook for Financial Stability

The analysis of the effects of rising household and corporate indebtedness in the United States, European countries and Japan, has lead to the observation that structural changes have taken place. These imply that households and corporates are now more exposed to volatility in financial asset prices than before. In addition, financial institutions have increased their reliance on various derivative instruments that are neither transparent nor easy to monitor.

In the forward-looking baseline scenario it is found that asset prices could weaken even if the recovery matches the present market expectation of the recovery process. In the alternative scenario where recovery is subdued or delayed, a broad-based correction in global equity markets is likely to be followed by tightened conditions in credit markets with increased credit spreads. Such asset price adjustments could negatively affect demand with repercussions for economic growth.

The alternative scenario may not be the worst-case scenario. Instead of a subdued recovery the possibility and implications of a more severe recession should be considered. One possible scenario is based on problems related to the financing of the U.S. current account deficit and on deflation and the financial system weaknesses in Japan. To elaborate:

The U.S. current account deficit is large in contrast to the situation during the recession in 1990–91. Sluggish growth in the euro area will not provide much demand for U.S. exports.

Total nonperforming loans in Japan are estimated to be about $320 billion, the Nikkei is at an 18-year low and government debt has grown to 140 percent of GDP. It is clear that unless the Japanese banking system is reconstructed there is little hope that the economy will be revived and there is a possibility of serious consequences. This would affect other parts of the world economy in ways that are difficult to assess and anticipate. Japan is the second largest economy in the world, and, hence, the world economy would benefit strongly if long overdue measures to turn developments around would be put in place.

Moreover, there is a risk that Enron’s bankruptcy and signs of irregularities in accounting practices will lead to a generally increased risk aversion in regard to highly indebted corporations and firms with complex financial accounts. This could lead to increased risk premiums, which in turn could have negative effect on global recovery.

Credit Risk Transfer Instruments

The discussion on credit risk transfer instruments is both appropriate and timely. Credit risk transfer instruments certainly have the potential to improve the efficiency and stability of credit markets overall by separating credit origination from credit risk bearing. This market has, however, largely been driven by regulatory arbitrage. Here the Fund is pointing to an important problem, as some of the OTC instruments seem to reduce transparency and disperse risk to market participants other than those usually regarded as being most competent in managing risk.

The LTCM crisis and the ongoing Enron case indicate that these instruments are poorly covered by traditional regulatory regimes. The collapse of Enron was, however, caused by weak corporate governance, use of loopholes in accounting practices and inadequate external auditing but does not seem to have been a direct consequence of the use of credit risk transfer techniques. Continued slow economic growth would further test the performance and stability of markets for credit risk transfer.

The emergence of credit risk transfer instruments underscores the need for a carefully designed framework for the management of public debt and international reserves. Transparency in this area is vital as well as other factors that allow for a proper assessment of risks.

Early Warning System Models

While the cases of Argentina and Turkey have been presented in a positive way as showing how resilient the international financial system is in containing financial crises, these two cases, at the same time, show that the financial system is not sufficiently effective in preventing crises from occurring. The run-down of EWS models with the Argentine and Turkish data emphasizes this fact quite clearly.

Further work on EWS models is necessary, and new efforts along the lines suggested by the report should be carried out. EWS models should continue to be one of the tools of the Fund’s surveillance process.

Alternative Financial Instruments

Various new instruments, including augmentation, time-varying instruments, state-contingent instruments, structured notes and collateralization have been developed in recent years. Such methods/instruments allow increased flexibility to satisfy both the needs of investors and issuers. When using these instruments, however, active and sophisticated risk assessment and risk management should be applied.

The impact on global financial stability of the use of "exotic" emerging market debt instruments can only be assessed if the risk management sophistication of the borrower can be assessed as well. We wish to state our full agreement with the concluding remarks on page 102 in the report.

Mr. Bennett submitted the following statement:

Key Points:

There is too much extraneous material in this report.

The cyclical risk is probably overstated and should be considered in a general equilibrium context.

The regulatory implications of credit risk transfer should be discussed in more detail.

Future reports should be shorter, with a sharper focus and stronger analytical and policy content.

Last June, at discussions on the final *International Capital Markets Report* produced by the Research Department, we encouraged the International Capital Markets Department to rethink the report and offered some guidance for them to keep in mind. We are pleased to see that they have decided to merge the *International Capital Markets Report* with the *Emerging Market Financing Report* and to produce quarterly reports. This has the potential of providing reports that are more timely and better focused. Unfortunately, this report does not realize its full potential.

This report does not convey a coherent vision or set of themes. Rather, as Mr. Callaghan has said, there is a certain collection of papers feel to it. What is it about recent developments that creates a need for chapter 5? Or, is it simply that a paper was already written? Chapter 4 could be relevant, but as it is written, it leaves the reader without any clear sense of what the research implies for assessing the current state of play in international capital markets. It also seems that the report is not covering important territory out of deference to the *WEO*. All in all, it is not a particularly auspicious debut for this new product. I hope ICM will sharpen the focus, strengthen the analysis, and draw out the policy implications better in the next quarterly installment.

Chapter 3 is the most relevant and analytical chapter of the report, so that is where I will focus my remarks. Taking the cyclical risk first, the comparisons with 1990-91, while interesting add little to the analysis. The shocks driving the two cycles and the initial conditions are sufficiently different so as to severely limit the usefulness of the comparison. It would have been better to focus more on the current conjuncture and to have spelled out more clearly and in more detail the concerns and policy implications.

At times, I had the impression that the concern was that financial market expectations would become unhinged from real developments in the global economy, but on balance, it seems that the staff is concerned that the recovery of the real economy will be slower than usual. I think that the latter is the more relevant concern. To come to terms with the implications of this risk, it would have helped if the staff had been more explicit on the possible factors behind a slower recovery and what they imply for excess supply, inflation, policy interest rates, and asset prices. The staff seems to be implying that it is the overbuild in TMT—I do not think that the capital overhang is big enough by itself to delay a recovery for long—but it could be a part of a combination of factors, including a lesser rebound in consumer spending on autos and housing than usual (owing to the fact that low interest rates have maintained activity in these areas at a relatively high level for a recession), or a slower increase in productivity, that taken together result in a more subdued recovery in global real activity. The reader needs a clearer sense of the underlying reason for slow growth and how it is distributed across countries to assess the policy implications. To the extent that the explanation implies a more prolonged period of excess supply, inflation would be lower than currently projected and central banks might be expected to reduce policy interest rates further and to keep them low longer than markets currently expect. This would mitigate some of the stress that this real scenario would otherwise place on global financial markets. To the extent that the underlying problem is unevenly distributed across countries, exchange rate changes should be part of the adjustment process.

The comparative advantage that the IMF has relative to the Bank of England and the BIS, both of which publish excellent financial stability reports, is its expertise in global macroeconomics and exchange rates – its ability to do a general equilibrium analysis. This comparative advantage is not being put to good use in this report. It may be that ICM does not want to infringe upon the territory of the *WEO*, but such artificial borders undermine the usefulness of an analysis of the type of concern addressed in the first part of Chapter 3. Indeed, if this report is too constrained in its approach, issues like this one should be left to the *WEO* in future.

Before leaving the analysis of this cyclical risk, I would suggest that the staff should have done more to place it in context. U.S. productivity growth has remained strong in the current recession, which supports the likelihood of a rapid turnaround in profitability. In addition, the share of business investment in equipment and software in the United States. GDP remains high by historical standards, which should support future productivity gains. Finally, U.S. growth prospects have been revised upwards recently. The situation in other G7 countries is more difficult to assess, however.

Productivity increases have not been as sustained in these countries as they have been in the United States, although growth prospects have been revised upwards in most other G-7 countries as well.

Turning to the issue of credit risk transfer mechanisms, this is an important topic that merits a more in-depth discussion. I found the questions posed by Mr. Padoan in this area to be highly germane, and I am looking forward to the staff's response to them.

Two final comments on Chapter 3. First, the analysis of Japan is essentially lost in the blur of information in this report. Unlike in the United States, where monthly information, on balance, suggests the economy has reached a turning point to recovery, the recent indicators for Japan point to a continuation and even intensification of its problems. Accordingly, the problems in Japan are widely perceived to pose a significant risk for international capital markets. The first time I read this report, I had the impression that Japan was virtually absent from it. When I went back through the report looking for discussion of Japan, I found that it was there in a low-keyed diffused manner. This material should be brought together in a box.

The second is on the perils of covering current events. I said at the outset that a benefit of a quarterly format is that it is more timely. The risk is that events might be too new to reach a judgment on them. This might be the case with Enron, for example. While there are a lot of references to Enron and a box devoted to it, one could argue that more could have been done to draw out the serious financial stability/integrity issues raised by this and other similar-type cases (companies from other countries have also been accused of "aggressive accounting"). These cases give rise to important questions regarding corporate governance, in particular the role of audit committees, and the ability of accounting standards to keep pace with the evolution of increasingly complex financial instruments. At the same time, one could argue that more analysis is needed before offering policy advice. It is not clear at the moment whether these problems require a regulatory solution, or can be solved by markets.

Conclusion

This new surveillance vehicle has potential, but its identity and role within the family of Fund surveillance documents need to be clarified. Future reports should have a sharper focus on key financial stability issues with a strong general equilibrium analytical foundation, and, where relevant, clear policy advice. They should also be much more concise.

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

We thank the staff for the comprehensive first issue of the Global Financial Stability Report attempting to merge two important financial market publications of the recent past. Despite the length of the document, we missed the detailed analysis provided in the much shorter previous quarterly reports on emerging market financing, focusing on the actors and factors driving financing flows to emerging markets, including in particular the presentation of the size of net flows by the different categories.

Clearly the main event in emerging market financing during this period has been the Argentine default and the limited contagion, thus far. The main reason provided for this important development is that the default was sufficiently anticipated by dedicated investors, allowing them to take the appropriate defensive action, helped by the reduced weight of Argentina in the market cap weighted EMBI+. We would very much appreciate comments from the staff regarding the relative importance of the announcements of Fund financing for other countries that were facing market pressure at the time, such as Turkey and Brazil, to also help contain contagion. In addition, while previous *Emerging Market Financing Reports* identified the role played by dedicated and crossover investors, Box 2.2 of the present report shifts to a new classification of investors without a methodological distinction or equivalence. In the same vein, the first bullet in Box 2.2 refers, without explanation, to the presence of "speculative investors and the street "front-running" the eventual change in dedicated investors' portfolio allocations". Staff clarification of its meaning would be useful, particularly if this paper is to be published for the benefit of a wider audience.

Another aspect of the Argentine crisis, which is critical for understanding the scope and severity of the situation, is that while dedicated investors appeared forewarned well ahead of the impending collapse, a large percentage of domestic depositors maintained their confidence in what was generally regarded as a highly capitalized and prudentially sound banking and financial systems. Given the globalized nature of financial markets it is right to make no sharp distinction between domestic and external financial asset holders. Yet, the different behavior in the Argentine case among these two type of creditors should give food for thought when assessing the future consequences of the Argentine default. In fact, the maintenance of confidence in the perceived willingness of the Argentine authorities to avoid default went beyond domestic financial asset holders, encompassing also retail investors in Europe and Japan, which as noted in Box 2.2 "held on in the somewhat optimistic belief that emerging market sovereigns would not default". Thus, this episode suggests different consequences not only between domestic and foreign creditors but also between retail and institutional investors, with the former bearing the most significant cost of the sovereign default. The possibility that this experience may create a more generalized distrust on the ability of banking systems in developing and emerging economies to turn to foreign currency denominated liabilities and, as significantly, of international financial markets to intermediate world savings to those economies, should not be downplayed.

Another aspect of the recent Argentine experience that may deserve further analysis relates to the contribution of the increased participation of foreign capital in the Argentine banking system, both in terms of the process of remonetization as well as on private sector credit allocation. An additional comment on the risk of contagion from Argentina is that the paper circumscribes the notion of contagion mainly to the impact of the Argentine default on the value of other sovereign bonds, without fully bringing into play other potentially relevant channels of disturbance on normal financing flows, in particular FDI and portfolio investments, as well as in financial conditions in emerging market economies more generally.

The other important event for international financial markets during the period analyzed has been the collapse of Enron. The explanations in the paper on how the events unfolded and their implications going forward are somewhat lacking. On the occasion of the LTCM debacle in 1998, the *International Capital Markets Report* had provided a comprehensive explanation of the ultimate outcome. That was not only very instructive but it also served to pin point with clarity the areas that needed to be strengthened. In the end, the lessons that supposedly were to be drawn from that experience in terms of a more prudent behavior on the part of financial market institutions were not fully heeded. The consequences of the collapse of Enron are as serious because they undermine the trust in institutions that are supposedly well supervised and observing best practices and standards. The Enron event also calls into question the effectiveness of one of the main pillars of the proposed Basel II banking supervision accord based on greater transparency and associated private market discipline. Disclosure thus exposes the need not only for an appropriate regulatory framework including adequate accounting rules and standards but also enhanced supervision. The expectation that private market discipline alone could be relied upon to substitute for government supervision may thus be falling short of expectations.

The staff report provides a worrisome picture of the risks associated with credit risk transfers, highlighting the possibility that credit events may spread across institutions and markets, at a time when corporate defaults are at record levels totaling almost US$150 billion since January 2001 in the United States alone, and a major sovereign default has occurred. The real question for us is not just the weaknesses in the legal and operational infrastructure of the OTC derivatives market in terms of the enforceability of credit risk transfers, but the potential for generating systemic financial market instability, particularly during a period of slower global growth. The analysis in pages 54 and 55 of the report warrants a comment: because of regulatory arbitrage banks are encouraged to transfer credit risk to other institutions such as hedge funds, pension funds and insurance companies that are not prudentially regulated. However, since these nonbank financial institutions fund themselves with bank credit lines, this may potentially put pressure on bank liquidity should a cluster of credit events simultaneously demand settlement of many contracts at once. Thus, credit risk may be seen as inherent in bank balance sheets, and because of the too big to fail principle—only one U.S. bank alone holds some 60 percent of the banking system's outstanding notional credit derivatives—the risk is high that, in the end, taxpayers will end up bearing some burden. It is symptomatic that the equity value of one of the main bank groups in the United States, JP Morgan Chase mentioned in the report as deeply involved in Enron's finances, has already declined more than 42 percent in the past year. At the same time, it is asserted in the last paragraph of page 43 of the report that "none of the weaker U.S. or European institutions may be systematically important". This constitutes a relatively strong assertion keeping in mind that the Enron episode is still unfolding. The international financial system has nonetheless showed marked resilience in dealing with this event thus far as well as with the successive shocks observed last year but a more determined effort in enhancing transparency and the efficacy of financial regulation seems warranted. Another lesson from Enron is that the task of adapting standards and codes should not be geared exclusively to addressing emerging market concerns, keeping in mind the increased use of credit risk instruments as well as the opportunities for regulating arbitrage. In this regard we look forward to staff comments on the issues raised by Mr. Padoan and Mr. Lombardi in their preliminary statement.

The staff has clearly described the interaction between macroeconomic developments and financial market conditions. While financial markets have priced in a recovery in economic activity and in corporate earnings during 2002, the underlying financial conditions, in terms of credit quality and balance sheets, of households, corporations and financial institutions are progressively deteriorating. This could weaken or delay the recovery, further impacting negatively on financial conditions and the ability to accommodate new spending. The many factors at play include, inter alia, the extent to which the stock market rally has been liquidity driven, the strength of productivity growth, the pace and size of absorption of world savings by the U.S. economy, the pace of structural reforms in Europe and Japan and the impact of the wealth effect on aggregate demand. The underlying weakness of the outlook is that even if the expectation of a recovery materializes, it is likely to reinforce the external imbalance in the U.S. economy.

From this broader perspective the state of the Japanese economy acquires particular importance. More analysis of the interlinkages between the second largest economy in the world and international financial markets would be welcomed. Keeping in mind that the Japanese economy has represented a sustained source of external savings for many countries in recent years we see merit in closely monitoring the changing attitudes of Japanese investors. We would also appreciate some staff comment on the size of net creditor positions among Japanese sectors in a context whereby the debt/GDP ratio of corporations is 275 percent, of households 75 percent and of the public sector, which is projected to grow to over 150 percent by end-2002. The weakening of the Japanese Government Bond market, as reflected in the negative outlook on the part of rating agencies, adds to the risks facing world financial markets, notwithstanding the assertion in the third paragraph of page 35 of the staff report, that "the potential for stress in Japan's financial system to give rise to international spillovers may have declined". Similarly, the staff seems to downplay spillover associated with exchange rate volatility. The first paragraph of page 31 notes that "the risks of a yen depreciation and appreciation seem to be equally likely" and gives only a succinct description of both scenarios without much indication of the international implications of such outcomes. In our view, although the linkages between the U.S. economy and the world economy are discussed in the report, i.e., second paragraph of page 45 highlights the significant adverse effects on Japan stemming from the global slowdown, it downplays the importance of events in Japan for the region and for the global economy more generally. Thus, we concur with Mr. Padoan and Mr. Lombardi on the desirability of broadening the analysis of the transmission mechanisms to include both Japan and Europe.

Regarding Chapter IV, "Early Warning System Models: The Next Steps Forward", we welcome the update on the performance of the EWS models currently used at the IMF as well as the different proposals to broaden the focus from foreign exchange to debt and banking crises and the linkages between them. The Argentine case confirms the appropriateness of the broader approach since the three type of crises alluded to above are present, pointing to the fact that for countries engaged in global markets one type of crisis is most likely to be accompanied by the other two. Moreover, the proposal to make a more efficient use of the information embedded in forward-looking asset prices, to anticipate financial market pressures, is reasonable. Information on the term structure of emerging market bond spreads and on credit default swaps could complement debt crises models. The debt service to export ratio mentioned several times by way of including the comparison between Turkey and Argentina requires, however, some nuancing to take account of the exchange regime, the nature of trade agreements, the level of exports relative to GDP and the openness of the capital account. Nevertheless, it is worth keeping in mind that anticipating crises also require a significant degree of subjective judgment regarding a critical component for confidence, namely the political environment which is not readily susceptible to econometric modeling.

Finally, the Chapter on Alternative Financial Instruments and Access to Capital Markets presents a useful overview of debt instruments with innovative features that may help borrowers to maintain access to capital markets even in times of financial stress. As such, it could serve as background for discussion on other topics, such as debt management and private sector involvement. In any event, it is worth noting that most emerging market sovereigns lacking well-developed domestic capital markets have been constrained by a maturity transformation/currency risk tradeoff. Reliance on longer maturity, foreign currency denominated debt to cover financing gaps inevitably confronts them with exchange rate risk and the uncertainty surrounding access to international financial markets. In the end. it is unlikely that financial engineering can reduce those risks, even when some innovative debt instruments may be more desirable than others in the particular circumstances described in the report.

Mr. Rustomjee submitted the following statement:

We thank and congratulate the staff for the very detailed first *Global Financial Stability Report*, which provides a detailed assessment of the global economic situation. This report provides a refreshing perspective of the global economic environment focusing on a financial and market perspective, which in our view is also very consistent with the mandate of the Fund to promote global financial stability. The report contains very many positive aspects, which we are grateful for, which include the detailed assessment of the market conditions in the United States and the conditions in emerging economies, particularly those currently facing crises. Regrettably, the report does not adequately provide coverage of the situation in other developing countries. We are also pleased to note that the report discusses at length other related issues including the Early Warning Systems, the tool used by the Fund to access crises in member countries, and Alternative Financial Instruments and Access to Capital Markets.

An Early Exit to the Global Slowdown

From the detailed discussion in the report, it is clear that the markets have sufficiently recovered from the September 11 shocks. We note that it was particularly the strong rebound of U.S. equity markets that have led to the recovery of global equity markets. This strong rebound of the equity markets in most developed economies was largely the result of very strong and decisive monetary policy actions taken by central banks, particularly in major industrial economies. The report suggests that the recovery of global equity markets points to a recovery of the real economy activity globally, and sufficient evidence exists that the U.S. economy may already be leading such a recovery. It is, however, our view that sustained supportive policy actions may be needed by major industrial countries, since the U.S. equity markets have recently continued to experience some volatility, as a result of disappointing corporate performances, and the announcement of major bankruptcies, particularly that of Enron and K-Mart.

Major industrial countries however, still face potential risks, which could have an impact on the sustainability of the recovery. Firstly, the United States still has a large current account deficit, which could negatively impact the recovery in the event of disorderly unwinding. Secondly, the banking sector in both the United States and Europe is generally sound, but could become less stable if interests rates were to rise without an increase in economic activity. And, thirdly, the Japanese banking sector still contains structural weaknesses, which continues to hamper the recovery of the Japanese economy. We would urge the Japanese authorities to urgently address weaknesses in the banking system, which would enable Japan to make its much needed contribution to global growth.

Crises in Emerging Market Economies

We welcome the fact that the report also discusses in detail the crises currently experienced by some emerging economies. These crises, which resulted, inter alia, from structural problems in the economies of the member countries and, the lack of adequate and timely policy responses, could also be attributed to the global economic slowdown and the deterioration of financial conditions in the aftermath of the September 11 events. It is comforting to note however, that contagion from these crises, unlike previous occasions of crises in emerging economies, was well contained within those countries. In this regard, it is particularly encouraging to note that market players now demonstrate a better ability to discriminate among emerging economies. This should further encourage authorities to continue to pursue sound macroeconomic and financial policies. Nevertheless, we concur with the view expressed by Mr. Alosaimi in his statement, that emerging economies which were spared from contagion at this time, should not become complacent, since access to several retail markets, which have been negatively affected by these crises, is now almost closed to most emerging economies.

The Shift of Credit Risk

We welcome the detailed analysis provided in the report as to how the development and continued use of new credit instruments in the financial markets have contributed to the diversification of credit risks. On the other hand these newer credit vehicles, inter alia, hedge funds, have also contributed to limiting transparency of corporate financial data, and the ability of investors to adequately access the financial soundness of public companies. The report provides a detailed analysis of how this development has contributed to the bankruptcy of Enron, which in turn has created volatility of the U.S. equity markets. We would, therefore, concur with the view expressed in the report that an assessment needs to be made of the regulatory implications of the continued use of these diversified credit instruments.

Early Warning Systems

We welcome the discussion of the Early Warning Systems (EWS) models as an instrument of Fund surveillance in the report, since these models could provide important warning signals of potential crises in member countries. These models have already been discussed in another context, and at that time was still considered imperfect as tools in accessing potential crises in member countries. We would, therefore, concur with the staff that continued effort seems appropriate to increase the predictive value of the models. We are, therefore, still very much concerned that these EWS models contain the inherent weakness of giving false alarms and failing to predict crises. Any of these two occurrences, namely, false alarms or missed prediction of crises, could result in inappropriate policy advice by the staff to members, and subsequently incorrect policy responses.

Limited Discussion of Developing Countries

The report provides in-depth discussions of very important issues with regard to financial and policy developments in major and emerging economies. We very much welcome these contributions. We would however also have welcomed a discussion of the impact of the global financial and economic developments on other developing countries. In this regard we would like to know what would be the possible impact of a failure to achieve a sustained recovery in developed economies on the economies of least resourced countries, in the short to medium term.

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

We welcome the discussion of the first quarterly *Global Financial Stability Report*, which will substitute two publications, the *Emerging Market Financing Report* and the *International Capital Markets Report*. As we see it, the change in format is aimed at even closer and more integrated surveillance of the capital markets. We sincerely hope that the new publication, after a “teething” period of its own, will play a substantial role in further improving the Fund’s expertise in financial markets. It is essential for the new publication to preserve the most valuable features of its parents. In particular, we are concerned that an extremely valuable description and analysis of developments in emerging market financing has shrunk from already traditional 30 pages to less than 10. We believe that, in search of the appropriate balance in presentation of material, the staff might think about rebalancing the material in future reports.

In the mature capital markets, the staff offers interesting observations on the gyrations of the stock market in the United States and Europe. The staff’s attempt to judge the validity of market expectations of the imminent economic recovery in the United States is welcome. Although evidence of improving economy in the United States is growing, we agree with the staff that it would be inappropriate to ignore the remaining downside risks. The spectacular recovery of the technology sector, admittedly, from a low base, is one of the notable developments in the recent past. In line with the "new economy" arguments about the medium term prospects for the global economy, the performance of the technology sector and market perceptions about its future to a large extent reflect and influence expectations of productivity growth and have to be monitored carefully. The staff is frank in their pessimism with respect to financial market developments in Japan. While there is little doubt that deep structural changes are underway in this large and complex economy, the challenges are formidable and the staff is correct to emphasize the strong link between financial assets performance and macroeconomic policies of the authorities.

The staff was successful in pointing out to the dichotomy between the apparent resiliency of the global financial system and emerging realization of the still remaining risks to its stability. Indeed, it is encouraging that the banking sector in industrial countries as well as in many emerging economies is now better regulated and supervised. Leading financial institutions in the industrial countries have not only become better capitalized, but also have significantly upgraded their risk management skills. At the same time, the LTCM debacle and the bankruptcy of Enron point to the dangers of complacency. We welcome the extensive references in the staff paper to the experience of Enron and its implications for the views on the stability of broader financial markets. We agree that the authorities in leading financial centers now have to revisit the risks posed by the regulatory arbitrage, more active role of nontraditional players, and prominence of more sophisticated financial instruments and strategies. Their task is even more complicated since Enron was internationally active company and, like many other multinationals, it relied on special purpose vehicles created in offshore financial centers.

In addition, it seems to be the case that implications of Enron's bankruptcy transcend the boundaries of mature capital markets, and have direct effects on emerging markets, for example, through the availability of FDI, where Enron used to be very active. Enron's bankruptcy also casts a shadow on the role of the international auditing firms. With an emphasis on transparency and governance, it has become standard in the Fund's programs to require that "internationally recognized firms" carry out the audits of the central banks and key state enterprises. However, as the Enron controversy shows, their participation may not necessarily guarantee best practices, and additional steps, like regular change of an auditor or a separation of consulting and auditing functions are also relevant for emerging markets.

The chapter on credit transfer market is certainly among the stronger parts of the report. The staff mostly refers to this market to illustrate their valid point about the potential risks for financial institutions in mature markets. However, this market may be even more important for financing of the emerging markets and we encourage the staff to further develop this line of research and analysis to link it even closer to the Fund's work in program countries. Several high-profile crises took place in the countries with high penetration of FDI and significant exposure of foreign creditors. To protect themselves in the future, private investors are seeking ways to diminish the risks of the introduction of transfer and other restrictions when the balance of payments pressures arise. The use of these techniques can limit the efficiency of an imposition of foreign exchange and capital controls during resolution of financial crises in the future. Better understanding and monitoring of such techniques could enrich our debate on PSI and highlight potential impediments to some of the popular proposals. For emerging markets financing, the official sector, including the World Bank, plays a major role in the transactions aimed at transfer of risk. The lessons from the analysis of the market for credit risk transfer vehicles in Chapter III, in our view, could be usefully combined with the analysis of the alternative financial instruments in Chapter V.

Related to the above is the point made by Mr. Toyama in his preliminary statement that the presentation of the alternative debt instruments in Chapter V could be related to the work on PSI. The coverage in this chapter clearly overlaps and, at the same time, differs from the material in two recent papers on PSI.

Various parts of the staff report contain interesting observations on the differences in returns on investments of various groups of foreigners into emerging markets. We note, in particular, the fact that, in 2001, most of the institutional investors have fared rather well, while less informed retail investors in Europe and Japan have not been able to discriminate among emerging markets and suffered losses. We agree with the staff that, while in the short run such an outcome is likely to reduce the investors' base and limit access to foreign financing, from a longer term perspective, it demonstrates that careful analysis of economic policies and market developments pays off. Hopefully, in the future, it would lead to more stable financial flows to emerging markets.

Mr. Daïri submitted the following statement:

Key Points

This is a commendable report but could have benefited from discussions with market players in emerging market economies as well as a fuller discussion of developments in Europe;

The soundness of the international financial infrastructure combined with “vigilance and ready action” to address areas of stress has helped limit the impact of adverse shocks to the system; nevertheless, risks remain and we should not be lulled into a false sense of complacency;

A period of slow and/or delayed growth could test the market further, adversely affecting confidence and intensifying pressures on weak institutions;

We join other Directors in expressing concern at the nature and operations of the market for credit risk transfer and the incentive structure that has driven its development; clearly, there is an urgent need to update the regulatory apparatus in industrial countries and put in place stronger disclosure and transparency requirements. The importance of revisiting accounting rules and standards, including those related to the independence and integrity of audit firms and their supervision will also be critical;

We support the research program on EWSs going forward but urge caution in the treatment and interpretation of the results.

We welcome this inaugural version of the *Global Financial Stability Report* and commend the staff for the clarity and rigor of the analysis contained therein. The report correctly focuses on systemic issues of contemporary relevance and is set against the backdrop of the evolving global macroeconomic picture. We are also pleased to note that, as in the case of the earlier *International Capital Markets Report*, the present report draws on, and incorporates, the views expressed in a series of discussions with market participants in key financial centers around the industrial world. This adds measurably to the depth of the report. We encourage the staff to consider expanding the coverage of these discussions to players in emerging markets as well. Furthermore, like Mr. Padoan and Mr. Lombardi, we agree that the report would have benefited from fuller discussion of developments in Europe.

The central message of this report appears to be that, despite many tribulations and significant disruptions, the international financial system has demonstrated a remarkable degree of resilience in 2001. This is a conclusion that we broadly share. The system’s ability to absorb shocks can be attributed to the conjuncture of a number of positive factors, of which two stand out: namely, the fundamental soundness of the financial infrastructure and the “vigilance and ready action” of financial and monetary authorities to promptly and vigorously address signs of stress. We are encouraged by the fact that financial markets have rallied significantly since the lows of late September. Equity and bond markets have performed well, the fallout from the Argentina crisis has, thus far, been largely contained—although we think it may be premature and not fully correct to declare victory—new issuance of emerging market sovereign borrowers have shown signs of revival, and markets appear to be anticipating a recovery in economic activity and corporate earnings during 2002, especially in the United States.

These positive developments notwithstanding, the staff is right to caution against being lulled into a false sense of complacency. The strength and timing of the global economic recovery remain a matter of considerable debate and subject to a wide range of possible outcomes. To be sure, financial conditions leading up to the present global slowdown were, on balance, more favorable compared to those prevailing in 1990-91 so that the starting position is stronger and the room to absorb shocks greater. Nevertheless, given the “weak links” in the financial system, the uneven progress with banking sector consolidation and restructuring, and the fact that the risks of a subdued and/or delayed recovery are “not insignificant”, further pressures could develop. Should a slow and/or delayed recovery ensue—and be accompanied by a large adjustment in asset prices and credit quality—the balance sheets of households, corporate and financial institutions would be adversely affected, dealing a fresh blow to the still fragile state of confidence and heightening the probability of a “double-dip” recession. Indeed, the present levels of indebtedness in the major industrialized countries, and an increasing exposure to traded financial assets in recent years with potential for feedback into economic activity, suggest that even a reasonably robust recovery would face much the same “strong headwinds” as in 1990-91 since recovery would be attended by growing imbalances and vulnerabilities of economies and financial systems to asset price fluctuations.

The performance and stability of the market for “credit risk transfer” is a subject of much interest, not least because of the recent collapse of Enron. While these instruments have the potential to improve the functioning of credit markets generally, their proliferation in recent years as “regulatory arbitrage” opportunities has encouraged a shift of credit risk exposure outside the (better regulated) banking system, the involvement of nontraditional players, and the greater complexity of financial transactions, thereby increasing the risks attached to these instruments. Moreover, the fact that investors do not have a good understanding of the costs and benefits of these instruments, with a tendency for a misalignment of spreads, is especially troubling. The staff seems confident that improvements in the infrastructure, accompanied by a maturing process, will make the markets more efficient over time. Nevertheless, risks in the short-term remain and, in any event, the full unraveling of Enron’s complex financial operations and its repercussions through banks’ exposures to other energy companies worldwide has yet to take place. Should the fallout have wider systemic financial consequences than hitherto, it would place further strains on the stability of the market for credit risk transfers and the financial system generally.

In the light of recent credit events and the risks ahead, we see an urgent need to update the regulatory apparatus in industrialized countries so as to catch-up with the rapid pace of modernization and globalization of finance. In this context, high priority should attach to filling the “gaps in regulation” that have allowed players to operate under differing rules and in less disciplined markets. While it will be important not to overreact to recent events with overly burdensome regulation, national authorities must move ahead decisively to develop and enforce stronger disclosure and transparency requirements in complex markets—especially as it relates to off-balance-sheet risk management structures. This would help identify financial vulnerabilities at an early stage and preclude the build up of unsustainable positions. Recent events also underscore the importance of revisiting accounting rules and standards, including those related to the independence and integrity of audit firms and their supervisors and we share Mr. Kelkar’s comments in this regard.

We welcome the discussion in the paper on the further development and refinement of early warning systems (EWS) as a tool for crisis prevention and support the parameters of the research program going forward. However, as we have mentioned on previous occasions, the results of even the best performing models will need to be interpreted carefully, given the inherent limitations of econometric work, and handled with circumspection so as not to provoke adverse market reaction. The suggestion by Mr. Toyama that the quarterly Board meetings on the Global Financial Stability Report could be used as an opportunity for the staff to appraise the Board on new developments in this area is worth considering and we look forward to hearing from the staff on this matter.

Mr. Varela submitted the following statement:

At the outset, I would like to congratulate the staff for their contribution in preparing the first *Global Financial Stability Report*, which I found quite informative and interesting.

I would like to make some comments firstly on the structure of the paper and secondly on its contents.

Structure of the report

The report is a useful attempt to replace the annual *International Capital Markets Report* and the *Quarterly Emerging Market Financing*. However, I would like to make the following suggestions for further improvement.

- I think it would be helpful to have a summary of the conclusions at the beginning of the report; as has been suggested by Mr. Wijnholds, that could complement the existing Overview.

- It is appropriate to combine the short-term assessment of global financial markets and developments in the emerging market financing with some other issues of more structural nature with systemic implications. Nevertheless, in the present report, I fully agree with Mr. Callaghan that there is a kind of disconnect between Chapters II and III, and Chapters IV and V. Like other colleagues, I think it would be better not to publish Chapters IV and V on this occasion, but in separate papers probably after more careful consideration by the Board, as the conclusions and implications of these two chapters could be further analyzed and enhanced. Chapter IV is specially sensitive in this regard.

Moreover, I think that Chapter III could be split in two different chapters. The analysis on credit risks transfer is a separate issue from the financial market implications of a subdued or delayed recovery, and as such it could constitute an independent chapter, particularly if Chapters IV and V are not included in the final report.

- Looking forward, it is advisable to select just one or two issues of more structural nature that could complement the general capital markets' assessment that could be analyzed in depth. It is important not to raise the expectation that three or four issues will be included in each report in order not to create an excessive burden on the staff.

On the contents of the report, I would like to make the following comments:

Chapter II—Recent Developments in International Markets

The staff argues that financial markets have anticipated and have priced in a recovery of economic activity and corporate earnings during 2002, taking into account that the equity markets have recovered remarkably since September 11, while yield spreads of corporate and high yield in bonds have narrowed against those of the U.S. Treasury. That might be the case, and we hope that the recovery takes place as expected in the report. Nevertheless, it is possible that developments in financial markets are in fact just a response to the overshooting after September 11. In fact, the figures in Box 2.1 do not clearly point to a full recovery in equity prices, so as to support a clear cut change in the underlying trend. Moreover, the fact that the price recovery in the last quarter of 2001 was stronger in the more procyclical sectors, as well as in the technology-related stocks and in emerging markets could be a sign that we are confronting just a reversal of the price drop in those sectors in the aftermath of September 11.

In any case we should pay close attention to developments in the industrial production and earnings during this quarter, as suggested by the report. Those indicators would be crucial, among others, to see whether we are close to a turnaround.

Another important contribution of the report is to highlight the resilience of the international financing system during 2001 amidst several negative factors that affected markets in that period. We concur with the reasons explained by the staff on this regard. However, two additional reasons could be emphasized; first, the role of the IMF in providing more information and being more transparent in the implementation of its surveillance and crisis prevention policies; and second, the efforts made in different countries so as to strengthen banking supervision in recent years in order to cope with increased market risks.

I concur with Mr. Padoan and Mr. Lombardi that the report should pay more attention to developments in European capital markets. No mention is made on any effects on the financial markets of the introduction of Euro coins and notes. It is a historical event that should be included in this first report.

When describing the behavior of currency markets, the report could give further explanations on the reasons why the dollar continues to be strong throughout 2001. The underlying reasons for that outcome might have changed during the year, among them, interest differentials in favor of the dollar, capital inflows to the United States, positive developments in the equity markets and finally incipient expectations of economic recovery.

Box 2.2, Argentina and the Asset Class, presents an interesting analysis on how the Argentine crisis could have affected investors in different regions. Nevertheless, some of the conclusions reached could be somewhat qualified, particularly as to the future of the euro-denominated market following the Argentine default. We think that, judging from experience in other severe crises, it is possible to have a more sanguine view on future developments in that particular market.

Regarding the question of whether the risk of contagion from Argentina has disappeared, the report rightly points out that it is necessary to remain vigilant particularly on foreign exchange markets, primary markets and foreign direct investment. We support this view and in particular we would appreciate a more thorough analysis on developments in foreign direct investment. Together with foreign trade, FDI is one of the main pillars for economic development. It could be useful to devote more attention to the evolution of FDI in connection with other financial flows.

On a factual note, the report mentions in page 7 that the crisis in Argentina have sparked a sell-off on Spanish stocks during the last quarter of 2001. It is worth noting that during that quarter equity prices of the Spanish companies that have invested in Argentina were in line or over performing the stock prices of other European companies in the same sectors. The Spanish stock index (IBEX) rose 14.7 percent vis-à-vis 14 percent of the European average, and the banking sector went up 14.4 percent compared to 12.1 percent of the European average; finally, telecommunications, 13.3 percent (50 percent in Europe). It is true that there were some temporary differentials in quotations starting in January once the Argentina crisis unfolded. I think it is fully justifyable for the sentence referring to Spain to be either eliminated or substantially modified.

Chapter III—Stability Implications of Global Financial Market Conditions

Here again, the report focuses on developments in the United States, which is appropriate given the importance and availability of data. However, it would be desirable to make a further effort to get more data from other relevant areas. In any case, sometimes it is a bit confusing whether the report refers to the U.S. economy as such, or whether it is a proof of what is happening in the world economy.

It would be useful to clarify in page 31 that household indebtedness growth in Europe has been lower than in the United States. On the other hand, when describing the increasing role of the banks and, therefore, the growing dependence of households and corporations to the equity markets, it could be useful to note the existence of off-balance sheet commitments by the banks to finance those corporations, so they can resort to banking lending if needed. Therefore, the banks could continue functioning as a shock absorber. The evidence in the United States in this regard is consistent with this fact, so there is an increase in banking credit when the market uncertainty grows.

Chapter IV—Early Warning Systems: the Next Steps Forward

We share the view of other Directors that Early warning Systems (EWS) are an important part of the tool kit in the surveillance process of the Fund. However, we think that these models should be used not only with judgment but also with care given the high frequency of false alarms and missed crises forecasted by these models. For this reason, we would strongly recommend maintaining the results of theses models for internal use only and for discussions with the relevant country authorities.

Even though the staff reports that the models used by the Fund have been found to be more reliable than those used by some investment banks, it is also true that they "still generate a substantial number of false alarms and missed crises”. In this regard, we echo Mr. Padoan’s and Mr. Lombardi’s question to the staff with regard to the fact that these false alarms could be attributed to the authorities’ timely policy response. What is important to note here is that economic developments are dynamic in nature whereas these models are not. So, although including these factors into the analysis could improve its forecasting results, these could also be used to support the authorities’ economic policies.

As we have noted in the past, a definition of a currency crisis in a country that has adopted a flexible exchange rate regime seems to be odd. The idea behind selecting this kind of regime is precisely to let the exchange rate play a more important role to offset external shocks to a country. So, the fact that the exchange rate depreciates by more than the threshold level imbedded in the models does not necessarily imply that there is, or will be, a currency crisis. The currency crisis will materialize if there is a substantial impact in the balance sheet of corporations and the financial and public sectors that could, in turn, affect the real economy. Hence, we think this definition should be broader based. In sum, what can cause a crisis is the impact of the exchange rate depreciation but not the depreciation per se.

Chapter V—Alternative Financial Instruments and Access to Capital Markets

The analysis in this chapter refers only to external capital markets. An interesting complement would be to include also domestic markets as the management of domestic sovereign debt could undergo similar difficulties as the external debt when the economy deteriorates. May the staff comment on the reasons to focus the report only on external debt and whether the same alternative instruments of debt management could be used for domestic debt in difficult situations?

The advantages and disadvantages of the instruments included in this chapter could be subject for further analysis as well as the relations between the use of these instruments and PSI.

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

We are very pleased to be discussing the *Global Financial Stability Report* for the first time. It is a very interesting and stimulating document, and I would like to thank Mr. Häusler and his team for producing such a document. That does not mean, however, that we think it is a perfect document already. I realize that Mr. Häusler is working under certain constraints. But, all in all, I think that a very good document was produced.

On the format of the report, a number of Directors reflected in their statements—with which I agree—that the report is still too long and could be more focused. I made a suggestion that the published version needs not include Chapters IV and V, which are very interesting but, as one Director mentioned, more in the character of essays and could be used as separate studies. Some of the conclusions could be incorporated into the main body of the report, and perhaps the report could also draw somewhat stronger policy conclusions.

I am less concerned with the geographical imbalance that other Directors pointed to. It is true that Europe was lightly discussed in this report, but, as the head of the International Capital Markets Department is European, I am not too worried that Europe will be forgotten. As stated in the preface, the report wants to focus from time to time on various aspects of various areas. So, I am certain that Europe will get its due soon, but hopefully not in a negative sense.

On contagion, like other Directors, I also noted that the contagion from Argentina is, thankfully, limited. The reasons put forward are the anticipation of the managers in contrast to what happened in Russia in 1998, better differentiation by the market, and better macroeconomic policies in emerging market countries, which I would like to underline.

I agree with Mr. Padoan that the Fund should not be too sanguine about markets having learned to discriminate better. They are differentiating better, but it is not certain how permanent that would be. That needs to be kept under close scrutiny. Mr. Padoan also noted that there might be delayed contagion—a point that should definitely be kept in mind. In this regard, he mentioned Uruguay and Venezuela. I would like to quote Mr. Shaalan from his statement that markets are wary about Venezuela and Colombia for the reasons that pertain to those countries, which is a fair comment.

A number of Directors, including myself, also mentioned Japan's unique problems and expressed some concern that, given the size of the market and the importance of Japan, if there were to be problems in the capital markets, there might be spillovers into other markets, and that would be a cause for concern, certainly. While these problems are being addressed, more needs to be done.

I would also like to highlight an interesting section on the potential implications of retail investor involvement, on page 57 of the report, which mentions that financial institutions like hedge funds and mutual funds are increasingly tapping the retail investor base. This is a development that I was not aware of, but I think needs to be paid full attention. I was very pleased that this was discussed, and carefully worded, in this report. It sends out a warning that some of these investors are not that sophisticated in gauging the risks of the instruments that they are buying, despite the fact that these are credit transfer risk-type instruments that are difficult to price and require a certain degree of sophistication on the part of investors. I was struck by the reference to mutual funds' engagement in this business and the fund of funds notion. For those who remember what happened in the 1960s, there was the debacle with the IOS with the funds. One cause for concern is when the smaller retail base is being tapped for investment in instruments they might not fully understand. So, the point was very well-taken, and Mr. Bischofberger probably has more to say on this, because I noticed not so long ago Minister Eichel wrote a piece on this very matter in the Financial Times, which was very interesting.

Finally, in Mr. Kelkar's statement, I noticed his reference to the possible relevance of the report in relation to the United Nations Conference on Financing for Development in Monterrey, Mexico, suggesting that the Managing Director write an amplified preface to the publication in that light. That might be a good idea. Perhaps, the Managing Director might consider that.

Mr. Daïri made the following statement:

I do not agree with Mr. Wijnholds's view that the primary focus of the report should remain on countries that pose risk on the stability of the international finance system, i.e., emerging market countries. It would be truncating the report and not giving it the right dimension. Financial stability does not depend only on the countries' policies, but also on how markets work. Box 3 on financial implication of Enron's bankruptcy points to the weaknesses in the functioning of markets and their supervision and the risks involved. The risks generated or unveiled by Enron's bankruptcy are much more significant worldwide than the crisis in Argentina or other emerging markets.

We have to maintain the comprehensiveness of the report, and, while I agree that the report is long, readers can choose what to read. I find the report rich and very interesting, and congratulate the staff for what they did.

Mr. Wijnholds took note of Mr. Daïri's point and clarified that he saw the potential problems in Japan and Europe and the U.S. external position as causes for concern. The report should focus on those aspects, but avoid being too descriptive about mature markets.

The Director of the International Capital Markets (ICM) Department (Mr. Häusler) made the following statement:

I would like to thank all the Directors for the many statements, which we take as an expression of your interest in the ICM's first report. We very much appreciate these comments. I am here supported by my deputy, Huang Tran, disguised by the fact that more people worked diligently on this report, and this table would not be large enough to hold all of them.

I would like to make a few general remarks and take up some of the issues that many Directors raised in their statements, and then, since there are more speakers to come, we could answer a few more detailed questions in the next round.

As Directors suggested, the preface should be expanded somewhat to provide in greater detail the rationale for the report for those who are not familiar with it.

Judging from the statements and oral comments from management, the staff, and the authorities who were kind enough to call me, there was quite a wide range of expectations, and thus different opinions on where the focus might be and should be. I find it quite natural to have a document that is lengthy on the one hand, but still does not cover all the grounds. Therefore, we need to think about the focus every time we do such an exercise. There were many suggestions for adding certain topics and, at the same time, making the report much shorter. We will try very hard to accommodate those suggestions as much as possible.

Let me emphasize that the idea was to combine the timeliness of reporting recent quarterly developments on the one hand, and to focus on some—maybe on one or two only—structural developments in financial markets that have a bearing on financial market stability, on the other hand. In this regard, the *Global Financial Stability Report* (*GFS Report*) is a successor product to the two predecessor products, which covered a time span of a quarter, and also covered some structural issues.

Timeliness, which is one of my main worries and concerns, is very difficult to achieve. This quarterly report, which covered the last quarter of 2001, will be published around mid-March, which is already the end of the next quarter. Timeliness is the issue, and some of the nuances may have changed, and sometimes it is not easy to get the balance of the risks right with the benefit of hindsight.

I take some consolation, however, on the choice of the topics from the fact that, yesterday, Stefan Ingves and I received the latest agenda for the next Financial Stability Forum's meeting, which would take place in Hong Kong, and the agenda include, in no particular order, Enron, Argentina, the Japanese banking system, and credit risk transfer mechanism, which may test the robustness of the system. All in all, we may not be totally off the mark here.

On the size of the report, we tried not to be comprehensive, but selective, and tried not to lose any messages in the report. Those who consider that the report should cover a particular topic need to be mindful that the staff is trying to be selective in what matters at a particular point in time to financial markets. Therefore, tough choices had to be made, and some areas had to be deleted deliberately. Also, there was a need for the report to be of general interest to the outside readership. While early warning systems may have been debated within the Fund a few times over the last couple of years, I think that the wider readership takes considerable interest in the issue, not recognizing the limitations of such early warning systems. There are some people not as well educated as those inside the Fund who may be expecting too much of early warning systems as they stand today.

This report is meant to be a financial market stability report. While the word “market” should have been added, it is already implicit, given the fact that it is produced by the International Capital Markets Department. It is, however, not a financial stability report in the macro sense of the overall financial stability. We define financial stability as private sector institutions collectively—as opposed to individually, which would be for the regulators—and infrastructure behind these private sector institutions, the reason being that, without their healthy risk appetite and their robust condition, capital flows to emerging market economies would suffer substantially.

On the other hand, there were quite a few comments and suggestions to include macroeconomic imbalances. But, as some Directors noted, the ICM Department deliberately did not want to duplicate the work on the *World Economic Outlook Report* of the Research Department, and thus refrained from any detailed discussion on such issues as the U.S. current account deficit and its implications for international financial markets. Going forward, the ICM Department will discuss that with the Research Department soon, and see where we can build on certain pieces of the world economic outlook and follow up from there.

While being a cause for concern, we felt strongly that the U.S. current account deficit does not pose serious short-term risks. It will matter later, but, in the short term, what matters are productivity and growth differentials. That issue has recently been discussed, and I would not be concerned that much about its short-term effects. It is a different matter over a medium-term time horizon.

Some Directors noted that the report does not focus on Europe to the same degree as the United States, and, as mentioned in the statements, that is a matter of the availability of data. Another reason is that developments in the European financial markets are rather trailing and following trends in the United States. Therefore, since this is a quarterly analysis, we felt the need to focus on the U.S. trends first.

I fully share the view expressed by Mr. Varela and other Directors that the introduction of the euro coins and notes was a historic event. However, for financial markets, especially the wholesale markets, the watershed had been in

1999, when the real introduction of the euro into financial markets had substantially changed the bond markets and, to a somewhat lesser, but significant, degree, the equity markets, which went from national markets to industrial sector-driven markets. The introduction of the physical coins and notes, in my mind, does not have the same implications for financial markets, although the general public may view this as more relevant.

As regards feature chapters going forward, a few interesting topics have been under consideration, including local domestic securities markets in emerging markets, which play a significant role in the interaction of capital flows. The *GFS Report* has been structured based on the expectation that a number of topics would be available for discussion for quite some time. But, at the same time, I am quite conscious of the constraint on resources, and we should think long and hard about the suggestion that we confine ourselves to a shorter report and perhaps to only one special feature rather than two in order not to make the report too long and stretch our staff resource.

We would also like to be focusing on issues that are critical for financial markets, and trying to be forward-looking and outspoken as much as Fund publications would allow. This is partly the purpose of the overview, which is deliberately meant to be the most policy-oriented part of the publication. The staff will take on board Mr. Wijnholds's and Mr. Varela's suggestion that one or two more conclusions from the main body be added in the overview. We thought we had done so to some degree, but we will have a second look.

Turning to some more specific comments, but still of a general nature, on Europe, while we have not discussed Europe comprehensively, some of the references in the overview to fragmented markets and the rigid cost base for financial institutions that may cause a problem at least for some institutions refer to European financial institutions, without mentioning them by name, for the reasons I just highlighted.

The report also discusses the Japanese banking system, but some Directors preferred a more forthright presentation. The first drafts are usually more outspoken. We are concerned about Japanese institutions, because they all, from a rating point of view, assume an explicit or implicit government guarantee. We plan to come back to the Japanese banking system either the next time or the time thereafter. Again, this is the question of where to focus on a particular quarter. The upside of the quarterly report is that the interval is not that long.

Mr. Zoccali and one or two other Directors mentioned the issue of FDI. The report already contains a small section on FDI, which is an issue that concerned us. Of the staff's concern are developments in Latin America—in particular those viewed by market participants as being under consideration in

Argentina at the moment—which may have a bearing on the general appetite for FDI in that region. However, we felt that it would be premature at this point in time to comment publicly on that, as this is all under consideration and may be outdated by the time of the publication.

To clarify the issue of Enron, the Enron remark is not about Enron as such, because this is an individual institution, which should not be scrutinized in the *GFS Report*. The discussion on Enron is about the general phenomenon of leveraged and possibly over-leveraged companies, particularly in the new economy, especially the TMT sectors. In that respect, Enron is a hybrid; it is, in a way, an old-fashioned institution, but it is also participating in the new economy, certainly, as to the trading part of it. Clearly, some of the over-leveraged companies have used creative accounting techniques to mask the lack of profitability, and hide the extent of its over-leveraging, which makes such institutions brutally exposed in a bear market. The issue is not about U.S. or any other national jurisdiction. Enron may have taken all this to the extreme, and we should be grateful to the U.S. authorities that they did not bail out Enron. Let me stress once again that this is about over-leveraged institutions in general around the world—wherever they may have appeared and may have been able to cover up their lack of profitability by creative accounting and the consequences of those activities.

Mr. Szczuka remarked that the presentation of the Enron case in the context of the credit risk transfer mechanism might have created some confusion, as the problems of Enron went beyond that of credit risk alone. Perhaps the Enron case was not a good example of credit risk.

The Director of the International Capital Markets Department (Mr. Häusler) responded that the masking of over-leveraging and projecting a company as having a higher profitability than what was actually the case by employing special purpose vehicles and other techniques were not unique to U.S. companies. Such practices were common among companies around the world, and were the two major characteristics of the credit risk transfer mechanism. The credit risk transfer mechanism was, therefore, relevant in the Enron case. It should be emphasized that the issue was not about Enron per se, as the Enron case concerned many more aspects than just this particular mechanism, which was only one of the mechanisms to hide the levels of financial loss and over-leveraging. The staff had considered it important to discuss the financial stability aspect, as the process of deleveraging by a large number of highly leveraged corporations around the world—which was inevitable in the period of an economic downturn—might entail a further weakening of some financial institutions and the international financial system as a whole.

With regard to the balance of risks, since the circulation of the report, there had been clear signs of a strengthened recovery of the economy in the United States and elsewhere, the Director continued. The staff was even more optimistic than it had previously been. At the same time, however, it had become clear that financial markets were, on a daily basis, scrutinizing and searching for highly leveraged balance sheets in the corporate sector that might have been dangerously exposed to the slowdown. The basis for their evaluation was slightly different from that applied in the bull market, and the cash flow aspect was an important consideration. Corporations that were potential candidates for over-indebtedness had to go to great lengths to demonstrate their accounting transparency, regardless of whether they were located in the United States, Europe, or elsewhere. Currently, they were operating without any regulation, and the first line of defense that the market was employing was increased transparency. The forces of market self-correction should not be underestimated, and a number of companies were currently under pressure to explain their position. In a nutshell, the report discussed Enron in a general sense of how to deal with highly leveraged companies.

Self-correction forces were also evident in the commercial paper market, the Directors related. As in the equity market, some highly leveraged companies had been downgraded in the commercial paper market, which was open only for best companies, and some had reacted violently. Some banks had to confront the reality that their backup lines that bore no adequate risk premium were suddenly being called upon against all odds. This tended to prompt large commercial banks to rethink their strategy about the pricing and the availability of these backup lines. Nevertheless, that would happen to only a small segment of companies that had been downgraded due to their over-leveraging.

Another market that would likely change in both scope and shape was the European retail market for emerging market investors, as pointed out by Mr. Padoan in his preliminary statement and by Mr. Wijnholds in his oral intervention, the Director observed. The report clearly noted the fact that many investors in Europe, particularly in Italy and Germany, had been under the impression, probably influenced by their advisors, that sovereign bonds, almost by definition, could not be restructured—a point also mentioned by Mr. Zoccali. The possibility of the Argentine debt restructuring, therefore, might come as a shock to some investors. Nevertheless, it was the issue of moral hazard that had to be addressed, as these retail investors locked in fairly high yields with significant risk premia, without assuming any real risk, because they never expected a debt restructuring to take place. This segment of the market might, therefore, be lost, but only initially. It might reemerge in disguise, as these retail investors might not invest directly in particular bonds in the future, but indirectly through mutual funds, which, in their view, were managed by professionals with better investment knowledge.

For most financial institutions, the first two months of the year 2002 had not been rewarding, the Director noted. Revenues had generally declined, while credit provisions had increased, which pointed to the fact that the credit cycle had lagged behind the business cycle by about two to three quarters. In that regard, following the upswing in the business cycle, the next few months might see a substantial increase in credit provisions.

Mr. Padoan said that he shared the Director of the ICM Department's view on the segmentation of the European bond markets. However, the encouraging comment by the Director of the ICM Department that markets in general were self-correcting through increased transparency seemed to convey a strong message. That message should be carefully worded and put in a proper context in the published report. His comment was not in line with the tone of the report, which noted the segmentation of markets and the inability of market players to discriminate, as well as discussed in some length the regulatory arbitrage and the Enron case.

Mr. Daïri made the following statement:

> Mr. Häusler's earlier comment on the U.S. current account deficit raises the issue of the time horizon of the report, particularly in assessing the risks to stability. If, as he said, the time horizon that is chosen is short-term, this should be spelled out more clearly in the report, and also with clear indication why the staff considers that there are no risks in the short term from the U.S. current account.
>
> Moreover, if this is the case, there is an issue with relevance of early warning systems used in the Fund because these have a 24-month time horizon. How can they be relevant in the whole stellar report, if we are talking about a report concentrating on a short-term period?

The Director of the International Capital Markets Department (Mr. Häusler) responded that, as the U.S. current account deficit had some short-term implications, the staff might feel the need to cover it in the next *GFS Report*. As regards the application of EWS to the United States, those models were not designed for such mature and large capital markets. Moreover, productivity growth in the United States had quite unique features, unsurpassed by any other mature markets.

The Chairman remarked that the U.S. current account deficit was of relevance to the discussion of the world economic outlook, thus warranting further consideration by the staff in that context. However, the first discussion on the *GFS Report* provided an opportunity to define the scope and themes of the report with a view to avoiding any overlap with the *World Economic Outlook*.

Mr. Daïri clarified that he had not suggested applying EWS models to the United States. Rather, he had compared the time horizon of the EWS with that of the *GFS Report*.

Mr. Palei said that he had expressed concern about the reduced scope of emerging market financing in the first *GFS Report*, compared to quarterly *Emerging Market Financing Reports*, which normally covered emerging market financing issues in both breadth and depth, especially for program countries. He wondered what the staff's intention was with respect to the coverage of emerging market financing issues in future *GFS Reports*, and whether the topic would be discussed in other Fund publications.

The Director of the International Capital Markets Department (Mr. Häusler) said that care had to be taken to strike the appropriate balance between the *WEO* and *GFS Reports*. Also, the staff had to reflect further on the coverage of emerging market financing issues in future *GFS Reports*. The staff was open to bilateral discussions with Directors regarding the details that should be included.

The Chairman noted that defining the scope of *GFS Reports* was important at this stage, as both the reports and the ICM Department as a whole were still in the process of determining the character and the scope of activity. The process had so far been smooth, but still in its early stages.

Mr. Jonas made the following statement:

> First, let me say a few words about the structure and content of the *Global Financial Stability Reports*. These reports will replace one of the Fund's flagship publications, the annual *International Capital Market Reports*. Those reports analyzed events from a wider perspective than the quarterly reports. Here, I can see a parallel with country surveillance. When programs are being monitored frequently, with bi-monthly or quarterly reviews, the focus is mainly on current developments, while annual Article IV reports usually give a broader picture of the situation. It is important for the *GFS Report* to combine both elements. The staff must avoid focusing too closely on recent developments while missing the big picture and the longer-term trends.
>
> Some Directors have commented on the regional coverage of the report. I do not think that it is necessary for every report to attempt to cover every region. This is not its purpose. I think the report's main focus should be on the countries, regions, and markets that pose potential risks to global financial stability, or on important developments having significant implications for the international financial system, such as new regulatory developments, new trends in the financial markets, and the like.
>
> The *GFS Report* should also be more forward-looking. Of course, the Fund's main forward-looking publication is the *WEO*. But, I think that there could be a useful synergy between the *WEO* and the *GFS Report*. The *WEO* produces balance-of-payments projections, including projections of the external financing needs of country groups. The *GFS Report* should provide updated information on market conditions permitting a comparison with the *WEO*'s projections of external financing requirements. In short, the report should update us on countries' borrowing needs and the prospects that the markets will be able to satisfy them. For example, exactly one year ago the *Emerging Market Financing Report* contained a very useful table showing the emerging markets' sovereign financing needs for 2001. Such tables should be a standard part of these reports. Such an approach would also be useful for keeping track of the potential need for official financial assistance as well.
>
> As for the size of the report, I think the staff should be quite flexible. The size should depend on how much there is to report about developments in

global financial systems. There should be certain constant element, plus some topical chapters addressing in depth some interesting issues related to Fund surveillance.

Now I will comment briefly on some issues raised in the report. The first is the puzzling discrepancy between the expectation of a rapid, strong recovery implied by asset prices on the one hand and market projections of earnings growth on the other. It is unclear to me how we should interpret this discrepancy or what it implies. One possibility is that the markets share the optimistic view of the present business cycle, which is that the overcapacity after the boom period will quickly disappear because of the short life of hi-tech investments. A second possibility, mentioned by Mr. Zoccali, is that the buoyancy of the equity markets reflects low interest rates and ample liquidity. Obviously, these two alternative explanations have different implications for global economic prospects. If equity market prices are mainly driven by ample liquidity, they could respond negatively when the cycle of monetary tightening begins. Of course, the effect of the expected recovery cannot be entirely separated from the effect of easy liquidity, since monetary easing is a major driving force of the recovery. But, if liquidity is the dominant effect on the stock market, equity prices could fall even as the recovery picks up speed.

We know that the equity markets have a history of correctly predicting economic recoveries, and that economic recoveries have been preceded by market turnarounds. But at least once we have also seen, in the spring of 2001, the equity market predicting an economic recovery that didn’t happen, and it makes me wonder how many other false starts there may have been. The recovery’s strength is another issue. The staff states that in the past, equity markets have correctly predicted the turning points of business cycles. But have they also correctly predicted the strength of the recovery?

I have one comment on emerging market financing. It is satisfying to note that the access of emerging markets to market financing is still reasonably strong, but as I said in the beginning, our discussion of this issue would be much better grounded if we had information about the projected financing needs of the emerging markets. Given the expected global recovery, and the strong liquidity position of asset managers, the prospects for energy markets should continue to improve, absent any further negative shocks and if stability-oriented, growth-supporting policies are in place. But one country is clearly an exception to positive picture—Argentina. The staff describes how Argentina’s weight in the EMBI+ index has fallen from about 25 percent to 2.6 percent. The implication is that investors that follow this benchmark no longer have to invest in Argentine bonds. Moreover, Argentina may have lost, for long if not forever, its European and Japanese retail investors. Under these circumstances I wonder how hard it would be for Argentina to return to the international capital markets? Of course an important factor will be the way the debt rescheduling will be handled. But Argentina's loss of its base of retail investors and its very low weight in the EMBI+ index could complicate things even further. I wonder if Mr. Häusler wants to speculate about how long it would take for Argentina to return to the capital markets. The experience of Russia and other countries that defaulted on sovereign debt is not very encouraging. Russia plans to return to eurobond market until 2002, four years after the credit event. And it has been doing extremely well during those four years!

On the early warning system models, I wish to comment on the concern expressed by several Directors that false signals send by these models could cause the Fund to give wrong policy advice. I think their concern is exaggerated. The EWS models do not tell us whether or not a crisis is going to happen, they only tell us how the probability of a crisis is changing. I cannot see how these models could lead economic policy in the wrong direction. For example, if foreign reserves decline, the Fund would advise a tightening of monetary policy. It is difficult to see how this could be the wrong advice, unless the cause of the reserve decline has been misunderstood. It is another question how the changing probability of a crisis affects the intensity of the policy response, but this ultimately depends on the judgment of the policymakers.

I also have a comment on developments in the credit risk transfer market. The staff suggests that these instruments could improve the efficiency and stability of the credit market, but simultaneously expressed doubts that these instruments can actually improve the efficiency of credit allocation. And many Directors have emphasized that these instruments may pose new risks and challenges to the international financial system. I think that at this stage the sensible approach would be to continue closely monitoring developments in this market, in order eventually to form an informed policy conclusion as to whether regulatory action is required or not.

And finally, I will comment on the alternative financial instruments. It is obvious that these instruments have both advantages and drawbacks. The potential shortcomings of collateralized borrowing seem particularly serious, for three reasons. First, it may undermine the will to pursue appropriate policies and thus erode the quality of the unsecured debt. Second, it may create a negative externality, by creating pressure for other sovereign borrowers to follow similar practices. And third, it reduces the private sector's exposure to sovereign risk, conflicting with the effort to increase the private sector's involvement in crisis resolution. In addition, as stressed by Mr. Zoccali, alternative financial instruments are unlikely to dramatically alter the basic dilemma facing the emerging market countries, namely whether they should borrow in foreign currency and be exposed to exchange rate risk, or borrowing short term in domestic currency and be exposed to liquidity risk.

Mr. Tombini made the following statement:

At the outset, let me thank the staff for this very comprehensive and well-focused report on Global Financial Stability. The report strikes an appropriate balance between the more optimistic view, which to some extent is being priced in mature capital markets, and the attendant downside risks, which are still present in the path towards global economic recovery.

I broadly agree with the staff's view presented in Chapter II, regarding the recent developments in international capital markets. In particular, I share the view that the current anticipation of advanced economies' recovery, implicit to some extent in financial markets, suggests, rather than a fast recovery, a sentiment that the recovery could be stronger than initially expected. The current global macroeconomic environment, with its still significant imbalances, introduced a number of uncertainties making it all the more difficult for market players to assess the effects of the policy easing of the late part of last year. In addition, the view of a stronger-than-expected recovery in the months to come is supported by a number of initial conditions in effect today, when compared to those prevailing in the 1990/91 recession. In particular, the more robust macroeconomic framework in advanced economies, with low inflation and stronger fiscal positions, the overall sounder banking systems, and the long-term effects of the previous technology investment boom, give us hope that the recovery, when it comes, could be stronger than initially expected.

In spite of this growing optimism, there are still substantial downside risks, as the staff recognizes. New channels of transmission and increasing responsiveness of households and corporate behavior to developments in financial markets in general, and in equity markets, in particular, are areas of potential risks in the way towards global recovery. Also, the lack of sufficient real sector evidence regarding an early recovery in advanced economies, highlights the risks expressed by the staff of unrealized market expectations, with its subsequent feedbacks on market developments, and, thus, on consumer and business confidence. This process could delay or, in the extreme, impair the recovery process. In this respect, the staff points out, supported by historical evidence, that industrial production and corporate earnings need to turn around in the first quarter, otherwise there is the risk of yet another market correction some time soon.

Considering the most recent market developments and real sector data released after February 8, the cutoff date of the report, does the staff see any grounds for a market reassessment of the expected timing and intensity of economic turnaround?

In addition to the risks portrayed in the alternative scenario of a subdued or delayed recovery short of market expectations, I believe that the potential implications of a turnaround to the ever-growing home financing market in the United States have been somewhat overlooked. Supported by the longest economic expansion in the U.S. history, and, in 2001, by aggressive monetary easing, together with active refinancing activity, this market has shown remarkable resilience, offsetting some of the negative impacts of equity price corrections and growing unemployment last year. Looking ahead, does the staff see any risks of an unpleasant correction in housing prices, if the alternative scenario were to materialize?

Regarding emerging market developments, the results were mixed in 2001. The emerging markets bond market provided evidence of modest contagion from the events in Turkey and Argentina. The more consistent macroeconomic frameworks with stronger fiscal positions and increasing reliance on floating exchange rates in many countries have strengthened the resilience of these economies to confront the deterioration in the global and regional environments in 2001. In addition, swift policy adjustments in major emerging markets and the international support channeled through the Fund, contributed to limit the degree of contagion in 2001. Technical factors in capital markets, such as the relative importance of dedicated investors and low leverage in the system, together with the lack of surprise around the major emerging market events, supported the low contagion observed. Looking ahead, however, I see with some apprehension the virtual closing of the European and Japanese markets for sovereign bond issues, after the Argentine's default and, in the case of Japan, after Enron's collapse. I will appreciate further comments from the staff on the prospects for the reopening of those markets in 2002.

Moreover, the recent evolution of total private capital flows to emerging markets has been quite disappointing. The only segment that shows some resilience is foreign direct investment, which has held steadily at US$163 billion, in 2001. Looking forward, I am not too convinced that FDI flows should be substantially affected by lighter M&A and privatization activity. Given its importance, I would appreciate a more comprehensive coverage of FDI in the next *Global Financial Stability Report*.

I found particularly interesting and relevant the overview presented in Chapter III of the market for credit risk transfers and its implication for global financial stability. I do share most of the concerns expressed in the report, regarding the low transparency and frictions that characterize these new instruments, making it highly complex to assess the transmission of shocks in financial markets. I believe this issue is not only important for a clearer understanding of the complexities of financial linkages in mature markets and sovereign bond markets, but also for the development of domestic credit markets in emerging economies. A number of emerging countries have searched for new ways, including credit derivatives, to foster their domestic credit markets, which for instance, in the case of Brazil, is characterized by very low leverage and high spreads between lending and borrowing rates. Regarding these credit derivative instruments, I have a couple of questions for the staff:

First, despite being treated under the same category of "credit risk transfer instruments", does the staff see any difference between the more traditional instruments of debt credit securitization, such as collateralized debt obligations (CDOs) and credit default swaps in terms of their potential impacts for credit market development, pricing and risk sharing?

Second, does the staff consider appropriate to treat these off-balance sheet instruments in a way that they do not imply higher capital requirements for depository institutions when they are the originators of the credit? My view is that at the end-of-the-day, if the counter party is not able to honor its payment or litigates, the bank will ultimately step in and bear the loss, avoiding a negative impact on its franchise value.

Finally, let me make some comments on Early Warning Systems (EWS) and their use in surveillance exercises by the Fund. This chair sees the effort to make this instrument a more reliable tool in crisis prevention as a necessary and welcome step. In this respect, the incorporation of forward-looking asset prices in the process of improving the EWS seems promising.

Nevertheless, given the current state of the art, as indicated by the comprehensive analysis of Chapter IV, our chair is particularly uncomfortable with a more intense use of this tool in surveillance. The high incidence of false alarms and missed crises does not provide the necessary assurances for this instrument to have a more prominent role, other than to complement other surveillance tools. It is particularly worrying that, at this stage of development, a number of Article IV reports have incorporated the results of EWS in assessing countries' vulnerabilities. It is understandable, however, that the application of EWS be a part of the confidential bilateral dialogue between the Fund and country authorities. Moreover, before substantial progress is made in increasing the reliability of such instruments, we see little benefit from extending, other than from a research perspective, the coverage of EWS to other areas such as debt and banking.

Like Mr. Shaalan, I am not convinced by the staff's contention that a false alarm may not necessarily be bad if it signals real risks, and, therefore, ensues policy adjustments. The argument supposes two unverifiable conditions: first, that there would have been a real crisis; and second, that the country authorities were convinced to take corrective action. Only if these two strong ex-ante conditions were met, the high degree of false alarm observed ex-post could be interpreted as not so harmful. I will appreciate a clarification of footnote 5 of Chapter IV.

At last, let me join other Directors in supporting the consolidation of the two previous reports into the Global Financial Stability Reports. I see this new approach as an opportunity to improve the understanding of the interactions between developments in mature markets and emerging market countries.

Mr. Bischofberger made the following statement:

Like other speakers, I very much welcome the first quarterly *Global Financial Stability Report*. We appreciate the decision to end the artificial distinction between the discussion of *International Capital Markets* and *Emerging Capital Markets Reports* by merging the two separate reports into one. The report correctly focuses on systemic issues of contemporary relevance. In addition, a quarterly assessment is appropriate to follow more closely fast moving trends on capital markets. We also welcome the fact that this report will be made available to the broader public. We are aware, however, that, given the very nature of financial markets, it may be difficult at times to frankly address potential risks and vulnerabilities at an early stage without thereby triggering adverse reactions. From our point of view, the report strikes the right balance in this respect. But, striking this balance properly will be an ongoing challenge. This point has been mentioned earlier in today's discussion.

We are confident that this report will soon develop into one of the Fund's flagship publications, complementing the *WEO* in a suitable way, and reflecting the Fund's mandate and growing expertise in capital market issues. However, for this to be achieved there is some scope for improving the format of the report. A lengthy quarterly report, supplemented with selected issues, absorbs not only a considerable amount of staff resources. At the same time the important policy implications may not come out clearly enough. In that sense, less could be more. Therefore, I join those Directors who are in favor of a somewhat shorter, more focused report. With respect to improving the format of the report, I concur broadly with the proposals made by Mr. Wijnholds. To be more specific, with regard to selective issues, I would recommend more selectivity and inclusion of a chapter in the report only if there is a close relation with the current analytical part of the report. In any case, it might be advisable to limit the number of selective issues to one chapter in each report. In order to make the analytical part of the report more prominent, it might also be considered to put the selective issue part in an annex. I welcome Mr. Häusler's earlier remarks in that respect. Having argued for a shorter and more focused report, like others, I would, nevertheless, have welcomed a more complete coverage of European markets.

Regarding the substance of the report, we broadly concur with the staff's analysis and assessment. Therefore, I will confine myself to a few comments only:

We share the view that the banking system might encounter difficult times if the global economic recovery will be slow. In this respect, it is important to bear in mind that the impact of an economic downturn on the business sector is usually delayed. Typically, not until three quarters after the low point in a business cycle has been passed, do problems in the business sector reach their peak, with all associated consequences for the financial sector. This view is supported by recent reports that the commercial paper market in the United States has declined dramatically over the past months and that more bank credit lines have being activated. Therefore, the resilience of the financial system as a whole and the robustness of individual financial firms might be tested even in the case that the positive growth scenario implied by market expectations is going to materialize soon.

On the discussion of the financial system in Japan, we agree with almost all of staff's findings. However, we do not fully understand the staff's conclusion that risks of international spillover may have declined. Concerns about major bankruptcies and the planned withdrawal of the blanket deposit insurance have already caused negative impacts on confidence of market participants, which is reflected in the steep decline in bank stock prices. Given the fact that Japan has accumulated huge amounts of foreign assets, a withdrawal of these funds from abroad may have major repercussions on the European, U.S., and other financial markets, particularly because in such an event the possibility of an additional reallocation of capital from Europe to the United States cannot be ruled out. I would welcome the staff's comments on this issue.

Finally, with regard to the staff's comment on page 31 on rising debts burden in Europe in the context of the slower growth scenario, I would like to point out that the underlying figures published by the OECD are somewhat misleading for statistical reasons, since they overstate household debt in relation to disposable personal income in Germany. In order not to draw too heavily on our joint time budget I would suggest that I discuss this issue with the staff on a bilateral basis.

With these remarks I would encourage the staff to keep up the good work.

Mr. Boitreaud made the following statement:

Let me first thank the staff for this first *Global Financial Stability Report* and let me welcome this new publication at a time when every word written by the IMF on financial stability is supposed to draw a lot of attention. Given the high expectations we had on this report, there was a high risk of getting disappointed: it is not the case. However, like others we could probably live with a shorter report. If it is not the case, we believe, like Mr. Callaghan, that we should focus on the main vulnerabilities we identify and on the particular messages we would like to send, given the quarterly periodicity.

So far, as stressed in the report, the latest events have, once again, demonstrated the resilience of the international financial markets to major shocks, either largely anticipated, like in Argentina, or unexpected, like the Enron bankruptcy. The limited financial contagion, which is all the more striking in a context of global slowdown, should however be treated with some caution.

Indeed, the jury is still out and, if market contagion is apparently subdued, it does not mean that both the Argentinean and the Enron crises won't have lasting effects that could impact durably the functioning of the international markets. I see, for example, three different channels of transmission to the sort of "delayed contagion" identified by Messrs. Padoan and Lombardi that should be analyzed thoroughly:

The first channel of transmission concerns the use of the Argentinean crisis as a new opportunity to denounce the IMF's bitter potions or the use of the Enron failure to criticize the work on standards. In this context, by sending too optimistic a message on the ability of financial markets to withstand the Argentinean crisis, we should be careful not to validate the thesis that "The IMF left Argentina alone at the worst times."

Second, the concomitance of bad news coming from Argentina, Venezuela or Colombia, for different reasons, despite the good discrimination we have observed so far, could eventually impact capital flows to Latin America.

Third, Argentina was one of the most attractive destinations for FDI flows and there is a risk that the crisis may have an impact both on the volume and the geographical repartition of FDI flows to emerging markets.

Furthermore, if markets have weathered rather well the latest developments, we have to recognize that there is a multiplication of bankruptcies or scandals like Enron or Allfirst/Allied Irish bank which are undermining confidence in financial markets. Clearly, doubts are mounting on accounting and reporting practices which could have lasting effects and which weigh on highly indebted companies.

Like the staff, we believe that the good health of the financial sector has greatly helped the relatively smooth absorption of the recent crisis. However, the situation in this context is uneven and the staff expresses concerns with regards the situation of the Japanese and other countries' financial sectors vis-à-vis their American counterpart.

Here we believe that the analysis could benefit from more balanced views.

We fully share staff concerns on the Japanese financial sector but it remains difficult to assess what are the risks. We believe that the Global financial stability report could in the future devote more attention to the international consequences of the restructuring of the banking sector in Japan and to adverse developments in Japanese financial markets.

In Europe, the financial integration process is proceeding smoothly and according to the baseline scenario identified by the staff, it would be unlikely that major problems occur in financial markets. Like Mr. Callaghan, we note that the concerns expressed in the overview on the situation in the banking sector apart from Japan and the United States are not very developed in Chapter III, leaving some ambiguity on the exact message we send.

However, even in such a benign scenario, the staff explains that the situation in the Japanese financial sector could worsen considerably while markets may have overestimated the strength of the recovery in the United States. For us, it means that in a context of global recovery, vulnerabilities in the developed markets could be found first in Japan and second, to a lesser extent, in the United States. Of course, in such a situation Europe would also be negatively impacted.

Let me finally say a few words on the evolution of the credit derivatives market. I found the staff's presentation very interesting and very instructive. Although older instruments like securitization could prove useful in that regard, it remains indeed difficult to assess the risks associated with the newest credit derivatives instruments. True, this part of the market has been very dynamic in recent years, partly due to a very classical process of financial innovation trying to circumvent regulations, but also largely due to a need for optimizing portfolios. We share the staff's views that these transactions add to the complexity of the system and that there is a risk that they could reduce its transparency. However, the same argumentation was used a few years ago for other types of instruments and despite some spectacular losses, financial derivatives are now commonly used. The staff rightly states that exposure to credit derivatives appears to be non negligible with regard to the credit risks associated with other derivatives, however this exposure appears to be far less impressive considering the total amount of banking credits. This being said, like Mr. Jonas and several other Directors, we share the staff's views that there is a need to monitor closely the evolution of this market, in particular to avoid too high a level of concentration of the risks. On the regulatory side, we associate ourselves with Messrs. Padoan and Lombardi on the need for further discussions on the two issues they have underlined in their preliminary statement. Finally, at the outset of today's discussion, Mr. Wijnholds had a valid point on the need to remain vigilant vis-à-vis the development of hedge funds and the increasing participation of retail investors in that market.

Mr. Scholar made the following statement:

May I first thank the staff for this report, which we found very useful and very interesting. We strongly welcome the decision to bring together the *International Capital Markets Report* and *Emerging Market Financing Report*, not least because financial markets under consideration are essential to the whole work of the IMF. Inevitably, some the issues covered here also feature elsewhere, but we certainly found it very useful to have all of these topics brought together in a single place to give a real market focus.

We also like the decision to combine an overview of the short-term conjuncture with a thematic treatment of some important structural issues, and we hope that, over time, this will build up into a real library of Fund opinions on these important issues. We also felt that, in this particular publication, the topics chosen were both important and topical, and the fact that derivatives issues are to be discussed at the Financial Stability Forum is an indication of that.

As other Directors have said, it would be quite useful, in some cases, to draw out more fully the policy implications of some of the issues discussed, although this is perhaps not the place for the fullest treatment of policy recommendations. In the issue-specific chapters, it might be helpful to add a short paragraph at the top, putting the issue in the context of the conjunction and drawing out its relevance to the current debate, as well as pointing to some of the policy implications, even if this is not necessarily the place to treat them in detail.

On structure, many Directors have made suggestions as to how the report could be structured. We all have our own views as to how anything should be written. I will not add to those other than to simply say that, as far as length goes, I share Mr. Jonas's view, which is that a report should be as long as it needs to be in order to discuss the topics that need to discuss. This is the first of these reports, and there is quite a lot of ground to cover since its predecessors' last appearance. Thus, we had no serious concern about that, and we also recognize that this is something we will see over time.

I would just like to comment briefly in a fairly general way on the main issues covered. We will let the staff have some technical comments on some issues bilaterally. On the treatment of the conjuncture and the implications for stability, we found ourselves in the overall message that markets proffered resilient, but there is no place at all for complacency.

In terms of coverage, since this is a report on stability and risks, it is important for the sake of balance to have a degree of comprehensiveness, although the focus needs not be on the markets where there is the greatest risk. In the interest of comprehensiveness, we felt that a fuller treatment of Europe might have been helpful, and also found ourselves in agreement with others on Japan. There is quite a lot of material there, and it might be useful to bring it together. I was grateful for Mr. Häusler's comment earlier that this is something that the report will come back to in the future.

One area where there is a slight difference of view is on credit derivatives. The report is quite right to bring out the need for vigilance over the use of these instruments and spell out the possible risks that they may bring. Nevertheless, I share Mr. Boitreaud's view that this is reflective of another discussion earlier on derivatives instruments, and we felt that the presentation in the report slightly overplayed the risks and underplayed the potential benefits. In our view, principal derivatives can be a very good tool. They could help spread risks between economic agents in cross-section countries by unbundling credit risks from the other levels. This is one way of meeting investor needs and enhancing cost effectiveness. A well-functioning market could hopefully improve the credit risk, and by diversifying credit portfolios, this ought to reduce the vulnerability of the system as a whole to particular credit shocks.

It is difficult at this stage to assess to what extent the market has achieved this, partly because there is obviously no counterfactual against which to compare it, and partly because the market, though growing fast, is still very small. In the United States, based on last year's figures, credit risk measured one percent of commercial banks' and trust companies' total notional derivatives. It is a small exposure, but one that could grow and become an important one. There have been episodes that suggest that useful role is already coming into play. For example, the market in the case of Xerox and Pacific Gas and Electricity did provide some valuable liquidity when the bond market was not able to do so during the sharp decline of the company's creditworthiness. There is some evidence of that in the wake of September 11 when activity in the bond market was severely curtailed.

Finally, I think the report does overdo the argument that the market has not been untested, because we have seen some quite big tests in recent months, Pacific Gas, as I mention, Railtrack, Swissair, Sabina, and, of course, Enron, and Argentina. These are tests that the markets have gone through, and fairly smoothly. Thus, we thought that perhaps a stronger case could be made for financial innovation.

In that case, policymakers need to be alert to appropriate degrees of regulation and disclosure requirements, and would want to examine the role of regulatory arbitrage, how risk is dispersed or concentrated and what will authorities need to do about that, as well as how the possible risk can best be monitored. Mr. Mozhin in his statement made an interesting point on emerging market. This is largely a question of tone, but it is quite an important one.

Finally, the early warning system was interesting, both to us and to people outside the Fund. It would be quite important to guide people and us to how these instruments are treated in the Fund, and thus a paragraph at the beginning of the section would be helpful, so that they are not given undue prominence. Early warning systems could be used as indicators as long as they are objective, if we do not think that objective means accurate. One of the useful things of EWS is that they are mechanical, providing useful information. But, just as in the formulation of monetary policy, while a wide range of indicators is examined, there is no substitute in the end for judgment, and that is really what surveillance is. I am sure that the Fund will continue to exercise that judgment.

Mr. Ismael made the following statement:

Let me first of all say that we view this paper in the context of the continued efforts of management and the staff to improve our understanding of international capital markets. As such, the paper contains a wealth of information. It covers a wide range of issues and provides useful analysis of developments in the global financial markets.

However, before commenting on the issues raised in the paper, I would like to associate myself with the comments made by Mr. Bennett and Mr. Callaghan on the presentation of the paper, which I did find as lacking focus, and looked more like a collection of papers put together. Except for chapters 2 and 3, it is not clear how the rest of the paper fit with our Surveillance exercise. Moreover, I also note that there was some hesitancy to tread on areas that are considered more the purview of the *WEO*. Mr. Callaghan has made a number of recommendations for improvement and I agree with them. I also agree with Mr. Rustomjee's suggestion that future reports should also cover developments in other developing countries.

Turning to some of the issues in the paper, I would like to say that I agree with the staff that in a context of deteriorating financial conditions, the international financial system (IFS) has shown remarkable resiliency. Indeed, despite the September 11 events, the financial crisis in Turkey, the default by Argentina, the bankruptcy of Enron and the onset of the recession in the United States, financial markets ended the year 2001 on a positive note. However, the overall situation remains fragile and development prospects of the IFS depend much on a quick recovery of the global economy.

On mature financial markets, I note that equity and bond markets recovered from their low levels of late September 2001, and that in the foreign exchange markets, the U.S. dollar strengthened, while the yen and the euro weakened against the dollar.

The staff report provides different views on the impact of the turnaround in global markets on the expectations of recovery in the global economy. The optimistic view points is that the performance of the equity markets, in particular, that of the telecom, media, and technology stems from changes in fundamentals and has created conditions for profit growth in this sector. The pessimistic view argues that the recovery in this sector depends on the recovery in other sectors. However, it is not clear from the staff paper what role macroeconomic policies have played in the recovery of global financial markets. Staff comments will be appreciated.

While I welcome the indications that global economy is expected to recover around mid-year, I share the staff's view that uncertainties and risks exist that may hamper the international financial stability. Renewed declines in equity prices and deterioration in credit quality that might occur during a weaker than expected global recovery could weaken balance sheets of corporations, households, and financial institutions. A subdued recovery would put pressure on many banks' profitability. The complexity of instruments and transactions is another source of risk. In addition, the Enron case and the risks associated with credit derivatives may put significant threat on the stability of the financial and capital markets.

The bankruptcy of Enron, which is well described in the paper, has also brought to light the weaknesses of accounting and auditing systems, as well as the inadequate oversight of financial activities of non-financial corporations. As has been noted by other Directors, these raise questions about the responsibility of the private financial sector to ensure market integrity. There is a need to look at those issues, especially in the context of our efforts to promote private sector involvement. Moreover, as noted by Mr. Mozhin and Mr. Palei this case casts a shadow on the role of international auditing firms, and should also make the Fund be more careful in the choice of accounting firms to carry audits, generally in program countries. It will be important that we take steps to guarantee best practices.

On emerging markets, as pointed out in the staff report, the most striking feature of recent developments is the absence of any significant contagion from the Argentina crisis. Nevertheless, I share the view that the risk of contagion has not disappeared completely. As emphasized, the foreign exchange markets and the foreign direct investment flows to emerging markets are two important channels through which financial crisis in Argentina may affect other countries. However, the magnitude of such risk is unknown. In addition, reading the report raises other questions, such as: what is the time required for analyst to assume that noncontagion is no longer a concern? What are the critical signals or indicators that reveal that the risk of contagion is completely dissipated?

Finally, on the Early Warning System, during our last discussion on this issue, we noted that the models were still imperfect and could not be relied upon to assess potential crises, although we agree that it can be useful as one of the many instruments being used to assess crisis situation. I agree with Directors who have noted the high propensity of the models to give false alarms, and I share the view that work should continue so as to improve the models.

Ms. Lundsager made the following statement:

We welcome this discussion on the first edition of the *Global Financial Stability Report*. The staff has put together an ambitious document, maybe too ambitious. Going forward, we would agree with Mr. Bennett's suggestion that the staff prepare a much more concise report that we recommend focuses on financial flows, innovations in financial markets, and implications, particularly for emerging markets. This would help address what I thought was a useful overall view presented by Mr. Varela that the report should be viewed as contributing both to our surveillance and crisis prevention responsibilities.

Overall, the report demonstrates that global markets have dealt with various shocks quite well. Economic recovery seems likely this year in many major industrial countries. In emerging markets, bond spreads have fallen and net financial flows have picked up again in recent months. Contagion effects remain subdued, so far.

Recent Developments

Turning to the first sections of the report, we concur with Mr. Padoan that the economic situation in the United States receives too much attention, particularly relative to Japan and even Europe. Once again, the impression from reading this document is that the recovery in the global economy depends on the United States, implying that everyone else is off the hook for contributing to global demand. The analysis of the United States, and to a lesser extent Europe, points to the disconnect between the markets' upbeat assessments of the prospects for recovery this year relative to forecasters' more cautious assessments. While this is relevant to our discussion here, we would suggest that growth-related and current account analysis remain centered in the *World Economic Outlook*.

Turning to Japan, any list of potential dangers to world financial stability should perhaps start with Japan, a point highlighted by

Mr. Wijnholds. The second largest economy is entering its sixth year of negative or marginal growth, with no relief in sight. The banking sector continues to be face asset-quality and bad debt problems, with nonperforming loans mounting rapidly. Mr. Wijnholds listed the many problems, so I will not repeat them. But the report notes on page 35 that the international spillover from this may have declined as the Japanese banks' loan portfolios have contracted every year as they have reduced their overseas operations. This presentation implies that this is a good result when I would argue this is quite a negative result for emerging market finance.

Turning to emerging markets, the report indicates that flows of bond financing, syndicated loans, equity investments and FDI held up well during the last months of 2001 considering the shocks from September 11 and Argentina. Again, like Mr. Callaghan, we emphasize that this reflects well on the ability of the authorities in these countries to take steps to strengthen their economies in recent years, particularly in financial sectors. It also reflects the shift to flexible exchange rates among many emerging markets. This increasing acceptance of responsibility on the part of policy makers in emerging markets will serve them well, given the many risks highlighted in this report.

We view the analysis of capital flows to emerging markets as a key part of this report. Going forward, we would encourage additional analytical work in this area, including on FDI, a point made by Mr. Varela and Mr. Mozhin. If the IMF could provide better advice on how to attract and retain FDI, we could make a major contribution to putting finance on a sounder long-term basis. The last section of the report on alternative financial instruments also includes information that is complementary to the section on flows to emerging markets. Perhaps this could be combined into a unified presentation.

Financial Market Stability Implications

The report includes a lengthy discussion on credit risk transfer vehicles. In general, we found some of the conclusions of this section to be unbalanced, including the discussion on highly leveraged institutions. As Mr. Scholar noted, the report highlights the risks while seemingly downplaying the benefits, or the power of markets or creditors to exert some discipline. And, as Mr. Häusler noted, there is some market self-correction occurring.

We also thought the discussion of Enron was somewhat one-dimensional. Enron's bankruptcy raises concerns about the application of specific accounting rules and pension fund regulations, and it reinforces the need for transparency in corporate governance. Our authorities are moving quickly to evaluate these concerns. This case also demonstrates that large firms are allowed to fail in the United States, without the benefit of government bailouts. More important, Enron's bankruptcy does not appear to have had a systemic impact on U.S. markets. Thus, we were surprised to find, in the second sentence of the report, that Enron's bankruptcy is listed in the same category as the September 11 attacks, the crisis in Turkey, and the default in Argentina. Finally, the report leaves the impression that this is only a U.S. issue, but corporate balance sheets can be equally or even more opaque in other parts of the world.

Alternative Financial Instruments

Turning to the section on alternative financial instruments, we would emphasize that country authorities need to pay close attention to the information that bond spreads provide about investors' views of their countries' creditworthiness. In particular, countries need to guard against the temptation to assume that high spreads are due to contagion or temporary factors that can be mitigated by using alternative financial instruments. If high spreads reflect investors' concerns about solvency, then additional debt, even using alternative instruments, could exacerbate these concerns. Countries would be better served to reduce their borrowing needs, and this reinforces the point I made earlier about the welcome policy strengthening in many EM economies and the IMF priority that should be placed on spreading those positive developments in our crisis prevention efforts.

As the staff notes, some of the instruments, such as step up bonds or certain warrants, increase the flexibility of debt, make debt service more counter-cyclical and can help achieve a voluntary bailing in of the private sector. Others can be procyclical. We need to think about ways that the official sector, and specifically the IMF, can encourage countries to use counter-cyclical instruments and avoid less flexible or pro-cyclical instruments.

Early Warning Systems

Finally, a few words on early warning systems. The discussion on EWS demonstrates the benefits and limitations of these systems. Given the ongoing innovations in financial markets, EWS will need to continue to evolve to take into account new information available from financial market instruments.

We have some questions about the methodologies used in this paper. It is unclear, for example, whether the explanatory variables—such as a low level of reserves—are seen as causes of vulnerability or symptoms of vulnerability.

In addition, the definition of the dependent variable—the 'crisis'—is key to the exercise, and we support the suggestion that we expand crisis definition to other types of problems, including, of course, debt crises. I should add that I agree with Mr. Padoan's point on crisis prevention—even a false positive can be good if it stimulates policy changes that result in no crisis.

Conclusion

In conclusion, we thank the staff for pulling together a substantial amount of work. Some of this, such as on EWS, could be done in separate papers as some suggested, but I think it useful to get more information out on the Fund's EWS approach, recognizing, of course, that a summary of the recent conference is on the website, I would leave it in. Going forward, we think it will be more user-friendly if the report is shorter and focused on specific topical issues in financial markets. In this regard, I was glad to hear Mr. Häusler say earlier that a future report will focus on developments in domestic capital markets in emerging market members. Finally, as others are doing, we will also provide some specific technical comments on the report directly to the staff.

Mr. Wei made the following statement:

At the outset, I would like to express my thanks and congratulations to Mr. Häusler and his staff for their very insightful and informative report which shows the strengthened work of the Fund in an increasingly important field. I also appreciate the scope of this research, appropriately defined as "global financial stability". This definition seems to be able to encompass all the relevant aspects—international capital flows, the international capital market, the international financial system, and international financial regulation. Management should be commended for their tremendous efforts in expanding and strengthening the Fund's ability in this direction. In the meantime, I share the concerns of other Directors that it would be better if the report were more focused on the most eminent issues that are critical to the stability of financial markets. In this regard, I share Mr. Häusler's idea that only one special topic will be included in future issues. I would like to focus my comments on *Recent Developments in International Capital Markets* and *Stability Implications of Global Financial Market Conditions*. Some brief comments will also be given to the Early Warning System Models and Alternative Financial Instruments.

On *Recent Developments in International Capital Markets,* the report shows that on balance the international financial system is in a more favorable position to deal with a slowdown, and even in the situation of a subdued or delayed recovery compared with the situation in the early 1990s. I tend to agree with this general evaluation and share a cautious optimism on the current trend of recovery. Part of my cautiousness comes from the fact that a key methodology used in predicting the recovery is the correlation between the equity price and the industrial production and corporate earnings. Although it looks convincing for the given sampling cases, the time horizon underlying this analysis was nevertheless relatively short—from 1970 to 1984. The study of such a correlation is also confined to the United States, although it is the most important one. In order to obtain a more robust conclusion, in future research I would encourage using a longer time series data set and include more economies. In general, we encourage the staff to give more coverage to emerging market economies and European countries in their future issues.

Another aspect where the report needs to be strengthened is in the analysis of the possible evolution of the foreign exchange market. I would suggest that more analysis be given to important issues—the trend of the three major currencies and the impact of their fluctuation on global financial stability, particularly the policy implications in the context of the Fund's bilateral and multilateral surveillance.

On the S*tability Implication of Global Financial Market Conditions*, like many other Directors, I share the view that the Japanese authorities are encouraged to make further efforts in strengthening their financial system. We find that the gap between the implied earnings growth rate and its historical average in Japan is much higher than that in the United States and in Europe. If this gap leads to a further significant decline in Japan's equity market, the financial system will be under tremendous pressure. Thus, the Japanese authorities are encouraged to carry out decisive structural reforms in the banking and corporate sectors. This, in turn, will help the recovery of their economy, which will have a great impact on Asian countries. In this regard, I share Mr. Callaghan's comments in his preliminary statement.

The wealth effect of the equity price deserves further analysis. Up to now, consumer confidence in the United States seems to have been little affected by the reduction in market capitalization of US$1.2 trillion. Is it possible for the wealth effect to change in cases of a subdued or delayed recovery? Staff comments are welcome.

On the issues of foreign direct investment to emerging markets, the staff made the judgment that net FDI flows are expected to fall further. The staff gave two main reasons for this forecast. One of them is the high cost of equity capital in EMEs will hinder privatization related FDI inflows. I am wondering whether the staff could elaborate a little more on this. Is this a general phenomenon for all EMEs? It seems to me that FDI to EMEs should gradually increase as the global economy is recovering although at a slow pace.

The analysis of the development of the Credit Risk Transfer Vehicles (CRTV) is pioneering and informative. I agree with the staff that the development of CRTV will help market participants to manage the risks and make the capital allocation more efficient. Further improvements in the relevant infrastructure and an increase in CRTV's transparency are necessary. An important issue associated with this market development is how the regulatory framework should evolve? It would be appreciated if some comparative analysis on the evolution of the financial supervision system in major developed countries could be conducted in the future.

On the case of Enron's collapse, we find Box 3.1 very useful. In this regard, we share the views of Mr. Kelkar and others that there is an urgency for industrialized countries to examine their regulatory systems, especially the accounting rules.

On the Early Warning System (EWS), the summary review in the report will certainly help the advancement of further research. It would be very helpful if the Fund could continue to strengthen its technical assistance to developing countries, especially those of systemic importance, in developing their own EWS. An enhanced exchange of information between the EWS in the Fund and EWS in the member countries will facilitate a more effective prediction of any possible financial crises. In this regard, I fully share Mr. Kelkar's view that there is no substitute for prudent macroeconomic policies and management on the part of the national authorities. On the issue of the false alarm, I share Mr. Shaalan's comments in his preliminary statement.

On "Alternative Financial Instruments and Access to Capital Markets", the conclusion that augmentations and warrants can potentially provide emerging market borrowers with access to capital markets without posing significant costs could be valuable for policymakers in many emerging market economies. While I would like to stress the importance of increasing ODA from developed countries, international financial institutions are called upon to play their due roles through providing timely financial assistance to developing countries in need.

With these comments, I am sure that the quality of the report will be enhanced in its future issues.

Mr. Szczuka made the following statement:

I would like to state my position on some issues and associate myself with some of the earlier speakers.

As I understand and indicated, this is work in progress. The Board is not here to criticize the staff's product, but rather to provide some friendly advice on how to structure this product for the future, because we understand that this is not yet a mature product but still developing and could benefit from some improvements.

On the structure of the report, I would associate myself, to a large extent, with the comments made by Mr. Callaghan and the Canadian chair. The report would benefit from being shortened and better focused, as well as having the conclusions, as Mr. Wijnholds indicated, brought more forward and made more prominent in the report. I share the particular comment that Chapters IV and V do not seem to be well connected to the rest of the report. I think that the other candidates for the topics that Mr. Häusler indicated should be critical for global financial stability. Compared to the issues of early warning system and alternative financial instruments, other issues, such as the financial sector situation in Japan, the U.S. current account deficit and household debt problems, the regulatory challenges arising from the derivatives market, and other market developments would be more relevant and better connected to the main body, and thus should not be treated as special issues.

I also have the impression that the report is struggling on how to delineate its contents—including in terms of geography—from other products like the *WEO*. The other struggle is related to the macroeconomic aspect. Even though Mr. Häusler indicated that there is no intention to focus on macroeconomic analysis, there is some macroeconomic analysis provided anyway, for example, the statement that a delay to the recovery is the most prominent risk. In the technical discussion on market developments, there was also a mixture of macroeconomic and technical aspects of market operations. They are not always very well segregated or linked, depending on the needs.

I also agree with Mr. Kelkar on the coverage of the primary and secondary markets, and on the data provision. Even though the report contains some visual information, there is no table or figure in the text on the volume or structure of issuance in those markets—FDI, syndicated loans, bonds, and so on. I think such a table would be useful.

I also agree with Mr. Varela that Chapter III largely consists of two parts. One is this question of the possible delay in recovery, and the other is the issue of credit risk transfer mechanism—an essay-typed study on creditors. We do not know how important a risk is for global financial stability at this stage. This chapter could be broken down into two chapters, as they represent two separate risks to global financial stability.

Mr. Daïri was right that the time horizon is also important. The staff should have a firm decision as to what type of time horizon it wishes to cover. More coverage of FDI and developments in the emerging markets would be useful.

One of the issues that are not probably sufficiently covered is exchange rate developments. The report only has three sentences on this point, and one graph referring only to three currencies. I am not sure if this amounts to the full coverage of this very important aspect of international financial markets and macroeconomics.

Briefly on some issues raised in the main body of the report, first on the developments in the mature market and emerging market economies, I think that Chapter II could present more prominently the interaction between the two segments of the market, in particular, of course, the impact of developments in mature markets on emerging or developing markets. Also, risks to developments in the U.S. market and other developing markets are slightly underplayed.

I found it very interesting the description of different developments in the three segments of primary markets—the dollar, euro, and yen—and the indication that these markets have been shut down for emerging market issuers. Differences in secondary markets are more pronounced. The secondary market for dollar instruments is different from that for yen instruments. I wonder if the euro market is actually close, as Turkey or Moscow was able to place its paper on this market, and as recently as yesterday, my country also managed to place a bond of 750 million euro, at the spread of about 75 basis points over the equivalent German paper. While this suggests some deterioration in that respect, it is not a dramatic deterioration. Moreover, there was somewhat less demand than was usually the case, but clearly the market was open for emerging market borrowers.

On Chapter III, there are more risks than the two issues we discussed. First, on the risk of a delayed or weaker recovery, we do not know how to assess that risk. The report is not assessing whether this risk may materialize or not, but is focused on the possible channels that could affect markets. While that may probably be the right topic, some assessment of the risk of a delayed recovery could be useful. Here, we have a slightly less optimistic view. There are some questions about this recovery—whether it would be economic, and what exactly are the risks, one of which is, of course, the U.S. current account deficit and its consequences.

One relevant aspect is exchange rate developments—the dollar exchange rate. If the dollar were to strengthen, what would be the implications for the U.S. current account in particular? Another question is the level of household and corporate debts and risks stemming from that. Again, I would welcome staff comments as to whether the large-scale refinancing of mortgages in the United States has somehow protected at least U.S. households from the risk of interest rate increases, and, if this is the case, who would be exposed to such a risk. Moreover, the other potential risk that could also be discussed is the Japanese financial sector. I share the comments made by other Directors that we should not downplay the spillover risk coming from the possible problems in the Japanese financial sector, because this translates not only directly into credit provisioning of the Japanese banks, but also to the demand for U.S. papers, through strong and broad links, which should be carefully considered.

In the political area, the staff was not willing to discuss it, but if anything happens on the global political scene, especially with its impact on oil prices, there is clearly a major risk for emerging markets. I fully agree with Ms. Lundsager that the first focus should probably be the Japanese market, and, Ms. Lundsager may disagree, the second should be the U.S. market.

There was also no discussion of the possible risk that may result from emerging markets—Argentina, which is one that has materialized.

We cannot exclude the development in Russia, which is now the best performing market, and that should at least be noted in the report. Data on that are available, but there is no comment on whether this is a positive or risky development. Some assessment of how to look at this situation should be made, because the three countries—Russia, Mexico, and Brazil—constitute about 65 percent of the emerging market bond index; such a concentration warrants a careful examination of any possible developments that may have an impact on the emerging market situation as a whole.

Finally on risks, there are risks arising from the corporate sector and their impact on the financial sector should be studied more extensively and carefully. Enron is just an example. There are also K-Mart and other relatively large-scale bankruptcies. A default of $31 million in January was quite alarming. We have an indication that J.P. Morgan is one of the banks experiencing some problems linked to problems in the corporate sector. There may be more banks or financial institutions that are exposed to those risks.

The next issue I would like to address briefly is the risk transfer mechanism. I share, to a large extent, the comments made by the U.K., U.S., and French chairs that this should be presented in a more balanced view. While the extent of the risks is not known, developments in these derivatives markets point to their potential. This reminds me of the general discussion on derivatives. The markets have been expanding for some time, and nothing dramatic has happened, despite the warning that they could collapse any time. Thus, there is not enough proof to put this topic in the same prominent place as other risks coming from the slow economic recovery in Chapter III.

There are, however, some worrying factors, such as the high degree of concentration in the U.S. financial market, where two banks account for 60-65 percent of those derivatives instruments. That statement applies to the banking and the insurance markets; it is not a widespread problem. Nevertheless, those two sectors are the net providers and net buyers, and thus they are exposed to each other, and should be analyzed from this perspective.

On Enron, I am still not convinced that Enron is really the issue. It is not strongly affected by this particular development, but more of an accounting and transparency problem, as noted by Ms. Lundsager. This has an important implication for the Fund's work on standards and Reports on the Observance of Standards and Codes. We should not be discouraged by this failure. Our aim should continue to encourage emerging or developing markets to aspire to these standards, because their markets are not more complicated than mature markets.

On EWS, like Mr. Callaghan, we may have the impression that EWS is the Fund's major tool of ensuring stability. Of course, this is not the case. Clearly, EWS is not a perfect instrument, and a reference should be made to this effect. At the same time, the Fund should continue its work on improving its EWS models, and the refinements could include short-term interest rates, which was one of the options contemplated by the staff, and stock market prices, which are also readily available. Also, as contemplated by the staff, it would be useful to consider the links between banking and foreign exchange crises, and some technical instruments, such as options and swaps.

Finally, on the last chapter, I do not think that it is well connected to the main body of the report. This is clearly not the development that is critical for the stability of the global financial system or global financial markets, at least not at this stage. It is more an issue suitable for a debt management paper or private sector involvement paper. Also, the use of those alternative instruments have been quite limited, as shown by the table in the report—except for augmentations, which are not really new or alternative instruments, but are existing debt issues that are expanded. The use of augmentations has expanded in recent years, and my country was also making use of that. Collateralized instruments, which are the second largest of those instruments, are also not new. There are risks involved in a number of debt instruments that are relatively new, which the paper could stress.

In conclusion, I think that the report provides a lot of useful information, but we should continue our work on trying to make it more focused.

Mr. Low made the following statement:

Firstly, I want to join others in thanking the staff for the report, which contains a wealth of information. As Mr. Häusler said, it is a question of what to leave in and what to take out. But, the report would benefit more from drawing clearly the conclusions and policy implications that the international community should take into consideration. In that regard, I find it a bit strange to have conclusions or concluding remarks in Chapters IV and V, but nothing on Chapters II and III. I wonder whether it would be useful to have similar concluding remarks in those chapters. It may not be constrained to one paragraph, but probably a page, to draw the main issues that are highlighted in the report.

On the focus of the report, I share Mr. Callaghan's comments on Chapters IV and V, and the general remarks made by Ms. Lundsager. Chapters IV and V could be taken separately.

In terms of the focus of the report, as the title of the report is *Global Financial Stability Report*, we are looking at financial market stability, which should remain a focus of the report. Also, just like the *WEO*, which discusses the world economic outlook, the *GFS Report* should have some forward-looking elements to it, in particular, an assessment of stability or financial markets on a global scale. That does not mean, however, that the report should look at it in a broad perspective without looking at individual financial markets where there are potential hot spots that could be identified. Also, as reiterated by Ms. Lundsager, an analysis of capital flows is important, because we have seen how sharp reversals of huge capital flows could cause problems in many economies.

The main message of the report appears to be that financial markets are more resilient nowadays. Although it seems to be more resilient, there are potential risks. What are those risks that we should watch out for? Thus, having a conclusion or some kind of summary of the main points would be useful.

On the coverage of the various markets, I agree with Mr. Wijnholds that we should not discuss in detail large mature markets on which information is already available in abundance. What is important is to analyze the interlinkages between these major markets and emerging markets and developing countries, which seem to be missing in the current report. We all recognize that the major markets drive emerging markets and markets in developing countries, as can be seen clearly in stock market prices in many countries.

On the issue of contagion, many Directors noted that the Fund should be cautious not to dismiss it too lightly. I am afraid that the staff is only focusing on Argentina, pointing out that the risk of contagion has been largely contained because markets have enough time to adjust and to divest out of Argentina. We should not confine our analysis of contagion to experience in Argentina alone. I do not want to identify any particular country, but the risk of contagion is normally heightened when it comes as a shock, and we have seen that quite clearly during the Asian crisis. Thus, let us not discount it too much.

Others have mentioned Enron, and I take Mr. Häusler's point that the report is not discussing any specific institution. However, I do not see how experience in the Enron case is different from that of LTCM or many high profile failures in the past where companies have engaged in financial derivatives they are not familiar with. The implications will be important.

On the early warning system, I think that the topic merits a separate discussion, and I will not comment on that here. Perhaps, a separate paper for that would be useful.

Finally, I would like to comment on one remark in the staff paper on page 22 where the report indicates, "Asian players remain skeptical about prospects for a U.S.-led global recovery, with creditworthy borrowers expressing little demand for investment capital, and new borrowing primarily related to balance sheet restructuring or consolidation." While I recognize that it is probably not the intention of the staff, this statement seems to have a negative tone in the sense that Asian players are not borrowing enough. I think that they have learned the experience of overleveraging in the past. So, while the prospects for a U.S.-led global recovery is not certain, it is probably wise for them to hold back on excessive borrowing now. Thus, I am not sure what the intention of this statement was, and some clarification on it may be necessary.

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

Developments in financial markets that occurred in the last quarter of 2001 seem to suggest that market participants' long term expectations for economic growth and inflation were eventually unaffected by the terrorist attacks. These attacks had a significant, but short-lived impact on market participants' expectations and sentiment, thus creating the so-called V-shaped blip in financial assets prices. At the same time, investors became somewhat more optimistic about a possible of recovery in the U.S. and euro area economies in 2002. Uncertainties about the prospects for an upturn in corporate profits seem to affect this cautious optimism about the likelihood of stronger economic growth.

Turning to the effects of the financial market developments on the economy, I broadly agree with the views in the report, namely, that the domestic and international links between financial conditions and the real economy have probably increased over the last few years. In the euro area, however, this effect has been more moderate than in the United States. Also, the relatively heavier weight of the banking sector in Europe means that the soundness of banks is comparatively of higher importance for the monetary policy transmission process than in the United States, where capital market conditions are of greater relevance.

In the euro area, financial conditions for banks have deteriorated in recent months but the sector seems to be in a stronger position than in the early 1990s. Specifically, the flow of credits has clearly declined over the last few months, but it does not seem to have been substantially curtailed. On the less positive side, the "un-bundling" of debt burdens by firms and consumers after a long period of loan growth could moderate growth prospects in the euro area. In addition, the less optimistic prospects for the telecommunication sector in the euro area are also likely to have an impact on the balance sheets of those large European banks that have heavily invested in this sector over the last two years.

Against this background, I largely agree with the baseline scenario presented by the IMF in this report. At the same time, it cannot be completely ruled out that a delayed recovery in economic activity might occur in line with a further decline in credit growth.

Turning to emerging market economies (EMEs), net overall inflows are expected to pick up this year after falling in 2001, due in part to outflows from Turkey and Argentina, and increased risk aversion following the events of 11 September 2001. This risk aversion has gradually abated and interest in emerging markets is returning. The attractiveness of emerging markets is dependent on improved growth prospects - which in turn depend on prospects for G7 economies—the perception of relative stability and an absence of contagion from Argentina. EMEs are currently benefiting from expectations of a sooner-than-expected recovery in the United States, as well as low interest rates and sluggish equity markets in the United States. Returns on emerging market investments are strong excluding Argentina from which most other EMEs appear to have de-linked.

The report notes correctly that euro-denominated issuance was markedly lower than U.S. dollar-denominated issuance for emerging markets in 2001, mainly as a result of a less sophisticated investor base in the European Union (i.e., "buy and hold" retail investors) compared with the United States (i.e., institutional investors using state-of-the-art portfolio management). However, across all issuers, the relative importance of euro-denominated bonds increased in 2001.

In Latin America, we continue to monitor developments in Argentina very closely. Implications for the euro area are mainly limited to the impact on euro area parent banks of Argentine subsidiaries and, to a lesser extent, retail level holders of Argentine sovereign debt. The most exposed banks have made large provisions against their equity investments.

While financial spillover to date appears largely limited to Uruguay, more crucial aspect of contagion center on the precedent that may be set by Argentine's handling of its debt restructuring, as well as the amended bankruptcy law, which carry potential repercussions for portfolio and foreign direct investment inflows into the emerging market asset class. Secondly, there is market concern over the policy implications of Argentina's response to its difficulties for other emerging markets, in particular, the potential rise of tendencies away from openness to trade, privatization and deregulation. In this context, FDI inflows into emerging markets may be at risk.

As for the credit risk transfer instruments, these issues are important in the context of the euro area financial sector. European institutions have also actively used risk transfer instruments to diversify their credit risk positions. The market is also diversifying in Europe beyond transactions designed to restructure banks' balance sheets and has witnessed a number of new market participants, including insurance companies. Some concerns have been raised in Europe about the ability of relatively small insurance companies to withstand the exposures shifted onto them from major banks.

Also in Europe, there have been concerns that recent events would show flaws in the market's underlying legal infrastructure. However, according to the International Swaps and Derivatives Association (ISDA), the documentation is proving robust, and sellers of credit protection are generally meeting their obligations.

As for the Early Warning System (EWS) models, Chapter IV provides a compelling argument that they can indeed provide a valuable tool for policy-makers to measure economic vulnerability and anticipate financial crises. Such models have been improved over the past few years and have become a useful tool in pointing towards potential crises. One should emphasize that, as also the report notes, EWS models cannot of course replace the sound judgment of policy-makers and their institutions, but they can play an important complementary role as an unbiased and objective reference.

Chapter IV makes a convincing argument of how EWS models can be further developed and improved in the future. We can agree to most of what is mentioned in this part of the report.

Let me add four points and remarks on Chapter IV. First, it may be of particular importance to emphasize the relevance of contagion. Most EWS models to-date still ignore the relevance and central importance of contagion in the dynamics of financial crises. Even though difficult to measure, a stronger effort to better account for the contagion element would seem promising in the future.

> Second, it remains unclear whether an increased monitoring of financial market instruments will improve EWS models of financial crises. A number of financial crises, including the Asian crisis, came as a surprise also for most market participants. Hence financial instruments, such as forward contracts and option prices, may often give only too short a lead time for policy-makers to take meaningful action to avert crises.
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> Third, and more fundamentally, it should be emphasized that EWS models are based on economic relationships of past financial crises. However, past crises may not resemble closely the type of crises we may see in the future. The changing nature of crises (i.e., currency crises, banking crises or sovereign debt crises) should make existing EWS models less reliable and may require adjusting EWS models so as to take into account a changed nature of crises.
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> Fourth and finally, there is a further very relevant way for improving EWS models, which has not been discussed in Chapter IV of the report. EWS models are currently still based on relatively simple econometric models, which may not be adequate to capture the rich dynamics of financial crises. In the future, EWS models may benefit substantially from employing different and newer methodologies. For instance, EWS models could be improved by employing forecasting techniques that have already been used successfully in other areas of economic modeling, such as business cycle forecasting.

The Director of the International Capital Markets (ICM) Department (Mr. Häusler) said that he wished to thank Ms. Lundsager for pointing out that the ICM was the smallest department in the Fund. Notwithstanding the size, the staff of the ICM Department was able to work very closely with all the area departments in the Fund. The staff had compiled a list of countries where the department was currently active in advising the authorities on various capital market issues. The list included about 20 countries, some of which were quite prominent and required considerable attention, while some were less time-consuming. Since the establishment of the ICM Department, the staff had been cognizant of the importance of working on operational and practical issues, which was regarded as an important benchmark.

On policy recommendations and conclusions, the staff would take on board Directors' suggestions that the report include conclusions either upfront or at the end of each chapter, and that the staff be more outspoken in terms of policy recommendations, the Director said. At the same time, however, the Fund needed to exercise caution in drawing policy recommendations, as it would be impossible to comment on every financial market issue. The report normally had a disclaimer that it did not necessarily reflect the views of the Fund, which would allow the staff to express candid opinions to a certain degree. The original draft of the report had contained strong language on some issues, but it had been polished in the process.

With regard to the time horizon, an issue raised by Mr. Daïri and picked up by a few others, the report could not have a single time horizon, the Director explained. The time horizon for some areas was fairly short, such as the latest quarterly data on primary market issuance, as requested by some Directors. Some issues, such as FDI, the U.S. current account deficit, and the credit risk transfer mechanism, were more structural in nature and spanned over a longer time horizon. In the future, the staff would try to strike a more appropriate balance between presenting issues that were recent and timely and complementing them with issues of a longer-term structural nature that merited attention from the international financial stability perspective. The latter might include FDI, the Japanese financial system, and the participation of nonbank financial institutions and nonfinancial institutions in financial markets and regulatory arbitrage associated with them. It remained unclear whether the Fund was in a position to suggest policy recommendations on some of those areas or other institutions should play that role.

Without any reservation, the staff would attempt to discuss in greater detail linkages among financial markets, the Director asserted. That should be the focus of *GFS Reports*. Specifically on the Japanese financial system, the issue had not been highlighted in the current report, as the Japanese financial system, particularly the banking sector, had become more and more insulated over the past years. That might not be an encouraging development, but, from the narrow perspective of vulnerability, it had the positive effect of reducing the vulnerability of the non-Japanese financial system, as the spillover effects through the interbank market and other segments of financial markets had become less pronounced compared with the situation in the recent past.

In response to Mr. Bischofberger’s observation that the report had not mentioned the potential repatriation of Japanese financial assets from other countries, the Director said that the staff, after consultation with financial markets participants, had come to the conclusion that, over the time horizon under consideration, such a development was not a relevant threat, as Japanese institutions would not be able to invest the repatriated financial assets in the domestic market that would yield satisfactory returns. If their aim were to offset bad assets or nonperforming loans, it would be more practical for them to continue investing in assets that would yield significant returns. At present, Japanese institutions were caught in this trap and had to take the exchange-rate risk. Therefore, the staff had decided to mention only a few sentences on the Japanese banking sector without going into detail in order to keep the report short and succinct. The issue of the Japanese banking system would be visited again in the future.

On credit derivatives markets, the staff focused on potential weaknesses and threats, while taking for granted the substantial benefits of credit derivatives, including, among other things, the diversification of credit risks among investors, as pointed out by some Directors, the Director acknowledged. The report highlighted the other side of the coin—the transfer of risks to sectors that were less supervised and less transparent. The staff would revise the report to make it more balanced in terms of benefits and risks.

Regarding Argentina and emerging market access to international capital markets, the Director noted the importance of differentiating among emerging market issuers, asset classes, and types of investors. Some emerging markets, largely investment grade issuers, had been able to access euro-denominated markets. Differences also had to be made between institutional investors and retail investors. While Croatia could tap institutional investors, Turkey, benefiting from the large Turkish population in other European countries, had been able to tap some of those retail investors as well. At present, issuance by non-Latin American borrowers was more attractive to European investors than Latin American issuers. In making investment decisions, retail investors normally considered the face value of bond issues rather than the net present value reduction that might result from debt restructuring, the full effect of which had yet to be seen. As regards the question of how soon Argentina could regain market access, it would not be realistic to expect a quick turnaround but a hiatus, and the authorities should remain cautious. That assessment, nonetheless, was highly speculative. The outcome would depend on further developments in the debt restructuring process, in particular on how the authorities would deal with their direct investors.

The present discussion on sovereign debt restructuring mechanism (SDRM) had had no impact on emerging market financing so far, as evidenced by the tightening of spreads, the Director observed. Markets expected that progress on SDRM would be slow, as it would likely involve legal changes.

On Mr. Wijnholds's question regarding the refinancing of U.S. mortgages in 2001 and its impact on interest rate sensitivities through changing the maturity structure of household loans, no data had been available to substantiate whether such a relationship existed, and the staff had not been in a position to speculate on that, the Director concluded.

The Deputy Director of the International Capital Markets Department (Mr. Tran) made the following statement:

> I would like to address several more specific technical issues raised in the preliminary statements and during the discussion. First, several Directors raised the question of whether the analysis in Chapter II on the gap between financial market pricing and expectations of economic activity should be extended to Europe and Japan. The problem is the unavailability of data on corporate earnings in many cases, since earning is an important factor in this analysis. Most companies outside the United States would report earnings on an annual or semi-annual basis, compared with the quarterly frequency in the United States. Thus, that is one of the reasons why Box 2.1 is focusing only on U.S. experience.
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> However, in terms of the potential gap between the expectations of financial markets and the eventual outturn of the economy, one of the charts on forward price-earnings ratios shows that the German DAX is higher than the U.S. S&P 500. In other words, the analysis of the U.S. and German markets, to a large degree, can be taken over to apply to the case of Europe as well.
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> The next question is whether the influence of financial variables on economic activity in the EU is comparable to that in the United States. The

staff's judgment is that it is less, as the ratio of financial assets to households in Europe is smaller than that in the United States.

Mr. Jonas asked whether equity markets have correctly predicted the strength of the upcoming recovery, and not only the turning points of the business cycle. To our knowledge, the anticipation of equity markets reflects the turning point rather than the strength of the subsequent recovery. The second issue is to what extent equity markets in particular anticipate growth and recovery, and to what extent ample liquidity also plays a role. The staff's view would be a little bit of both, particularly with respect to the role of liquidity in the stabilization of capital flows into emerging market assets.

Mr. Wei raised the issue of the wealth effect on the recovery prospects. I would like to take this opportunity to say that the upcoming *WEO* will contain an excellent chapter on that, and that particular issue is expected to be well covered there.

Several Directors mentioned that, in the context of emerging market financing activities, more information, particularly a table on capital flows and debt issuance, comparing what has been done with the financing needs, would be useful. We concur with that view, and we will try to include that in future issues.

The next set of issues concerning recent developments and risks related to the dichotomy between bank loans and mutual funds that invest in emerging market asset class. Going forward, we do see some potential for that dichotomy, to the extent that banks in general had a very bad year last year and, as Mr. Häusler mentioned, they have not done so well so far this year either. In particular, European banks, which, at this point, have the highest degree of exposure to emerging markets, are, in our view, even more pressurized in terms of profitability and the strength of their balance sheets and could face the situation similar to that faced by Japanese banks earlier. If faced with financial problems, particularly in terms of profitability, the first reaction of banks is to retreat from commitments in higher risk markets, which, in this case, include emerging markets. On the side of mutual funds, however, dedicated emerging market mutual funds had a very good year last year—three consecutive years in terms of overall performance. Most of the funds have, in the course of 2001, taken action to lighten up on their Argentina's bond holdings; so, by and large, they performed well. They have attracted far more inflow into their funds this year, and that will remain a steady source of funds for emerging market bonds.

As regards Mr. Alosaimi's comment about the emerging dichotomy between bank lending and bond financing, there was no evidence that syndicated loan spreads and high-yield bond spreads had moved in opposite directions. Rather, both had been on a downward trend, reflecting, as noted in the report, the lack of contagion and ample liquidity in mutual funds investing in other markets outside of Argentina. Therefore, the behavior of banks and that of the bond market appeared to be consistent.

The staff concurs with Mr. Shaalan's view that Venezuela should be regarded more as a source of contagion rather than a recipient of contagion, and we highlight that in the paper. The pair-wise correlations between Argentina and Venezuela are high, but both face problems specific to their own countries.

Mr. Zoccali asked the staff to explain the meaning of "speculative investors and the street "front-running" the eventual change in dedicated investors' portfolio allocations." When brokers/dealers sense that their major clients are about to sell one asset class, or one set of securities, to another, as part of their market-making activity—due to the fact that they have to carry large inventory of securities to fulfill this market-making role—they usually make their own trading decisions on the basis of this information, and if it happened in front of the actual orders placed by the clients, it is called "front running." Clearly, there is a limit to what they could do.

On stability implications of global financial market conditions, there are several sets of issues raised by Directors. First, what is the implication for overall stability resulting from the increased concentration of risk in the hands of a relatively small number of specialized institutions? The situation is rather complicated in that, on the one hand, there is clearly a concentration of risk in a few major banks due to the process of financial industry consolidation, but that entails the risk of two counterparties. On the other hand, credit risk has to be diffused widely beyond the banks through credit risk transfer vehicles, thus spreading risks associated with counterparties more widely outside the banking system. If one of them failed to perform, the impact on the remaining counterparties would be sizable, and that is the subject that the staff intends to look into in the future as well.

Regulatory incentives under which protection sellers operate in this credit risk transfer environment, by and large, are regarded as regulatory arbitrage, as one set of players—banks—are subject to capital adequacy requirements, while the other set of players—insurance companies and nonfinancial players—are not subject to the same degree of capital requirement. Therefore, the process of arbitrage takes its costs and this is what we have seen. The staff has raised this issue as something that ought to be examined in greater detail, and the national authorities, either singly or together, will have to come to grips with that somehow. The staff feels that it is not in a position to suggest what kind of regulation is needed.

Mr. Kelkar asked about the evolving standardization of contracts in the credit derivatives market, similar to that in other markets. The answer to that is, yes, such standardized contracts are beginning to evolve, but one has to keep in mind that credit derivatives are much more difficult and complex than the benchmarks like treasury yields or LIBOR rates for interest rate derivative contracts.

The staff does not have any information on the size of the net creditor positions of various Japanese sectors in the overall context of the deterioration of the financial imbalances in Japan. If we could find any useful information to shed some light on this issue, we will try to do so in the future.

Turning on to the set of specific issues related to the early warning system, first of all, we concur with Directors' comment and would like to reiterate the point that EWS is only one of several inputs currently used in the Fund. It is used in a more comprehensive assessment of country vulnerabilities. It is done on a quarterly basis, and the output of the whole exercise has been treated very confidentially and on a very limited basis. Thus, Directors' concerns about whether or not it is unduly used and about its confidentiality have been observed.

On the question of whether false alarms are good or bad, I believe that is part of the objective of the exercise, that is, to highlight potential vulnerabilities, and that has led to discussions between the staff and the authorities concerned. It serves a useful purpose. Of course, it should not be used in a mechanic way, as mentioned by some Directors.

Ms. Lundsager raised a methodological question of whether net international reserves are seen as a cause or a symptom of vulnerability. It could be a little bit of both. It is used as an independent variable in EWS models—both of the Fund and of investment houses—particularly the first generation models looking at foreign exchange market crises. But, on the other hand, when it comes to the definition of a crisis or a foreign exchange market pressure index, net reserves appear in a different form, that is, as a percentage change showing the intensity of a crisis. I personally do not think that the treatment of this variable is satisfactory, and, therefore, the staff will look into it further to see if there is a better way to address the issue.

On alternative financial instruments, we note with interest the intriguing remark by Ms. Lundsager about pro-cyclical versus counter-cyclical instruments. That is a very useful concept to have in mind, and we will try to explore that further.

The Chairman said that Directors might recall that, at the meeting in Prague, he had made a call for the Fund to be center of excellence in the promotion of international financial stability. It might take some time for that vision to come true. Nevertheless, the first *GFS Report* and the responses by the Director and staff of the ICM Department had proved a remarkable step forward, which was indeed encouraging, and more could be contributed by all Fund staff toward the realization of that goal.

As suggested by many Directors, *GFS Reports* should be even more forward-looking, and articulate in terms of conclusions and policy implications or even recommendations, the Chairman agreed. At the same time, however, it should be acknowledged that the staff had staked its reputation on this product, which was open to more criticism than previous reports, as it touched on issues of market interests and policy implications. Difficulty and controversy notwithstanding, the staff was encouraged to continue its work in that direction.

It was agreed that the report, with appropriate revisions, would be published on the Fund's external web site, the Chairman concluded. However, it was not proposed that the Chairman' concluding remarks be published, as much of the current discussion had been on the format of the first *Global Financial Stability Report* and subsequent ones, and thus should not be put in the public domain. Also, it would be useful to assess public reaction to the first report before deciding whether concluding remarks of Board discussions on the *GFS Report* should be published in the future. Eventually, as normally practiced, concluding remarks should be published along with the report. This publication issue would be revisited in the next Board discussion of the *GFS Report*.

The Chairman made the following concluding remarks:

> Executive Directors have had a fruitful and wide-ranging discussion on the inaugural edition of the *Global Financial Stability Report* which, upon publication, will become an important tool in strengthening the IMF's multilateral surveillance of international financial markets, and helping the Fund in looking forward and in drawing policy implications that support its role in promoting international financial stability and preventing crises. The planned quarterly frequency of the report should enable the Board to keep up with fast-changing events in financial markets. Also, combining the two previous publications, *International Capital Markets Report* and *Emerging Market Financing*, into a single document should eventually result in a focused and more integrated surveillance of international capital markets. Directors have made many useful and constructive suggestions for improving the structure, focus, coverage, and format of the report, which the staff will reflect upon and take into consideration in revising this report and preparing future issues.
>
> Directors welcomed the recovery in global markets and reduction in global risk aversion since the fourth quarter of 2001. They noted the remarkable turnaround in market sentiment regarding the strength and speed of U.S.-led global economic recovery. Overall, Directors concluded that financial markets have responded well to the uncertainties that arose in the context of the slowdown and the events of September 11, and recovered quickly once it became clear that economic prospects remained strong.

Directors noted that, so far in 2002, mature equity markets have shown lackluster performance, reflecting widespread concerns about accounting problems, which, among other things, reduced transparency on the true extent of leveraging undertaken by corporations and financial institutions during the boom years.

In emerging markets, Directors agreed that contagion from the default and devaluation in Argentina has been subdued. More careful discrimination by investors across emerging markets, a variety of technical factors, and the adoption of sound economic policies—such as the move to more flexible exchange rates, higher official reserves, lower short-term debt, and stronger current account positions—contributed to the resilience of emerging markets during the fourth quarter of 2001 and beyond. However, it was recognized that risks remain, given that events in Argentina are still unfolding and that there is significant uncertainty going forward. Contagion might become evident with some delay in the form of slower capital flows, including foreign direct investment, to some emerging markets. Furthermore, Directors observed that any unexpected changes in the global risk environment or the global economic outlook could have an adverse impact on emerging market borrowers.

While the international financial system has remained resilient in the face of serious disruptions, global financial conditions worsened during 2001 across a broad range of markets, institutions, and sectors. Deteriorating credit quality and corporate earnings were reflected in higher corporate bond spreads and lower stock prices. These price adjustments adversely affected the balance sheets of corporations and households, which had increasingly relied on markets during the 1990s, adding to the pressure from cumulated financial imbalances. The slowdown has also affected financial institutions, although the systemically important institutions in the United States and Europe seem to be well capitalized. Directors acknowledged the heightened strains in Japan's financial system, and underscored the importance of decisive moves by the Japanese authorities to deal with the long-standing weaknesses of banking, insurance, and corporate sectors.

Turning to the outlook for global financial market conditions, Directors agreed that the main risks relate to the potential for subdued or delayed global recovery. With asset prices seemingly reflecting expectations of a near-term economic rebound, a subdued or delayed recovery could give rise to market corrections. These corrections could put stress on household and corporate balance sheets, thereby weakening consumption and investment spending. Directors noted that Japan and emerging market borrowers could experience particularly adverse effects in this scenario. The adjustment could also include a temporary and selective withdrawal from risk-taking by financial institutions. At the same time, however, Directors considered that the resilience of international financial system during financial disruptions in the

1990s which reflected important elements of dynamism and self-correction is cause for optimism that the adjustments will be manageable.

The global economic slowdown is posing the first real test of the credit-risk transfer markets, which have grown very rapidly in recent years. Directors saw the markets as working reasonably effectively to ensure credit risk, but acknowledged that the slowdown has highlighted weaknesses in the legal and operational infrastructure for OTC credit derivatives markets. Improved disclosure and transparency about the activities of newer and less regulated participants in credit markets should be helpful in dealing with these weaknesses, as would strengthened oversight and regulation of nonbank and nonfinancial entities that are active in financial markets. Directors also noted that there may be additional shortcomings in accounting and auditing standards and practices in several major countries. Against this background, Directors suggested that updating the supervisory and regulatory frameworks for such activities should be a top priority in the period ahead. This should enhance the useful role that the credit derivatives market play in spreading risk among economic agents, thereby helping to meet investor needs.

Directors agreed that one important element for effective market surveillance and crisis prevention is the development of forward-looking models that could provide advanced warning of a country's vulnerability to crisis and of the buildup of systemic risk in financial markets. Although such early warning could be a useful instrument for helping the Fund to provide timely advice to prevent crises, Directors cautioned that, given their current limited predictive power, early warning system models should be used carefully and in conjunction with qualitative and other methods of vulnerability assessment. With this caveat in mind, Directors supported the staff's efforts to refine the EWS models now being used in the Fund's work. These efforts could usefully complement work at the national level on early warning systems. Noting that currency crises are not the only threat to financial stability, Directors welcomed the staff's efforts to develop the basic building blocks of a more general early warning system able to predict other types of crisis, including debt and banking crises.

Strong policies are, of course, the main foundation for sound and sustainable access by emerging markets to international capital markets. At the same time, Directors noted that emerging market sovereigns may use alternative debt instruments other than plain vanilla bonds and regular loan issues, to maintain access to global capital markets and better manage their risk through diversification. They stressed that prudent debt management practices are needed to eliminate additional risks that arise from using debt instruments that create, among other things, inflexible debt structures and further shift risks to sovereign borrowers. Directors were of the view that the number of alternative debt instruments, including those that embed risk diversification features, such as warrants and structured notes, can potentially provide emerging market borrowers with access to capital markets while being consistent with sound debt management policies. However, they considered that some instruments, particularly collateralized instruments, could pose strong risks and complicate debt management, especially at times of financial stress. More broadly, Directors emphasized the need for sovereign borrowers to develop appropriate policy to assess the benefits and risks associated with borrowing using alternative financial instruments to maintain access to capital markets, both during normal market conditions and at times of financial stress.

2. BULGARIA—STAND-BY ARRANGEMENT

Documents: Request for Stand-By Arrangement (EBS/02/24, 2/12/02; Sup. 1, 2/27/02; and Cor. 1, 2/14/02)

Staff: Schiff, EU1; Van der Vossen, MAE, Ebrill, PDR

Length: 1 hour, 30 minutes

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

This statement provides information that has become available since the issuance of the staff report for the Request for Stand-By Arrangement for Bulgaria (EBS/02/24).

Indicators, including on industrial exports and retail sales, suggest a slowdown in growth in the fourth quarter of 2001, perhaps in excess of staff's expectations. Thus, while the estimate of 4½ percent growth for the year as a whole may still have been achieved, growth on the order of 4 percent now appears more likely.

The consumer price index rose by 2.8 percent in January 2002, increasing the 12-month rate to 7.1 percent. This increase largely reflected the one-time impact of increases in administrative prices, including for energy, and the imposition of new indirect taxes. We do not foresee the need for a major revision in our inflation projections at present.

Monetary data for end-2001 confirm that, as in a number of other southeastern European countries, the changeover to the euro stimulated substantial deposits of DM and other euro-area currencies into euro-denominated deposits in the banking system. This raised the measured money supply significantly in December, but without an actual impact on total liquidity.

A no confidence vote in parliament on February 13 failed by a wide margin, suggesting that broad support remains for the government's economic program.

Mr. Wijnholds submitted the following statement:

The Bulgarian authorities welcome the paper and appreciate the continued support and candid advice from staff and management. They are firmly committed to implementing the policies under the proposed Stand-by Arrangement, building on Bulgaria's excellent track record in performing the Fund-supported programs. Following the discussions with staff in December 2001, the authorities has managed to pass a 2002 budget consistent with the program, put in place new tight incomes policy and pass energy amendments and a privatization law.

Background

Since 1997, under the successive Stand-By Arrangement and EFF, macroeconomic stability has been achieved and maintained, real GDP has increased by 16 percent, inflation has decelerated to single digits, and external debt has declined from over 100 percent of GDP to 75 percent. This outcome has been accomplished in the context of a currency-board arrangement supported by prudent fiscal policy and strict incomes policy for state enterprises. Significant progress has been achieved in implementing the structural reform agenda. The positive developments have also been recognized by the European Commission (EC) by stating in its 2001 progress report that Bulgaria has established a satisfactory track record of macroeconomic performance and is close to being a functioning market economy.

Despite the encouraging economic achievements, my authorities are fully aware of the remaining vulnerabilities and the challenging reform agenda. The income gap between Bulgaria and the EU is still very large, the unemployment rate is high and progress of the structural reforms in several areas, including in the energy and transportation sectors, is still insufficient. The authorities' intention is to address these problems more aggressively in the context of the new Stand-By Arrangement.

Policy Framework and Macroeconomic Objectives

The new program is based on three equally important and mutually dependent assumptions: (i) maintenance of the Currency Board Arrangement (CBA) until accession to the European Monetary Union (EMU); (ii) implementation of a cautious and flexible fiscal policy; (iii) acceleration of structural reform. It is worth mentioning that there is a broad understanding and support for these key elements of the policy framework across the political spectrum. They have already been incorporated in the Pre-Accession Economic Program (PEP) developed with the EC and some other strategic documents of the Bulgarian authorities.

Macroeconomic objectives have been formulated in the context of the main goal of the authorities to achieve significant progress in improving the living standards of Bulgarian citizens. In order to achieve this goal, the country needs to sustain economic growth of at least 5-6 percent annually in a medium-term perspective. After real GDP growth of 5.8 percent in 2000 (one of the highest amongst the countries in transition), it has moderated to about 4.5 percent in 2001. Having in mind the uncertainties of the external environment the authorities agreed with staff to keep the projections on the conservative side by setting growth at 4 percent in 2002, and 5 percent in 2003 with the expected restoration of external demand. Inflation declined to 4.8 percent by the end 2001 and is expected to remain low in 2002 despite the increase in January by 2.8 percent due to the one-time impact of the planned increase in prices for electricity and heating, upward adjustment of excise tax rates and the imposition of VAT on all medicine. The authorities project the current account deficit to decline from 6.5 percent of GDP in 2001 to a moderate level, thus preserving the positive trend with respect to the level of reserves and the debt-to-GDP ratio.

Fiscal Policy

Under the CBA, fiscal policy remains the main instrument in maintaining macroeconomic stability. Since 1998 the authorities have kept the budget broadly balanced. The small deficits (below 1 percent of GDP) for the last three years were entirely due to one-off expenditures to cover the cost of structural reforms. The authorities committed to maintain the strong fiscal stance by further lowering the budget deficit from the targeted 0.8 percent in 2002 to balance over the medium term while keeping the primary surplus in the range of 2.4 to 3 percent of GDP. This commitment was confirmed with the adoption of the 2002 budget. The program agreed with staff addresses the main challenge to reconcile within the agreed fiscal stance the reduction in the corporate and personal income taxes and the increase in social spending.

In order to achieve this task the authorities have already implemented a set of measures, included in the 2002 budget. On the revenue side, they removed the zero VAT rate from tourist packages sold abroad and imposed VAT on all medicine. In addition, they adjusted the excise tax rates toward EU levels, introduced a road tax, revised municipality fees, updated the property tax base to better reflect the true property values, and raised the patent tax rates to compensate for the accumulated inflation in the last three years. It goes without saying that these measures created some tensions. The imposition of VAT on all medicine more specifically was one of the formal reasons for a no confidence vote, which failed in parliament on February 13.

The recent developments show the strong commitment of the authorities to implement strictly all measures agreed with staff as well as the political support for the program.

The main focus of the authorities' consolidation efforts is the control over expenditure. They have adopted as a nominal target to keep non-interest expenditure at around 35 percent of GDP. In order to accommodate in this limit a stronger social safety net, a proper level of public investment, and EU and NATO accession related spending, the authorities envisage to increase the efficiency of spending and to accelerate needed structural reforms in the public sector. They are advancing the reform process in close consultation with the World Bank and other international organizations. In the context of the program they especially focus on the measures with considerable fiscal impact, as the privatization or closure of around 10 percent of hospitals in 2002 in order to reduce excess capacity and improve efficiency of the system and similar measures of rationalization in the education sector by reducing teacher employment and raising the student-teacher ratio towards the average level in OECD countries. The authorities intend to address more aggressively the fiscal decentralization issues. They work closely with the association of the municipalities to strengthen further their financial performance and improve the regulatory framework.

The authorities are also implementing an ambitious program for administrative and institutional reforms, which will help increase the capacity to better manage the fiscal program. Key elements of those reforms are the establishment of the Unified Revenue Agency and strengthening the customs administration. With technical assistance from the Fund the authorities have begun to streamline the budget preparation process to focus more on spending composition and quality, to foster economic growth, and continue to improve the already well functioning treasury system.

Labor Market Policies

The authorities envisage to further increase labor market flexibility and to continue to implement a strict incomes policy in the state enterprise sector. The appropriate measures in this area are key not only to safeguarding the CBA but also to address adequately the problem of the high level of unemployment. The authorities issued an incomes policy ordinance that closely links wage increases with financial performance and limits wage growth for the SOEs that have the largest losses and arrears, are monopolies, or receive subsidies. With respect to the minimum wage, after the 17 percent increase in October 2001, the authorities agreed with staff not to increase it throughout 2002 and intend to link future increases to the average public wage increase.

Financial Sector

The banking sector is generally sound. The main task of the authorities is to generate the necessary environment that would yield higher levels of credit to the private sector and to expedite the full privatization of the financial sector. The authorities declared their intention to implement market-based measures in line with the conclusions and recommendations of the Financial Sector Assessment Program, conducted in October-November 2001. To stimulate long-term lending, they will exclude long-term deposits in the banking system from minimum reserve requirements, while maintaining the level of the requirement at 8 percent for the deposits that continue to be covered. The regulatory framework will be further developed to reinforce creditor rights and insolvency procedures as well as to strengthen the oversight of the financial system. This includes the respective amendments to the Banking Law, the Civil Procedure Code, and the Anti-Money Laundering Law as well as adoption of the Bank Bankruptcy Law. At present 82 percent of the banking sector has been privatized. Of the two remaining large state-owned banks, the authorities plan to privatize Biochim Bank by mid-2002 and to move to the implementation stage of privatization of DSK Bank before the end of the year.

Structural Reform in the Enterprise Sector

The authorities firmly share the staff view that the reform agenda in the enterprise sector is key to their plan to create a fully market-oriented and competitive economy. They have adopted an ambitious action plan: (i) to improve the transparency and quality of privatization; (ii) to finalize privatization of all viable non-infrastructure SOEs by end-2002 and make major progress in privatizing the infrastructure companies; (iii) to complete the liquidation of those SOEs that are not viable and further improve the liquidation and bankruptcy procedures; and (iv) to implement rigorous rehabilitation plans for those companies that provide specific public services, particularly BDZ (the state railways company). The new Privatization Law that removes all preferential terms for the management-employee buyouts and restricts privatization methods to auctions, tenders, and public offering of shares, ending the practice of direct negotiations with buyers, was already adopted by the Parliament a week ago. The authorities are also continuing to work on initiatives to improve the business climate by simplifying the licensing, permit, and registration systems, and proceeding with reforms in the judicial system. A key element of the structural reform agenda is energy sector reform. The authorities are revising the medium-term national energy strategy with a view to: (i) speeding up liberalization; (ii) increasing private sector participation; (iii) privatizing the production and distribution companies; (iv) increasing transparency and competition in the electricity and natural gas markets; and (v) bringing the energy legislation in line with EU directives.

External Sector Policies

The authorities will pursue further trade liberalization in order to prepare for EU accession, and to create a more attractive environment for foreign investors. On the basis of a multiyear schedule they intend to reduce the unweighted average most favored nations import tariff rate to 6 percent by 2006, to eliminate the gap with the current EU average and further reduce distortions to international trade. The 2002 Customs Tariff Decree is in line with this strategic goal.

The authorities are also pursuing a more active debt management strategy. The main goal is to lower the public sector debt-to-GDP ratio. They expect parliament to adopt a new Sovereign Debt Law, which provides a firm legal foundation and procedures for issuance of state debt and guarantees, by end-March 2002. The issue of the first Eurobond in November has been successful. In order to maintain market confidence and to ensure that the external obligations will be met the objective is to keep sufficient liquidity in the Fiscal Reserve Account at a level in excess of 90 percent of anticipated annual debt service.

Design of the Program

My authorities would like to express their satisfaction with the streamlined conditionality under the new program with a clear focus on areas that are macro-crucial and with structural conditionality limited to measures that are deemed critical for the success of the program.

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

The pursuit of prudent financial and incomes policies supported by strong structural reforms, as well as the smooth operation of the Currency Board Arrangement (CBA) served Bulgaria well and helped the country establish a good track record. This is well brought out in the staff report as well as in Mr. Wijnholds's preliminary statement. Since the introduction of this arrangement in the wake of the financial crises of 1997/98, not surprisingly real GDP growth turned positive, inflation came down to a single digit rate, the banking sector stabilized, public debt ratios declined, and market confidence was restored as evident by the relatively narrow interest rate spreads and large FDI inflows. However, these favorable developments were affected to a small degree by a modest deterioration in the economic environment in 2001 associated with the slowdown in external demand and a deterioration in the terms of trade which contributed to a relatively large current account deficit. The response of policy makers was both prompt and appropriate when the fiscal stance was tightened towards the end of the year. It should be noted, however, that the delays in structural reforms could have further contributed to a decline in GDP growth and to the persistence of the high rate of unemployment.

Looking ahead, the balance of payment position will remain sensitive to external developments and the current account deficit is not projected to show a significant improvement in the near term. Furthermore, it is anticipated that, in addition to the need to raise much-needed social expenditures, the country's aspiration to join the European Union will continue to require added budgetary outlays over the medium term. The program before us contains a well-designed and comprehensive policy package that addresses these challenges. Strict adherence to this program is essential to meet these short and medium-term challenges while safeguarding the CBA and facilitating a smooth transition to an eventual EU accession. Since we are in general agreement with the staff appraisal, we support the proposed decision and will focus the rest of our statement on certain key fiscal and structural reform issues.

In view of the risks and challenges highlighted above, it is encouraging to note the authorities' intention to keep the fiscal deficit in 2002 below 1 percent. While such a stance implies a moderate increase in the primary deficit over 2001 on account of the operation of the automatic stabilizers, the projected budgetary outcome remains consistent with the program's macro framework. To safeguard against the downside risks, however, it would be important to maintain the prudent practice of last year with regard to limiting discretionary expenditures to 90 percent of the budgeted amounts in the first three quarters of the year in order to ensure that sufficient revenues are raised and that the overall fiscal target is achievable. Furthermore, we urge the authorities to resist any pressures to increase expenditure or delay the fiscal structural reforms required to meet the budgetary targets. Full implementation of these reforms is also essential to achieve the planned balanced budget over the medium term.

While non-interest expenditures for 2002 is programmed to remain unchanged from the previous year, the structure of such expenditures is envisaged to improve by a reorientation towards social outlays. In this regard, we would highlight the importance of implementing the plan to reduce wasteful and non-targeted subsidies as well as the sizable excess capacity that prevail in the health and education systems. The latter would help achieve the target to bring down the wage bill, of which teachers' wages account for about half, in 2002 and beyond. On the other hand, it is heartening that well-targeted subsidies are budgeted to increase. Reforming the pension system will also help reduce budgetary liabilities over the medium term and, thus, release resources for priority expenditures.

On the revenue side, we are encouraged to note that the authorities have already introduced measures for 2002 that will further reduce the distortionary effect of taxation and enhance the business climate. In addition, the decision to cancel the plan to eliminate corporate taxes on reinvested profits was appropriate in view of the large revenue implications, and the fact that such an elimination would have discriminated against small and medium sized enterprises. Raising presumptive taxes and other taxes and fees to adjust for accumulated inflation, along with strengthening tax and customs administration through the establishment of a unified revenue agency, would also help raise revenue.

In addition to structural reforms in the fiscal area, other structural reforms are vital to promote private sector-led growth and maintain external competitiveness. In this regard, it is important to adhere to the privatization program as well as the plan to improve the regulatory and legal environment. Further improving the functioning and flexibility of the labor market is also important to help reduce unemployment from its very high level.

On the banking sector, while various indicators confirm its soundness, financial intermediation, particularly private sector credit, remained limited since the 1996-97 crisis. In this connection, we welcome the authorities' effort to eliminate structural impediments to private credit, including the lack of quality credit information and accounting data, weaknesses in corporate governance, and uncertainties in the enforcements of creditors' rights. At the same time, we concur with staff's prudent advice on the need to prepare for the hoped-for pick up in private credit by further strengthening oversight to maintain the soundness of the financial system. The implementation of the FSAP recommendations would go a long way in this direction. In particular, it would be important to improve the process of handling insolvent banks and enhance the supervisory powers of the central bank, including the supervision of insurance companies and pension funds, through the necessary legislative changes and capacity buildup.

Finally, we are pleased to note that the CBA has served the country well since its inception, and hope that the exit strategy implicit in Bulgaria joining the EMU, as indicated in Mr. Wijnholds's informative preliminary statement, will be timely and appropriate .We would be very interested in hearing staff's views on this aspect.

With these comments we wish the authorities all success in their endeavors to maintain their stabilization gains and improve the economy's growth prospects.

Mr. Lushin and Mr. Zakharchenkov submitted the following statement:

At the outset, let us say that we broadly agree with the staff's assessment of the recent economic developments in Bulgaria. Indeed, the economy performed well and successfully resisted external shocks. Although the GDP growth has lowered somewhat as a result of the slowdown in the European Union and the Turkey crisis, it remained robust at 4.5 percent in 2001. Inflation was subdued. The fiscal position improved and allowed for a reduction of public debt. The external position has showed a modest deterioration as the current account deficit widened but remained under control. As noted by the staff in Box 2, indicators of external competitiveness do not expose any major misalignments over the last few years. In contrast, progress in the structural area was modest and lackluster on several fronts, and the remaining reform agenda will need to be forcefully addressed under the proposed arrangement.

We concur that the CBA has served Bulgaria well, by providing a stable monetary environment, contributing to low inflation, and boosting confidence. It will rightly be the cornerstone of economic policies throughout the duration of the Stand-By Arrangement. As mentioned in the MEFP, the authorities are committed to maintain the CBA at least until accession to the EU. We noted that the staff is also in favor of maintaining the CBA. While we generally share this view, we would be interested to know whether the authorities are cognizant of the risks embedded in a CBA and whether they gave thought to any exit strategy, especially if the accession to the European Union takes longer than planned.

The announced fiscal stance for 2002-03 is fully consistent with the program's objectives. The 2002 budget seems to strike a right balance between the need to lower tax rates and to increase social spending within the budget deficit limit. The authorities remained committed to implementing the budget flexibly so that to be able to respond to external shocks. Looking ahead, one of the major risks to the program stems from the recent political developments, and the authorities should be advised to resist pressures to increase social spending and to maintain tight fiscal stance.

The main challenge under the proposed arrangement will be to push ahead much needed structural reforms. In the fiscal area, this refers to the need of proceeding with public sector reforms by bringing the pension system on a sustainable footing and downsizing education and health care systems. We broadly concur with the measures envisaged in these areas that are articulated in paragraph 13 of the MEFP. We support steps to impose hard budget constraints on the local authorities in order to end the accumulation of arrears and reverse past practice of covering losses stemming from excessive spending at local levels. Envisaged fiscal administration reforms are commendable. Most importantly, we welcome the creation of the unified revenue agency to strengthen collection of taxes and social security contributions. Similarly, we support steps to improve budget preparation process, to strengthen customs administration, and to increase the efficiency of social spending.

On the labor market, overall employment declined by more than 10 percent in 1997-2001, with the contraction in the public sector not being offset by gains in the private sector. As a result, unemployment rate increased to 18 percent and calls for proactive labor market policies, particularly in light of existing large regional disparities, the lack of geographic mobility, and other labor market rigidities. In this connection, recent labor market reforms outlined by staff in Box 1 are commendable, but they have not gone far enough to reverse the employment situation. Therefore, we welcome the emphasis placed by the authorities on this issue (MEFP, paragraphs 15-17) and broadly endorse the proposed course of actions.

The financial sector remains sound and is generally well supervised. However, much remains to be done to improve its efficiency, especially in light of the remaining agenda for privatization of state-owned banks and other financial institutions, and further strengthening of banking supervision. In this connection, we welcome the authorities' decision to expedite privatization process and to implement recommendations of the FSAP mission, in particular with respect to strengthening the supervisory capacity of the BNB and improving the process of handling insolvent financial institutions.

We welcome steps to address long-delayed reforms of the energy sector, specifically by reducing direct and indirect subsidies from the central budget and gradually bringing household tariffs to cost-recovery levels. A new Energy Act to be prepared by mid-2002 will be an important milestone in this process.

Proposed measures to improve business climate and address existing rigidities in the legal system to facilitate the creation of new companies and the resolution of commercial disputes (MEFP, paragraph 23) are entirely appropriate.

Finally, the Bulgarian authorities are to be commended for adopting a more proactive debt management strategy and continuing the process of trade liberalization.

With these remarks we support the proposed decision. We welcome the authorities intention to treat this arrangement as precautionary in the future if external accounts improve more than expected. We wish the Bulgarian authorities every success in their endeavors.

Mr. Varela and Mr. González-Sánchez submitted the following statement:

We thank staff for the set of papers for today's meeting on Bulgaria, and Mr. Wijnholds for his very informative preliminary statement. We also commend the Bulgarian authorities for their good record of macroeconomic stability. Although the country started late its transition to a market economy, the authorities have taken bold structural reforms in the framework of a currency-board arrangement (CBA) and appropriate fiscal and income policies. This approach has paid off and, accordingly, the recent economic evolution of Bulgaria has been positive. Although economic growth has slowed recently reflecting basically the slowdown in trade partners' economic activity, Bulgaria's economy is growing at rates above 4 per cent, the inflation has been brought down from hyperinflation levels to single digits and remains at low levels, and the external debt-to-GDP ratio has declined rapidly. The good track record of Bulgaria has been recognized by the European Commission, and negotiations for the country to become a EU member are under way.

We support Bulgaria's request for a two-year Stand-By Arrangement, and consider appropriate that the arrangement has as its elements the continuation of the CBA—which has served Bulgaria well—until accession to the European Monetary Union, prudent fiscal and income policies, and continuing progress in structural reforms. These elements indeed appropriately address the challenges that the country faces, and will contribute to put its economy on the path of sustainable growth. Risks remain in the short term, as indicated by staff, such as slower than projected EU growth, a reversal of the oil price decline, and the possibility of insufficient foreign direct investment. In this context, prudent macroeconomic policies are essential, and we encourage the authorities to resist pressures to relax fiscal and income policies and to slowdown the pace of structural reforms. For the medium term, the challenges to the country include reducing unemployment and poverty and the full establishment of a functioning market economy.

The staff rightly notes that in the event of significant adverse external developments, concerning economic activity in the European Union and the level of oil prices, corrective policy actions would be required in order to maintain the viability of the external accounts. Indeed, the authorities have already shown their disposition to take corrective measures, as demonstrated by the tightening of the fiscal stance in the last quarter of 2001 in response to the deterioration of the current account balance and high debt-to-GDP ratios. This was indeed achieved in spite of the pressure of overruns in subsidies and election-related capital spending.

It is encouraging that the authorities have managed to pass a 2002 budget consistent with the program, appropriately addressing the increase in social spending as well as a reduction of corporate and personal income tax rates, this reduction being compensated by adjusting excise taxes toward those prevailing in the European Union, and by other measures described in Mr. Wijnholds's preliminary statement. The reduction of the corporate taxes will improve the business environment, a very important factor in the country's efforts to become a fully functioning market economy. Needless to say, the continuation of structural reforms is another essential component in this quest, and we encourage the authorities to actively pursue the structural reforms in those sectors where those reforms are still needed or incomplete, such as the energy and transportation sectors, administrative reform and governance issues. The ambitious action plan concerning privatization described in Mr. Wijnholds's preliminary statement is very reassuring.

Concerning the financial sector, it is encouraging that the stress tests carried out in the context of the recent FSAP suggest that the country's banking system is resilient to foreign exchange and interest rate risks, and capable of absorbing substantial credit risk. Nevertheless, banking credit to the private sector remains modest, and as indicated by Mr. Wijnholds in his preliminary statement, the main task for the authorities is to generate the environment to spur credit to the private sector and to complete the privatization of the financial sector.

We welcome the authorities' indication that they might treat the Stand-By Arrangement as precautionary in the future, and wish them every success in their policy and reform efforts.

Mr. Harzer made the following statement:

Bulgaria's track record of macroeconomic stability, sound policies, and strong commitment to structural reforms is evident from the staff's well-focused report and from Mr. Wijnholds's preliminary statement, and it is also reflected in improved ratings in financial markets. However, as the staff points out, Bulgaria's current account remains vulnerable. We therefore support the proposed Stand-By Arrangement. We encourage the authorities to be ambitious with the implementation of the program, which would allow them to treat the arrangement as precautionary.

As already mentioned, the main program risk stems from the current account. The staff also points to potential risks related to the new political constellation. The possibility that domestic political considerations could unduly delay privatizations cannot completely be ruled out. In addition, the level of foreign direct investment (FDI) inflows could turn out to be lower than projected. A surge in the oil price or a general decline in the terms of trade could further deteriorate the situation.

While we generally deem a CBA an appropriate exchange rate regime for accession countries, like Mr. Lushin and Mr. Zakharchenkov in their preliminary statement, we would be interested in the staff's view on the room for maneuver available under such a regime and on the sustainability of this regime.

On labor market and income policies, we concur with the staff that the 17 percent increase in the minimum wage is counterproductive in light of the continuing high unemployment. The argument that the rise would help strengthen social sector contributions is not convincing.

On the positive side, the envisaged measures aiming at increasing flexibility in labor markets are encouraging. Bulgaria's FSAP showed that the banking system as a whole is sound and profitable. However, financial intermediation has to be further developed to ensure that the assumed increase in the private savings rate is being used to fuel private sector-led growth. As we found no mention in the staff report, we wonder what role foreign banks could play in that respect.

With a view to Bulgaria's envisaged EU accession, further trade liberalization is advisable in those areas in which progress has been limited so far, especially regarding reductions in tariffs. Existing bureaucratic hurdles must be overcome, as they constitute structural disadvantages for medium and small enterprises, and they distort the development of a more balanced structure in the economy.

Mr. Jonas made the following statement:

The currency board arrangement (CBA) enabled Bulgaria to recover quickly from the crisis of 1997/98, bringing financial stability and a resumption of growth. Positive as these achievements, however, they must be kept in perspective. Bulgaria's post-crisis economic growth has been much weaker than the steep decline of 1996 and 1997, and real GDP in 2001 has not yet reached the level of real GDP in 1995. In addition, unemployment has continued to increase rapidly despite the post-crisis resumption of growth, showing that all is still not well with the Bulgarian economy. Problems remain, and must be addressed for growth to strengthen.

The staff observes that investment and higher productivity, which are closely related, must be increased for medium-term growth to surpass 5 percent. But the medium-term projections for both leave me somewhat concerned.

First of all, increased investment will require higher domestic savings, but Bulgaria's savings outlook is quite dismal. Gross domestic savings fell below 10 percent of GDP in 2001, and a decline in gross domestic investment was avoided largely by turning to foreign savings, which financed nearly half that year's domestic investment. There is little chance of stimulating investment and growth without a significant increase in domestic savings. The staff suggests that in the medium-term, Bulgaria's domestic savings should approach the levels currently seen in the advanced transition economies of central Europe. This seems far too optimistic. It is projected that Bulgaria's domestic savings will increase to 13.2 percent of GDP in 2006, which is only about half their current level of 25-26 percent of GDP in the Czech Republic and Hungary. The implication of this scenario of continued low domestic savings is not very reassuring. Either gross domestic investment will remain relatively low, or a significant increase of domestic investment would have to be financed by a larger reliance on foreign savings. Obviously this is risky: a sudden interruption of Bulgaria's access to external savings would damage the economy: investment would have to be cut, and growth would fall.

So what can be done? For the short-term, Bulgaria must ensure the continued availability of external savings by attracting foreign investors; and the medium and longer terms, Bulgaria must gradually reduce its dependence on external savings by stimulating domestic savings.

The best way to attract external savings is to restart and speed up the stalled privatization program and make the country into an attractive destination for foreign direct investment. But the authorities' recent signals have been somewhat confusing. They have decided to keep the golden share of Bulgartabac and Telecom, two important companies slated for privatization. Obviously doing this will reduce the sale price and the privatization revenues. It has been argued that keeping the golden share is necessary to placate domestic critics of privatization. But how to placate the critics who will be disturbed by the loss of hundreds of millions of dollars in privatization revenues?

The stimulation of domestic savings is not something that can be accomplished in the short-term: it will require a long-term effort. Of course, maintaining financial stability will help, as will continued progress in improving banking intermediation. Sustained economic growth, and higher household incomes would also promote higher domestic savings.

Finally, a comment on the CBA. The authorities have decided to keep the CBA right up until Bulgaria's EMU accession, a strategy which I find appropriate. But we must be aware of what this may involve. Bulgaria is not likely to be one of first group of accession countries to join the EU and EMU. And even if we assume that Bulgaria will join the EU in, say, 2005 or 2006, the earliest it could join the EMU would be in 2007 or 2008. This means the CBA would remain for another five or six years. As other Directors have pointed out, the authorities must be aware of the risks connected with maintaining the CBA, must thoroughly understand the policies required its successful operation, and should have in place an alternative plan for a different monetary and exchange rate regime in case the CBA turns out to be unsustainable.

With these words of caution, I support the request for the Stand-By Arrangement.

Mr. Baukol made the following statement:

We commend the authorities for their good performance under the previous Fund program. Bulgaria has continued to show dramatic improvement since the 1996-97 crisis, with an expanding economy and remarkable drop in inflation. Access to international markets is improving, and debt levels are decreasing. World Bank statistics also suggest a significant drop in the incidence of poverty in Bulgaria.

The reforms laid out in the new program are sensible and build upon the successes in the previous program. They focus on areas that are necessary to strengthen the fiscal balance, which is a fundamental ingredient to the success of the currency board arrangement. I would like to comment first on fiscal issues, then turn to structural and program issues.

The authorities have stated their intent to achieve a balanced budget in upcoming years. This goal is credible given the already low deficit, cautious plans for implementation of the 2002 budget, and reforms to address subsidies and inefficient social welfare spending. Privatization revenues in recent years have allowed the authorities to reduce overall debt levels, and it will be important to continue this going forward.

The new program includes some conditionality on areas that are deemed vital to continue fiscal improvement, including energy prices. In our view, the conditions related to the energy sector and banking seem particularly important. We expect that there will be ongoing Bank involvement in these areas in case reforms fall behind schedule or need to be modified.

A key task facing the authorities is improving the operations of state enterprises. We support the authorities' plans to privatize many of these enterprises and encourage them to conduct auctions in an open and transparent manner as seems to be the intention from reading Mr. Wijnholds's statement. Privatization will help the authorities meet their goal of attracting FDI at the peak rate seen in 2000. For the remaining state enterprises, we encourage the authorities to work on aggressive restructuring plans with the assistance of the World Bank.

Turning to labor market issues, unemployment remains high, and the staff notes that job creation has slowed because of a lack of restructuring. Past experience suggests that job creation from restructuring lags the immediate employment effect as employees are released by restructured companies. Therefore, it will be important to support private sector development in small and medium enterprises to help raise overall employment. It will also be important to increase labor market flexibility. We are somewhat concerned that the issue of high payroll taxes seems to have taken a back seat to lowering personal and corporate income taxes.

Like Mr. Harzer, we have concerns about the increase in the minimum wage. The authorities have stated that they intend to tie future changes in the minimum wage to average public sector wage increases. If public sector wages increase in line with expected productivity improvements coming from restructuring, would this be mirrored in the minimum wage? This could also pose a problem if public sector wages are raised in order to remove an incentive for corruption. The staff's comments are welcome.

We encourage the authorities to take further efforts to liberalize trade. We note the linkage between general investment climate and obstacles to better export performance, as regulations are stifling the growth of export-related businesses. The authorities appear to have recognized this and committed themselves to a more transparent business environment with an improved legal framework. Part and parcel of this is addressing the continued problems of corruption and an ineffective legal system. The authorities are taking steps, including amendments to the Commercial Code and Company Law and a public awareness campaign on corruption. Investors will be looking at the implementation and enforcement of these initiatives.

Further efforts are also needed in the financial sector, as recognized by the program. We encourage the authorities to continue to promote lending activity by improving the banking sector framework rather than through government interference in banks' lending activities. The authorities state that they will introduce measures in March to strengthen the Financial Investigations Bureau and other anti-money laundering services. We look forward to the summary results of the FSAP and ask if it was able to address money laundering issues?

Turning to the other issues of the program. From a financing perspective, we should be cautious that Bulgaria avoids a situation where it becomes reliant upon Fund resources to roll over past Fund debt. To this end, we note that access under this Stand-By Arrangement is well below average, and we would support the authorities' intention to consider treating this arrangement as precautionary going forward. We also expect that strong implementation of this program would allow Bulgaria to graduate from Fund programs. The authorities have already demonstrated their ability to tap private markets for financing.

Finally, we note that the governing coalition's political popularity has suffered due to unrealistic expectations prior to its entering office. It is important going forward that the authorities speak with one voice in conveying policy priorities to increase domestic public support. On a related issue, we commend the authorities for publishing the staff report.

Mr. Guinigundo made the following statement:

We support the staff's recommendation to approve the request of the Bulgarian authorities for a two-year Stand-By Arrangement in the amount of SDR 240 million. The staff's support is based on the authorities' strong commitment in the fiscal, incomes and structural reform policy areas, and on the authorities' excellent track record in implementing the Fund program. The Bulgarian authorities deserve commendation in this respect.

We would like to raise a few issues for clarification. The first point is the financing needs of Bulgaria. We note that Bulgaria faces a $300 million financing gap for 2002 and 2003, due to the need to boost foreign reserves in an uncertain external and financial environment. The staff advises us that the authorities' intend to treat the facility on a precautionary basis in the future, once the external payments position improves beyond their expectations and full financing is obtained. I have three questions. First, is the foreign reserves level in Table 7 already reflective of the impact of Fund assistance? I observe that import coverage is expected to deteriorate after 2002. Second, what is the staff's view on the likelihood that the program will be treated as precautionary? Risks that this might not be the case include the high public debt ratios, impediments to more vigorous business activities posed by regulations, and uncertainty over the slowdown in Europe and elsewhere. Finally, how sensitive would the market be to Bulgaria drawing from the facility once the arrangement had been announced as precautionary? Does Bulgaria intend to access capital markets further in 2002 or 2003?

On structural reform, we understand the need to cement macroeconomic stability—given the constraints of the CBA—and to complete the transition process. According to the staff, the coverage of the new program is significantly more focused compared to the Extended Fund Facility (EFF), and Mr. Wijnholds echoed in his preliminary statement the authorities' satisfaction with streamlined conditionality in the new arrangement. The Memorandum of Economic Policies provides a list of prior actions, five structural benchmarks for end-June 2002, one structural benchmark for December 2002, and one structural performance criterion for end-April 2001. Without these ambitious structural reforms, including the strict implementation of the incomes policy and further liberalization of the labor markets, a tight fiscal policy stance may not suffice in the period ahead. This is the real challenge to the authorities. It is commendable that the authorities are determined to cut subsidies, pensions, and unnecessary spending in the areas of healthcare, education, railways, and energy as part of an overall policy framework centered in the CBA. In this context, could the staff clarify what justifies the expectations for higher growth in the period from 2004 to 2006.

While I agree with the staff that conditionality under the program focuses on areas which are consistent with the Fund's core expertise and which are also critical to the success of the new program, I hope the timetable for completion is realistic. The challenge to the Fund will be to grant waivers in the future only for reasons beyond the control of the authorities. Aside from the structural measures covered by Fund conditionality, the Fund will also monitor measures in other areas formally covered under World Bank conditionality. The Fund and the World Bank should be particularly careful to prevent a repetition of past delays like those seen in amending the energy law and in completing privatization-related structural benchmarks. The fact that some measures require parliamentary approval and are not directly within the control of the government complicates the assessment of compliance by the authorities with Fund conditionality.

The points made by Messrs. Shaalan and Lushin in their preliminary statements regarding the exit strategy for the CBA implied by the entry into the European Monetary Union (EMU) are also important.

Finally, on the staff's recommendation to pursue restructuring of those public enterprises that cannot be privatized in the short term, could the staff give their views on how the authorities could reconcile the need to keep a tight fiscal policy with the likely budgetary expense required to restructure those enterprises?

We reiterate our support for the proposed decision to approve the authorities' request for a Stand-By Arrangement.

Mr. Al Azzaz made the following statement:

Bulgaria made considerable economic progress under the Extended Fund Facility. The staff report and Mr. Wijnholds statement detail the achievements. This is also reflected in the EU's recognition, that Bulgaria has established a satisfactory track record of macroeconomic performance and is close to being a functioning market economy.

The outcome last year, however, was less favorable as growth slowed, current account deficit widened, and external reserves fell. The challenge now is to ensure that this development is temporary and to put the economy back on a sustainable robust growth path. It is thus reassuring that the authorities are cognizant of the challenges and ready to take further steps. The requested Stand-By Arrangement has my support.

I broadly agree with staff's appraisal and only have a few brief remarks.

First, The authorities' fiscal stance is appropriate in view of the need to reduce both the pressure on the external accounts and the public debt to GDP ratio. It is encouraging to note that the 2002 budget deficit is targeted to decline, reflecting the authorities' determination to achieve the fiscal target. In this regard, it is important for the authorities to achieve the planned decrease in non-interest spending in view of the expected reduction in total revenue. Further structural reform is also critical for successful implementation of the budget. In this connection, improved efficiency of government spending and additional strengthening of tax administration cannot be overemphasized.

Second, regarding the authorities' incomes policy, containment of wage increases and inflationary pressures is needed to help safeguard competitiveness and export growth. The authorities are right to maintain a strong link between financial performance and wage increases in public enterprises. Further improvement in the business climate will also bode well for investment and export performance. In this regard, redressing the regulatory obstacles noted in Box 2 is a priority.

Finally, completion of public enterprise reform is crucial for enhancing confidence and promoting private sector investment. I endorse the authorities' efforts in reforming the financial sector. The sale of the government's share in the Central Cooperative Bank, the plan to expedite full privatization of the remaining state owned banks, and the effort to further strengthen bank supervision and prudential regulations should help enhance the banking sector's overall efficiency, including improved provision of credit to the private sector.

With these remarks, I wish the authorities further success.

Mr. Vittas made the following statement:

I am pleased to support the authorities' request for a 2-year Stand-By Arrangement for several reasons:

First, Bulgaria has indeed compiled an impressive track record of policy implementation over the past few years. This record, and the very high priority that the authorities attach to the completion of the requisite preparations for early accession to the European Union, provide assurances that the program will be rigorously carried out.

Second, the amount of assistance that is being requested is very modest and well within our policy on access limits. Moreover, there is a very good chance that even this modest amount will not have to be drawn upon in full.

Third, the program for which Fund support is requested is in general well designed, and its objectives, at least as far as the reform agenda is concerned, are quite ambitious. However, I tend to share Mr. Jonas' view that the macroeconomic goals may not be as ambitious as one would like to see, given that Bulgaria still has a long way to go to catch up with the more advanced transition economies in Central Europe.

Last, but not least, while the program is not entirely free of risks, one can be reasonably confident that Bulgaria will not encounter much difficulty in servicing its future obligations to the Fund in a timely manner.

Let me now offer a few observations on the contents of the program.

First, I welcome the fact that the macroeconomic framework continues to be firmly centered on the CBA. The CBA is well supported by prudent fiscal and incomes policies. Moreover, its credibility among market participants remains very strong as demonstrated inter alia by the fact that Bulgaria has not experienced any discernible contagion effects from the financial crisis in Turkey or the collapse of the CBA in Argentina. This to me is not surprising given not only the strong support that the CBA in Bulgaria enjoys among all the political parties and the public at large, but also the authorities' success in maintaining its consistency with an adequate level of external competitiveness and a solid growth performance.

Second, I am pleased to note that, within the tight budget deficit limits, some room was found to accommodate a modest reduction in tax rates as well as a modest increase in social spending. The staff report emphasizes the margin of flexibility embodied in the budget to ensure that it is able to respond to negative shocks. This is reassuring. Nevertheless, I have the feeling that in practice the authorities are more likely to experience "positive" surprises than negative shocks. I am saying this because I believe that the budget is based in some respects on very cautious assumptions. If this turns out to be the case, it would make sense to use at least part of the additional margin of budgetary maneuver to implement measures designed to lower unemployment and reduce poverty, both of which remain very high.

Third, the structural reforms envisaged under the program are appropriately focused in my view in the areas in which progress in the past has been limited or inadequate, including on privatization, improving the environment for private investment and the functioning of the labor market, strengthening further the financial sector and accelerating the pace of reform in the energy sector. I am especially pleased to note that trade liberalization is also receiving adequate attention as it can make an important and lasting contribution to attracting FDI inflows and increasing Bulgaria's growth potential.

Finally, I welcome the progress that has been made under this program in streamlining structural conditionality.

Let me conclude, by wishing the authorities continued success in their endeavors.

Mr. Gallardo made the following statement:

Bulgaria's has an excellent track record in performing the Fund-supported programs, and has established a good economic performance record in the context of a currency-board arrangement supported by prudent fiscal and income policies. Real GDP growth is estimated to have reached 4.5 percent at end-2001, and is projected to reach 4 percent this year. Inflation was low during 2001 at 4.8 percent and is expected to remain low during this year. The current account registered a 6.5 percent deficit of GDP in 2001, and is projected to improve during the next two years as a result of a recovery in exports and lower than expected oil prices. Under this scenario, the authorities have requested a two-year Stand-By Arrangement. The new program is based on three pillars: maintenance of the Currency Board Arrangement until accession to the European Monetary union, implementation of tight fiscal and income policies, and acceleration of key structural reforms to allow Bulgaria to function as a fully market economy.

We commend the authorities for the impressive economic track record, and the decisions taken to introduce structural reforms, some of them highly controversial, but necessary to pave the way toward a market economy. In this respect, the authorities are fully committed to continue the needed reforms in the labor market and in the energy and transportation sectors. Therefore, we support the authorities' request for a new Stand-By Arrangement due to their strong commitment to apply prudent fiscal and income policies, and to implement structural reform policies under previous Fund programs.

The staff representative from the European I Department (Mr. Schiff), in response to questions from Directors on the exchange rate regime, explained that the staff's support of the CBA was conditional on the authorities' commitment to the accompanying measures required to make the regime sustainable in the short and medium terms. The authorities had established their commitment to the CBA as part of their electoral campaign. In that context, the staff had focused during the discussions with the authorities on ensuring that they would also be committed to the policies required to make the regime sustainable. The CBA had served Bulgaria well, helping to achieve a good growth and inflation performance. The authorities had shown the ability to respond well to external shocks in 2001, and, perhaps even more importantly, the CBA enjoyed broad support from all political parties, as well as from trade unions, business groups, and all other important actors in society. Such broad support would serve as an anchor for all other policies, including the strict fiscal policies and ongoing structural reforms.

Looking forward, the CBA should remain viable, the staff representative observed. The exchange rate remained competitive and there was scope to improve the economy's competitiveness further over the medium term through continued improvements in the business climate and in the financial sector. The medium-term framework was also appropriate. While debt was still high, it was falling quite rapidly, and the maturity structure of debt was favorable, with long-term maturities and limited rollover risks given the lack of serious spikes in debt payments. As for the banking sector, the results of the FSAP mission showed that, while the banking system was not yet playing its intermediary role to the full extent possible, it was robust in respect to interest rate changes—the results of the FSAP would be reported more fully in the context of the Article IV consultation. For all those reasons, the CBA had worked reasonably well, and could continue to do so in the future. Judging from the experience in the Baltic countries—which had managed to maintain CBAs for eight or nine years without significant pressures—it should be possible to maintain a CBA for a relatively long period before EU accession.

On financing needs, as Mr. Guinigundo had pointed out, import coverage of reserves would fall even after Fund financing had been provided, the staff representative said. The reason for that was that balance of payments needs had been defined with respect to a fixed nominal level of reserves, and the import coverage of this level of reserves would fall if imports increased. The authorities could perhaps access private markets if it were decided that additional reserves coverage was to be required.

On the issue of market perceptions and the authorities' caution against making the arrangement precautionary, the staff representative explained that the authorities were concerned that the possible need to draw from the arrangement in future, after the arrangement had been declared precautionary, would send a negative signal to the markets that the situation was deteriorating. Therefore, it would be preferable to engage in an ordinary program and move to a precautionary program in the future if possible. It had been difficult to assess the probability that that would be the case, given the uncertain evolution of the external environment.

Regarding the question on the inclusion of restructuring costs in the public budget, the staff representative confirmed that funds had already been assigned to the restructuring of railway and district heating companies in the public budget.

The intention behind the link between the minimum wage and the public sector wage had been to remove minimum wage determination from the political debate, the staff representative remarked. While linking the minimum wage to the national average wage would probably had been the most appropriate way to achieve that aim, the poor quality of data on private sector wages had made the use of public sector wages as a comparator advisable. Presumably it would be possible to link the minimum wage to private sector wages as the relevant data improved over time.

The staff representative from the Monetary and Exchange Affairs Department (Mr. van der Vossen), in response to a question on the role of foreign banks in credit intermediation, observed that foreign banks had the expertise and the ambition to further extend their lending activities to the private sector, according to the analysis and the conversations held with representatives of those banks in the context of the FSAP. The reason why they were only doing this cautiously was that the legal and judicial frameworks in the country still posed considerable limits to lending activities, and there were still issues of disclosure and governance that needed to be resolved. Access to the European Union would certainly facilitate the provision of direct cross border services and the free establishment of branches in the country. While foreign banks were still somewhat cautious, they had already started taking strategic positions to take advantage of future opportunities posed by EU accession, and they would increase their intermediation of private sector credit as further progress was made toward EU accession. In that regard, the positive assessment given in the most recent EU accession report regarding the country's progress toward becoming a functioning market economy was welcome.

The overall framework of rules and regulations on anti-money laundering was consistent with international standards and practices, according to the results of the FSAP performed in November 2001, which was remarkable given the resource constraints faced by the authorities, the staff representative explained. While the authorities had been cooperating actively with other anti-money laundering agencies on the domestic and international fronts—for example with the interior security authorities and with foreign agencies—resource constraints were clearly an issue. In this respect, the recent decision of the Bulgarian authorities to provide additional resources to the Bureau of Financial Investigations was welcome.

As for the methodology used in the assessment of anti-money laundering rules and policies, the FSAP mission did not have at its disposal the current methodology document developed by MAE, but relied mainly on discussions with the management of the Bureau for Financial Investigations and on the review of anti-money laundering laws and regulations, the staff representative concluded.

Mr. Bhatta made the following statement:

> We thank the staff for their well-written report and Mr. Wijnholds for his informative preliminary statement. Despite a unfavorable external situation, the Bulgarian economy has performed reasonably well. Real GDP grew at about 4.5 percent in 2001, inflation remained subdued, external position was under control, and budgetary operations remained broadly on track. Overall, Bulgaria has established a good track record of macroeconomic stability. The authorities deserve to be commended for these achievements, and we support the requested Stand-By Arrangement.
>
> Notwithstanding a number of structural reforms and achievements, progress in some of the key sectors such as energy transportation and governance has remained inadequate. Unemployment and the current account deficit have remained high.

We broadly agree with the staff appraisal and will limit our comments on the structural reforms, unemployment problem, and fiscal policy.

On structural reforms, we welcome the efforts made towards achieving a fully market-oriented economy. We urge the authorities to accelerate the unfinished reform agenda, mainly in the transportation and energy sector. We welcome the authorities' intention to run some of the enterprises on a commercial basis rather than privatizing them immediately. For this purpose, the authorities need to strengthen corporate governance and build up management capacity so as to properly solve the issues of subsidies and labor problems.

Unemployment rate is higher in Bulgaria. As mentioned by staff, the country's overall employment declined by more than 10 percent in the last four years, as the large contraction in the public sector was not fully offset by gains in the private sector.

The authorities should pay more attention towards solving the problem of unemployment that is 18 percent at present. Since the problem of unemployment is due to the mismatch between the skills and the needs, attention should be paid towards building an adequate capacity of its labor force. Labor mobility should be encouraged minimizing regional disparities.

Turning to the fiscal policy, we commend the authorities' efforts in implementing prudent fiscal and income policies in the context of CBA. The authorities' intention to lower the budget deficit in 2002 and even to balance it over the medium-term should be appreciated. We also welcome the move to broaden the tax base and strengthen the tax administration. The reduced corporate and personal income tax rates would be helpful in promoting business and employment opportunities in the country.

On the expenditure side, social outlays should be allocated to support those that suffered the heaviest burden of transition. We also share the staff view that the authorities should limit the scope and size of the loan guarantee program.

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

Ms. Wei made the following statement:

Bulgaria has demonstrated a very convincing track record in terms of maintaining macroeconomic stability supported by its currency board arrangement, prudent fiscal and income policies, and continued structural reforms. The authorities' memorandum on economic policies well targets the important challenges facing the economy and the authorities have shown strong commitment to the arrangement. We are quite willing to support the authorities' request for Stand-By Arrangement.

I will make the following comments on the fiscal and unemployment policies.

On fiscal policy, we fully concur with the authorities' prudent and flexible fiscal policy, and its prudent income policy. As other speakers have pointed out, the prudent fiscal policy is crucial for the well functioning of the currency board and for maintaining fiscal sustainability. We join other Directors in welcoming the authorities' policy measures to lower corporate and personal income tax rates and to increase social spending and accompanying structural reforms to cut spending, including discretionary subsidies, strengthen tax administration and improve spending efficiency. Like Mr. Shaalan and Mr. Sakr, we see it as essential for the authorities to adhere to the program.

The unemployment rate has been quite high for years although the authorities have made great efforts to promote labor market flexibility. As the authorities tackle privatization and reforms in the health and education sectors with full force, efforts to cultivate a dynamic private sector should also be strengthened. Strong economic growth or the emergence of a dynamic private sector will help reduce unemployment. However, as pointed out by staff there is a mismatch of skills between what is needed in the private sector and those of the unemployed, and the unemployment rate among young people is disproportionately high. Good education and training seem to be a more effective solution, especially in the long run, as Bulgaria will need a well-trained labor force to compete in the international market. That said, we welcome the authorities' plan to amend the Labor Code and other policy initiatives to improve labor market flexibility and enhance productivity.

With these comments I wish the authorities success.

Mr. Monajemi made the following statement:

We would like to thank the staff for their clear and concise report and Mr. Wijnholds for his helpful statement. Bulgaria's overall economic performance in 2001 was favorable. Macroeconomic sustainability was maintained through appropriate policies in the context of the CBA. Despite adverse external shocks, real GDP growth has been higher than the average growth experienced in recent years, and domestic demand has remained robust due in large part to strong investment. Progress was achieved in maintaining fiscal discipline and implementing structural reforms. However, unemployment remained stubbornly high.

On the fiscal front, we welcome the authorities' commitment to balance the budget over the medium term. Their intention to continue with lowering taxes on labor and capital, broadening the tax base, and enhancing tax administration is noteworthy. The establishment of a united revenue agency is a positive step to strengthen collection of tax and social security contributions. Considering the uncertainty of the external economic and financial conditions, the authorities should stand ready to adopt a tighter fiscal stance if unwanted.

To sustain economic growth in the medium term, the authorities should step up their efforts to ensure the continued success of the CBA. According to the staff's analysis, developments in the banking sector are encouraging. We welcome the authorities' efforts to strengthen supervision through legislative changes and capacity buildup. However, to sustain the good performance in this area, privatization of state banks should be accelerated. Reducing the high unemployment rate, especially among the young and the unskilled, should remain on top of the authorities' agenda. While we welcome the positive steps taken by the authorities to increase flexibility of the labor market, we urge them to take measures to improve education and skills training, and to further build on economic incentives, especially through adequate wage setting and pension systems. The authorities' decision not to increase the minimum wage in the current year in light of the continued high unemployment is welcome.

To enhance competitiveness, the authorities are encouraged to accelerate the structural reform program and hence open opportunities for further private sector growth. We commend the authorities' efforts in privatization, including the passage of the privatization law. We join the staff in commending the authorities for their efforts in improving efficiency, particularly in the transportation and energy sectors.

On the external sector, further trade liberalization would strengthen Bulgaria's competitive position and reduce adjustment costs at the time of the EU accession. The average tariff is still high, and the authorities' intention to cut the most favored nation (MFN) tariff rate is encouraging. Their emphasis on improving debt management is welcome in view of the still high level of external debt.

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

Mr. Skurzewski made the following statement:

The EFF that expired last September was a success: Bulgaria has managed to restore macroeconomic stability after going through a financial crisis and later suffering from the Russian crisis and the impact of the Balkan conflicts. The new government, formed last July, passed its first test of macroeconomic responsibility by adhering to a tightened fiscal deficit target for 2001.

Nevertheless Bulgaria continues to face some vulnerabilities, of which the authorities are fully aware, as Mr. Wijnholds notes, and rightly chose to request the new arrangement, which we gladly support. The program centers on the continuation of the currency board, which implies that external pressures cannot be lessened with exchange rate adjustments. Therefore the support for the CBA has to come from a cautious fiscal stance and decisive structural reforms. In this context, while the authorities aim at a small budget deficit in 2002 and fiscal balance in the medium term, it will be important to improve efficiency of state owned enterprises and to set hard budget constraints for them in order to achieve those targets. In particular I fully support the wage control measures introduced for the public enterprises and I urge the authorities to strictly monitor the observance of the limits. I am also looking forward to the gradual adjustment of electricity and gas tariffs. The prolonged discrepancy between energy prices and the actual costs imposes a significant burden on the budget and may also affect the privatization of the energy sector.

Regarding the external position, a worrisome deterioration of the current account took place in 2001. The slowdown in the EU and the crisis in Turkey have taken their toll on Bulgarian export growth. Although the current account seems now under control, its deficit is under the risk stemming from the sustained weak EU growth and possible oil price changes. It is therefore comforting to learn from the staff that the decrease in exports does not seem to have been caused by a loss of competitiveness, since unit labor costs compare favorably with other countries. Nevertheless, I would encourage the authorities to make efforts to preserve and improve competitiveness in order to offset external pressures.

The external financing gap and the still high debt to GDP ratio underline the need to attract foreign direct investment, which the program assumes to increase from its depressed 2001 level to 900 million dollars this and next year. But the staff also points out that its actual level could be lower than expected. Therefore while a significant share of FDI is dependent on the privatization receipts I urge the authorities to drive the privatization process forcefully ahead. I welcome that a new privatization law, which aims at ensuring the transparency and quality of the privatizations, has been submitted to parliament, and that it will remove all preferential terms for management-employee buyouts.

Apart from attracting the FDI the overall business climate needs further improvement, in particular in the governance and regulatory areas. I welcome the plan to amend the civil procedure code to reinforce creditor rights. Moreover, while the recent tax rate cuts will contribute to improve the business conditions, I would also like to see explicit measures in the program that would address the complaints mentioned in Box 2 regarding red tape and an inadequate legal system. Private sector growth will be important to absorb the extremely high number of unemployed, particularly since further layoffs must be expected from SOEs. I also welcome authorities' efforts to amend the Labor Code to enhance the flexibility of the labor market. The policies aiming at allowing unemployed to acquire new skills look reasonable and I hope they will produce some positive results. Like the staff, I would warn, however, that the program which extends guarantees for Micro Crediting should not be augmented to limit the budgetary costs. I also share the observation of the staff and Mr. Shalaan/Mr. Sakr and others that private sector credit seems to be limited by underdeveloped financial intermediation and structural barriers to borrowing, also reflected by sustained large interest rate spread.

To conclude, the way ahead is clearly laid out in the program. Given that Bulgaria's track record is particularly good with respect to macroeconomic policies, but less so with respect to structural reforms, I would like once more to stress the importance of the latter.

I encourage the authorities to move forcefully ahead with the needed reforms and wish them success in their endeavors.

Mr. Kropas made the following statement:

I join previous speakers in welcoming the remarkable achievements by the Bulgarian authorities in putting the economy on a quite solid growth path. Bulgaria has made impressive progress on macroeconomic stabilization, structural reforms, privatization, especially in regards to banks, and institutional reforms.

EU accession tops the political agenda and has provided a sound framework for stability and economic progress and has become a key driving force behind the country's reform efforts. The latest EC progress report acknowledged that Bulgaria is getting close to being a functioning market economy, and even in a less favorable international environment, international rating agencies upgraded Bulgaria's credit rating.

I have no difficulty in supporting the new Stand-By Arrangement. To reinforce the success of the previous program it is absolutely essential for the Bulgarian authorities to continue a very close cooperation with the Fund. The new program seems to be very ambitious and broadly consistent with the country's needs in the medium term.

The fiscal stance of the program is generally appropriate to preserve and gradually improve external vulnerability. The measures to enhance tax collection by strengthening the tax administration and tax reform, targeted to the elimination of distortionary effects and improve the business climate, are welcomed. The program also covers important measures to preserve the sustainability of social benefits in a short-term perspective.

I welcome the authorities continuous efforts to strengthen the budget's flexibility and readiness to move to a tighter fiscal stance in case of less favorable developments. The authorities already demonstrated determination to the adherence of their commitments by tightening the fiscal stance and implementing difficult measures in response to the deteriorating current account balance. However, moving expected future dividend payments of the state-owned monopolistic companies forward and extending one time payments to the pensioners are measures the authorities should avoid in the future.

With regard to the middle-term fiscal stance, my main concern is the inadequate progress in addressing governance issues and in strengthening the administrative capacity which might undermine the authorities' ability to implement new legislative and regulatory framework, fight corruption and achieve efficiency gains.

The persistently high unemployment rate is perhaps one of the most troublesome aspects of the economic performance. As many other transition and accession countries, Bulgaria is facing similar problems due to unemployment losses associated with structural reforms, which are not compensated by job creation because of the weak business climate and due to skills mismatches. SMEs, which should become the main source of job creation, have not developed their potential since they are suffering from the worst aspects of an unfriendly business climate including corruption and burdensome bureaucracy.

Therefore, the additional allocation of resources for targeted training of long-term unemployed or those in high-unemployment regions are welcomed. Labor market flexibility measures such as lowering labor taxation and broadening the tax base, introduction of more flexibility in the termination of the contracts and working hours are important, but might not be sufficient to prevent unfavorable tendencies. Further implementation of the labor market flexibility measures would be essential.

The banking sector is generally sound and will gain substantially by implementation of measures based on conclusions and recommendations of the FSAP. However, financial intermediation remains thin, and the level of commercial bank lending is low. Lack of financing remains a serious obstacle to the healthy development of the SME. Therefore, market based measures aim to eliminate structural barriers to credit growth, including strengthening corporate governance in the enterprise sector, improving accounting standards and regulatory framework are welcomed.

Privatization of the remaining state-owned banks will strengthen competition and reinforce further credit growth, but the authorities should be aware that a high level of foreign ownership often leads to reorientation of the business strategy. Lending to the SME usually is not among the first priorities. So the creation of additional incentives and mechanisms, based on market principles and facilitating SME access to the financing, are essential. We welcome the intentions to allocate additional recourses, committed to the SME lending, but agree with the staff that the authorities should avoid distortions of credit market based lending decisions.

With these remarks, I wish the authorities all the best.

Mr. Le Gal made the following statement:

I am glad that negotiations for a new program with Bulgaria have been successfully completed. Since 1997, Bulgaria's performance has been remarkable. The relationship with the IMF has been constructive and I think this is a success case for both the Bulgarian authorities and the Fund. The success of the Eurobond issuance and the increase in Bulgaria's rating are also clear signs of the progress achieved so far.

The Staff's report is comprehensive and analyzes with candor all the strengths and challenges of the Bulgarian economy. From Mr. Wijnholds's statement, I understand that the authorities' commitment to pursue the reforms and to continue toward EU accession remains strong. The proposed program is well designed and consistent with this objective.

I find it difficult to add much to the report and previous speakers' comments and therefore I will limit my intervention to two comments.

My first comment is centered on the Currency Board and its sustainability. In focusing the debate on exchange rate regimes and whether one should or should not support only corner solutions, one might forget that the key question is how consistent a country's economic policy is and whether its regime and its policy mix are supporting each other.

In that regard, and as it was confirmed by Staff's answers, Bulgaria has made a clear choice and its recent history of fiscal prudence, implementation of structural reforms alongside a prudent debt management justify the authorities' confidence in this regime and their intention to maintain it. Mr. Wijnholds's statement makes it clear that the new program is indeed based on three "equally important and mutually dependent" assumptions consistent with Bulgaria's goal of joining the European Union. I share the Staff's appraisal and I agree with the recommendation for fiscal prudence as well as the attention paid to structural reforms. The coverage of structural conditionality is broad and I think this is appropriate to support Bulgaria's transition and accession strategy.

My second comment is to emphasize the need for growth and employment. Since 1997 Bulgaria has made a lot of progress in imposing hard budget constraints throughout the economy. There is still an unfinished agenda and I agree with the measures taken by the government to impose further this constraint on the local authorities as well as on the state owned enterprises. Unfortunately, the impact on employment has been negative with a decline of 10 percent during this period. We welcome the authorities intention to make room in the budget for the social spending. However, the true success will come from a development of the private sector and new job creations. In that regard, it is critical to improve the business climate and I concur with Staff's recommendation in paragraph 9. Regarding corruption, I thought that during the last five years things had improved. Maybe the staff can confirm this and further elaborate on the next steps envisaged by the government in this area. The two themes of the next World Bank Country Assistance Strategy planned for this spring will be addressing the improvement of living standards and the investment climate. We think this focus is well placed and will appropriately support the Fund's program. With these comments I support the proposed decision.

Mr. Mellor made the following statement:

I would like to congratulate the authorities on their progress, and agree with many of the comments already made by other speakers. In particular, I would like to associate myself with the remarks made by Mr. Baukol on small and medium enterprises (SMEs) and by Mr. Vittas on the fiscal stance in the 2002 budget. On the latter point I agree with the aim of reforming schools, health and the pension system. Perhaps the staff could obtain more detailed data on the proposed measures and their impact, particularly in terms of poverty reduction.

I would just like to make two additional remarks at this point in the discussion. On inflation, I have some concerns over the attainability of the projected inflation target of 3.5 percent by the end of 2002. I would be interested in the staff's views on the realism of this inflation target, given the CPI inflation in January and the government's welcome intention to increase energy tariffs to the cost recovery level. I would also welcome any thoughts the staff might have about appropriate policy responses if inflation significantly exceeds the target.

Regarding the outstanding reforms for Bulgaria to become a fully functioning market economy and meet the Copenhagen economic criteria for accession to the European Union—the outstanding reforms are listed in paragraph 9 of the staff report and have also been mentioned in Mr. Wijnholds's preliminary statement—I would like to have further explanation from the staff on the methodology used to reach this assessment, assuming that the assessment has been made by Fund staff, rather than being simply based on analysis by the European Union. Obviously in the context of EU enlargement, the European Commission will have an independent view on Bulgaria's progress, but it would be valuable to see if there are ways in which the Fund could work alongside the Commission in assessing this progress.

With these remarks I can support the request for a Stand-By Arrangement and wish the authorities well.

Mr. Maino made the following statement:

We thank staff for a well-written report on Bulgaria's economic prospects in the context of its request for a two-year Stand-By Arrangement. The three-year extended arrangement that recently expired provided the framework for reducing inflation, lowering the external-to-GDP ratio and stimulating output growth. Bulgaria has made significant strides towards establishing macroeconomic stability, supported by key structural reforms and a steadfast policy implementation by the authorities. Notwithstanding the economic slowdown during the last two years, the authorities managed to pass a budget for 2002 consistent with the program proposed under the Stand-By Arrangement and a privatization law to provide the necessary legal framework to reinforce the structural reform in the enterprise sector.

The challenge for Bulgaria is to sustain economic recovery amid adverse external shocks arising, mainly, from a slowdown in Europe and deterioration in the terms of trade. The outlook for the economy is quite promising, provided the authorities persevere with implementation of pending fiscal and structural reforms. Additionally, we encourage the authorities to remain engaged in the free trade arrangements by lowering tariff rates and bands with the European Union. The adoption of a clear schedule for tariff reduction emerges, as an opportunity to strengthen trade with the European Union and to consolidate efficiency gains associated with the trade liberalization process, thus paving the way for transition to an eventual EU accession.

As we broadly agree with the thrust of the staff appraisal, we would like to emphasize three aspects.

Monetary Policy

The authorities commitment to the currency board has provided a firm nominal anchor for the economy. The authorities' pledge to maintain this monetary strategy enacted in 1997, is contributing to the stability of domestic prices. At the same time, as Mr. Shaalan and Mr. Sakr underscored, it is not surprising that real GDP growth turned positive, inflation came down to a single digit and market confidence was restored in an environment of larger FDI flows and narrower interest rate spreads. In this respect, a credible path for pending structural reforms is key for the continued viability of the currency board arrangement. The process of rebuilding credibility and maintaining market confidence, in an environment sensitive to external developments is in our view closely linked to avoiding fiscal slippages and a loss of the structural reform impetus. In this regard, we welcome the firm commitment of the authorities to seize this opportunity offered by eventual EMU association for the formulation and implementation of policies and at ensuring a smooth exit strategy.

Fiscal Policy

We are encouraged by the on-going efforts to reduce the budget deficit within a framework of lower taxes on labor and capital, a broader tax base and improved tax administration. We also concur with Mr. Shaalan and Mr. Sakr on the appropriateness of maintaining the prudent practice of limiting discretionary expenditures to 90 percent of the budgeted amounts in the first three quarters of the year in order to ensure sufficient counterpart revenues.

Structural Front

The main challenge facing the authorities in the period ahead is in particular related to the capacity to advance the restructuring or closing of SOEs. Given the authorities' objective of promoting the private sector and competition to bring about further efficiency gains, putting in place and enforcing an adequate regulatory framework is paramount. Similarly, the moderate expansion of credit to the private sector is a matter of concern. In this respect, we concur with staff on the desirability of privatizing the remaining public banks and acting on the recommendations advanced by the FSAP mission. In this sense, we would welcome staff comments on the progress achieved in revamping the legal framework to facilitate corporate workouts and in implementing the FSAP recommendations.

In sum, we concur with the positive staff assessment of the Bulgarian economy advanced in the staff appraisal. We commend the authorities for the progress made and encourage them to persevere in their reform agenda. With these comments, we support the authorities request for a Stand-By Arrangement and the proposed decision, wishing them every success in their future endeavors.

Mr. Milton made the following statement:

We thank the staff for the very comprehensive document that provides a detailed appraisal of Bulgaria's economic outlook and program parameters in support of the country's request for a Fund supported Stand-By Arrangement. We also thank Mr. Wijnholds for a very informative and helpful preliminary statement that provides further information and analysis supporting the authorities' request. Given Bulgaria's consistent performance under previous Fund supported programs, their current sound implementation of economic policy, as well as the well designed but sufficiently ambitious proposed program with the Fund, we can state from the outset, that we support the proposed decision.

Since we are in broad agreement with the overall thrust of the staff paper, we will limit our comments to a few issues.

Macroeconomic Performance

We commend the authorities for the consistent pursuance of macroeconomic stabilization policies since the severe financial crises of 1996/97. Following the implementation of a broad range of policies in the fiscal area, the introduction of the Currency Board Arrangement (CBA), as well as structural reforms to expedite the privatization process, the economy rebounded from a period of severe GDP contraction, to the highest GDP growth performance over the last few years among transition economies. Furthermore inflation was reduced from very high levels to single digit levels, a small fiscal deficit was recorded over the last three years, and the public debt as a ratio of GDP was reduced from more that 100 percent two years ago to 75 percent in 2001. We would urge the authorities to continue to pursue the implementation of this sound policy framework, particularly the CBA arrangement, which indeed served the country well with regard to inflation.

Fiscal Policy

We would urge the authorities to maintain a strong fiscal stance, since fiscal policy under the CBA remains the main instrument in maintaining macroeconomic stability. In this regard, we are pleased to note from Mr. Wijnholds statement that this is indeed the intention of the authorities, and that this commitment was confirmed with the adoption of the 2002 budget. We are also pleased to note that the authorities have continued to pursue reforms on the revenue side to ensure a broadening of the tax base. To this end, the government's commitment has clearly been illustrated by introducing VAT on medicine, which we appreciate from Mr. Wijnhold's statement, was clearly a very risky political decision.

On the expenditure side, we welcome the commitment towards increased social expenditure, as highlighted in the recent budget. We would nevertheless support the views expressed by Mr. Shaalan and Sakr that the authorities should resist any pressures to increase expenditures that could jeopardize their medium-term budgetary outlook.

Labor Market and other Reforms

The high level of unemployment in the country remains a concern. We are pleased to note that the authorities intend address this problem by introducing policies to increase labor market flexibility. We would also urge the authorities to continue to implement their privatization program, and to improve the regulatory and legal environment, which in our view could contribute to increased competitiveness and enhanced growth.

With these remarks we wish the authorities success with their every endeavor.

The staff representative from the European I Department (Mr. Schiff), in response to Mr. Le Gal's question about the progress made in reducing corruption, observed that some progress had been made. Notwithstanding the difficulties associated with measuring corruption, the perception according to surveys performed by Transparency International was that the situation had improved in the previous four years. Certain elements of the program, such as the privatization law and improvements in customs administration would help reduce corruption and increase transparency even further.

On Mr. Mellor's question about the impact of proposed cuts in education, the staff representative explained that there was scope to reduce the number of teachers without adversely affecting the quality of education, as the student-teacher ratios were currently among the lowest in the world as a result of demographic trends. The authorities would also be careful to ensure that expenditure cuts did not result in unintended reductions in enrollments in areas with special needs such as rural areas or areas of residence of minority populations.

Regarding the achievability of the annual inflation target for 2002, the staff representative pointed out that, while it was possible that the 4.5 percent target for the 2002 average annual inflation could be somewhat exceeded, 12-month inflation figures would likely come down quite rapidly after January. The high inflation rate in January mainly reflected one-off effects of measures such as the introduction of new excise taxes, the extension of the VAT to medicine, and increases in energy prices.

To conclude, the European Commission's characterization of Bulgaria's economy as one close to a functioning market economy was based on their own assessment, with which the staff had broadly agreed, the staff representative informed.

Mr. Wijnholds made the following concluding remarks:

I welcome the recognition by Directors of the progress made under the previous arrangement and the approval of the request for a new Stand-By Arrangement that will help address the remaining weaknesses in the country and help support the process of EU accession. The Fund's support is needed in a country that still has significant poverty, and it is also deserved given the cooperative approach that Bulgaria has also taken in its relationship with the Fund.

Unemployment is clearly a problem, although it has to be seen in the context of the restructuring of state-owned enterprises, which has entailed significant liquidation and streamlining of companies. In that context, the emphasis needs to be on job creation in the private sector, a process that will clearly take some time. The World Bank has an important role to play, for example by helping improve the business climate.

The support from all political parties for the CBA has helped make the exchange rate regime sustainable. In particular, the stringent fiscal policy followed has played a key role, as this is a requirement for the successful operation of a CBA.

On the discussion over whether the arrangement should be precautionary, as Mr. Vittas has noted, the amount of assistance requested is modest and well within the Fund's policy on access limits. While the decision whether to make the arrangement precautionary is of limited practical importance under current circumstances, there is a risk that pressures of external financing could arise in the future. If that were the case, drawing on an arrangement that had previously been announced as precautionary would send a negative message to markets. In addition, it is important not to push the country toward international capital markets too rapidly, given the already high external debt and the need for caution under the current exchange rate regime—this lesson has been learned after recent developments in the international community. Such considerations notwithstanding, the country has successfully tapped the markets in 2001 and it can do so again in the future in relatively good terms, given the market's appetite for diversification.

Finally, I look forward to further good cooperation between the Bulgarian authorities and the Fund staff, and I am optimistic about the outcome of this program.

The Acting Chair made the following summing up:

Executive Directors approved the Bulgarian authorities' request for a Stand-By Arrangement. Bulgaria has established a good track record of macroeconomic stability and sound policies under the three-year program that expired in the fall of 2001, and Directors encouraged the authorities to be ambitious in the implementation of the program. They stressed, however, that the country continued to face reform challenges.

Directors agreed that an economic program centered on the currency board arrangement, the continuation of a prudent and flexible fiscal policy and strict income policy, and an acceleration of privatization and other structural reforms, offered the best prospects for achieving rapid sustained growth, safeguarding external viability, and reducing unemployment and poverty. They urged the authorities to resist pressures to relax their policy stance in these areas.

Directors considered that Bulgaria's prospects for 2002 are broadly favorable, but noted the downside risks due to the uncertain timing and strength of the recovery in Western Europe. They cautioned that the external current account deficit, projected to be near 6 percent of GDP, should be closely monitored. Directors noted the large increase in inflation in January, but agreed with the staff that this was mainly due to one-off factors, and that inflation would be subdued in the remainder of the year.

Directors welcomed the authorities' commitment to maintain the currency board arrangement at least until accession to the European Union. They agreed that this arrangement continued to provide a stable monetary environment, contribute to low inflation, and boost confidence. Directors cautioned, however, that the continued viability of the currency board arrangement will require perseverance with sound macroeconomic policies and structural reforms. They underscored the need to safeguard Bulgaria's external competitiveness and to increase the economy's flexibility to respond to external shocks.

Turning to fiscal policy, Directors welcomed the authorities' intention to keep the budget deficit in 2002 below 1 percent of GDP and to reduce it in 2003 further toward balance. Attaining these deficit targets will require strict implementation of reforms aimed at limiting the growth in expenditure through reforms in health care, education, railways, and the energy sector. Directors commended the measures to strengthen the social safety net and ensure better targeting of social assistance.

Directors urged the authorities to implement the incomes policy for state-owned enterprises and take steps to further enhance labor market flexibility. They considered that these policies would guide appropriate wage formation in the private sector, improve labor mobility, and facilitate enterprise restructuring. In view of the continued high unemployment, Directors also stressed the need to pursue targeted labor market programs and, following the substantial raise in late 2001, to refrain from further increases in the minimum wage this year.

Directors considered that the banking sector was overall well supervised, highly capitalized, profitable, and resilient to foreign exchange and interest rate risks. They were concerned, however, that bank lending to the private sector remained low and the nonbank financial sector underdeveloped. Directors urged the authorities to complete as a matter of priority the sale of the last two public banks to well-qualified strategic investors. To stimulate credit to the private sector, Directors encouraged the authorities to provide quality credit information, strengthen corporate governance and enforce creditor rights. They welcomed the plans to develop financial markets and intensify efforts to combat money laundering, as well as the intention to implement the recommendations of the FSAP.

Directors commended the authorities on their efforts to privatize non-infrastructure enterprises. They also emphasized the need for further restructuring in the transportation and energy sectors with a view to improving efficiency and reducing risks to the budget. Announcing a timetable for the adjustment of household energy prices to cost-recovery levels, making the new regulatory pricing regime fully operational, and adopting a new Energy Act will be particularly important in this regard.

Directors welcomed the initiatives to liberalize trade further and pursue a more active debt management strategy. Directors encouraged the authorities to develop and implement a public debt management strategy aimed at lowering the debt-to-GDP ratio and reducing portfolio and roll-over risk.

The Executive Board took the following decision:

1. The government of Bulgaria has requested a Stand-By Arrangement in an amount equivalent to SDR 240 million for a period of two years from February 27, 2002 to February 26, 2004.

2. The Fund approves the Stand-By Arrangement for Bulgaria set forth in EBS/02/24, Supplement 1 (2/27/02), and decides that purchases may be made under the arrangement on the condition that the information provided by Bulgaria on the implementation of the measures specified as prior actions in Table 1 of the Memorandum attached to the letter dated February 12, 2002 is accurate.

3. The Fund waives the limitation in Article V, Section 3 (b) (iii). (EBS/02/24, Sup. 1, 2/27/02)

Decision No. 12687-(02/20), adopted
February 27, 2002

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/02/19 (2/25/02) and EBM/02/20 (2/27/02).

3. BANGLADESH, BRUNEI DARUSSALAM, JORDAN, AND UKRAINE—ARTICLE IV CONSULTATIONS—POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance Over Exchange Rate Policies," attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board decides that the period for completing the next Article IV consultation with Ukraine, Brunei Darussalam, Bangladesh, and Jordan shall be until the dates indicated in EBD/02/29 (2/19/02) for such country.

Decision No. 12688-(02/20), adopted
February 26, 2002

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 01/126, 02/1, and 02/3 are approved.

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors, by Advisors to Executive Directors, and by Assistants to Executive Directors as set forth in EBAM/02/25 (2/22/02) and EBAM/02/26 (2/25/02) is approved.

APPROVAL: May 8, 2002

SHAILENDRA J. ANJARIA
Secretary