ANNEX

SUMMING UP BY THE CHAIRMAN

The following remarks by the Chairman were made at the conclusion of the Executive Board's discussion of the Global Financial Stability Report *on March 19, 2007.*

Directors welcomed the balanced, in-depth analysis and discussion of financial risks in the *Global Financial Stability Report* (GFSR). They agreed that global financial stability continues to be underpinned by solid economic prospects, although downside risks have increased somewhat in a few areas.

Assessing Global Financial Stability Risks

Directors considered that a number of market developments warrant increased attention, reflecting a shift in underlying financial risks and conditions since last September's GFSR. While none of the identified short-term risks constitutes, in and of itself, a threat to financial stability, adverse events in one area can lead to a reappraisal of risks in other areas—with possible broader implications for the economy. The recent market turbulence validates this assessment, and serves to remind market participants that such reevaluations can occur quite rapidly.

Directors agreed with the general assessment portrayed in the global financial stability map presented by the staff, namely, that macroeconomic risks as well as those faced by emerging markets have eased marginally since September, but that market and credit risks have risen, albeit from relatively low levels. This has occurred against the backdrop of relatively benign monetary and financial conditions and a continued increase in investors' appetite for risk. Directors welcomed the global financial stability map as a useful tool for visualizing changes in the main near-term risks. They considered that further staff work on the analytics underpinning the map and their integration with the GFSR should serve to strengthen the framework for assessing financial stability.

Directors had a wide-ranging discussion of the near-term risks to the global financial system. Some Directors felt that the risks of a possible spillover of the deterioration of credit quality from the U.S. subprime mortgage segment to broader market segments were relatively minimal, given the underlying support provided by the strong household income growth and the low unemployment rate, as well as the relatively small size of the subprime segment and the concentration of problem loans in states with weak employment. However, most Directors expressed varying degrees of caution or concern going forward. Mortgage securities are now held more widely by both public and private international investors as a result of wider securitization. Directors noted that the risk has been distributed more widely, thereby enhancing the resiliency of financial markets. At the same time, the identification of the ultimate holders of risk in the mortgage-related derivatives market has become more complex, and many Directors called for more focused attention to the possible spillover effects of an unwinding of risky positions on other asset classes or on U.S. consumer confidence.

Directors observed that the wider use of leveraged buyouts and the heavy flows into private equity have increased the risks to the corporate sector, but agreed that this is not yet worrisome. At the same time, continued supervisory vigilance and scrutiny of credit discipline and lending standards will be required. A few Directors noted possibly longer-term effects on corporate leverage, with newly acquired companies with very high leverage ratios potentially experiencing difficulties if the current benign financing conditions change. Moreover, developments in the leverage loan market suggest some relaxation of credit discipline that could weaken overall corporate credit quality. A key question is whether the possible reactions of investors in credit risk transfer markets to changing circumstances could give rise to wider financial stability concerns. A promising area for further research is the medium-term ramifications of private equity activity, including the extent to which regulatory costs may be a factor in encouraging a shift from public to private companies.

Directors noted that although the risks of a disorderly unwinding of global imbalances have eased somewhat, they remain a concern, and require the pursuit of appropriate policies. Large inflows are still needed to finance the U.S. current account deficit. Directors underscored that fixed-income inflows have become more dominant and more sensitive to interest rate differentials between various countries and the United States. Many Directors noted that the increased sensitivity could make attracting inflows more susceptible to changes in investor sentiment, pointing to the need to pay continued attention to the role of shifting exchange rate expectations in the demand for U.S. fixed-income securities.

Directors generally agreed that risks and vulnerabilities in emerging markets have broadly declined, reflecting improved economic fundamentals, sound macroeconomic policies, and prudent debt management. Combined with investors' search for yield, this has resulted in large capital inflows in a number of countries, posing challenges to policymakers. Directors observed that an investment environment conducive to the maintenance of confidence, the efficient use of capital, and the development of local financial markets should help emerging markets reap the benefits of foreign capital. At the same time, they called on staff to continue to work toward identifying measures and strategies that would help mitigate the adverse effects of rapid capital inflows or possible reversals.

Directors discussed the relative contributions of structural and cyclical factors in bringing about the current low financial market volatility and historically tight risk spreads, which have encouraged risk-taking. Some concern was expressed that investors may be giving insufficient weight to downside risks, particularly the prospect of near-term reversal of the cyclical factors contributing to the low volatility environment—abundant global liquidity, still low corporate leverage, and high risk appetite. At the same time, it was suggested that market participants generally understood the risk outlook, and that the recent turbulence was evidence that rapid price changes can be absorbed easily. In this regard, while carry trades are a natural outcome of the current set of interest rates and low volatility in foreign exchange markets, some Directors expressed concern about the possibility of large currency swings if investors attempted to unwind carry trade positions suddenly in response to an increase in underlying volatility. Directors noted that hedge funds have played a constructive role in improving market efficiency and stability, but cautioned that their size and complex risk structure can lead to increased transmission or amplification of shocks. They underscored the importance of greater transparency to investors and counterparties for monitoring hedge fund activities as a means to support financial stability. Some Directors emphasized that indirect monitoring of hedge fund activity is likely to remain the most effective and practical approach. Directors noted the work and analysis under way both nationally and internationally, including at the Financial Stability Forum, and some Directors also saw a positive role for the IMF in the design of constructive solutions for hedge fund regulation or monitoring.

Changes in the International Investor Base and Implications for Financial Stability

Directors observed that the increased diversity of assets, source countries, and investor types contributes to a globalized financial system which, by allowing capital to flow freely, should enable a more effective diversification of risks, enhance the efficiency of capital markets, and support financial stability. They underscored the importance for market participants to bear the risk of their positions, while policymakers should underpin the strength of the financial system through structural reforms and strong macroeconomic policies. Directors also stressed the need to devise mechanisms to deal with the considerable gaps in information concerning global financial flows.

Directors believed that the larger global diversity of investors and the increase in institutional investors with longer investment horizons should support financial stability. However, several Directors expressed concern that in some countries increased demand has outpaced the availability of domestic financial assets, leading to a sharp increase in asset prices, rapid credit growth, and currency appreciation.

Directors noted that the development and improved functioning of domestic financial markets can help reduce the likelihood of foreign investors withdrawing their funds. Directors acknowledged that facilitating capital outflows to allow domestic investors to better manage risks and help mitigate strong inflows may be of particular relevance for certain emerging market economies. At the same time, Directors underscored the importance of gradual and carefully sequenced liberalization of financial markets, and several Directors observed that economic efficiency, rather than conjunctural factors such as the need to reduce pressures on asset prices and currencies from rapid inflows, should be the main rationale for outward capital account liberalization.

Globalization of Financial Institutions: Financial Stability Implications

Directors noted the accelerating trend toward the globalization of financial institutions—which is most evident for banks, but also present in the asset management, insurance, and reinsurance industries. Directors considered that the process of globalization has generally improved financial stability, although some Directors cautioned that it cannot be taken for granted that global financial systems as a whole are more resilient in the face of extreme events. In this respect, some Directors noted that increased international linkages within and across countries may make crises more broad-ranging and complicated to deal with.

Directors welcomed the contribution being made by the GFSR to financial sector surveillance, including in encouraging national legal, regulatory, and supervisory systems to adjust to the more globalized financial environment. In this respect, Directors favored improved mechanisms for multilateral collaboration, specifically for strengthening ongoing supervisory coordination, including through better application of well-established international standards and further work on crisis management and resolution arrangements. Overall, Directors thought that even relatively modest but practical steps to make progress on domestic policies and procedures, while enhancing cross-border cooperation and coordination, will increase the benefits of globalization while mitigating some of the potential risks to financial stability.

ANNEX SUMMING UP BY THE ACTING CHAIR

The following remarks by the Acting Chair were made at the conclusion of the Executive Board's discussion of the Global Financial Stability Report *on August 23, 2006.*

Assessment of Financial Stability and Policy Implications

Directors welcomed the concise and focused analysis of the *Global Financial Stability Report* (GFSR). The staff's assessment was seen as balanced, pointing to both the resilience of international financial systems and the downside risks to the baseline scenario of continued strong growth.

Directors noted that increased uncertainty about the sustainability of current global growth amid rising inflationary pressures, persistent global imbalances, and a weakening U.S. housing market had triggered a bout of volatility in mature markets and turbulence in emerging markets (EMs) during May and June 2006. Global financial markets calmed subsequently as inflation fears declined, as the likelihood ebbed that key central banks would tighten more significantly, and as some EMs were seen as correcting from lofty valuations. Directors considered that markets remain underpinned by a favorable overall outlook for the global economy, and that recent market volatility does not foreshadow a sustained downturn in global growth. Corporate balance sheets and profitability are strong and financial institutions are healthy, supporting the resilience of international financial systems.

However, Directors agreed that international financial markets face risks—tilted to the downside—to the *World Economic Outlook* baseline scenario. These risks are an intensification of inflation pressures requiring more monetary tightening than currently expected; further increases in oil prices due to geopolitical uncertainties; and a more pronounced slowdown in the U.S. economy, led by a rapid cooling of the housing market. Also, a rapid unwinding of global economic imbalances, although unlikely, could be accompanied by financial turbulence. Several Directors cautioned that standard measures of expectations indicate that financial markets may not be factoring in potential greater uncertainty, increasing the risk that market movements could be amplified in the event of unexpected shocks. A number of Directors commented that while the development of credit derivative and structured credit markets have been, on balance, supportive of a diversification of credit risks, the rapid growth of hedge funds and credit derivative mechanisms in recent years adds to uncertainty, and that they merit further analysis. They stressed the importance of being able to anticipate how these entities will react in the event of market turbulence and the systemic impact.

Directors concurred with the staff's conclusions regarding policies for sustainable capital flows and the orderly adjustment of global economic imbalances. The depth, liquidity, and breadth of U.S. financial markets have played an important role in attracting capital inflows from both the foreign official and private sectors. At the same time, most Directors considered that these comparative advantages may diminish over time as the demand for foreign holdings of U.S. assets approaches its limits, and as structural improvements are made in competing international financial markets. Most Directors noted that growing liberalization of private capital outflows and the diversification of the investment of official reserve holdings support the smooth adjustment of global financing flows. Nevertheless, although considered unlikely, the risk cannot be ruled out that a dollar decline could create financial turbulence, given that foreign investors' exposures to losses from such a decline are large and growing.

Directors agreed with the staff's assessment that the recent turbulence in EMs reflected corrections in the wake of substantial past investment inflows and price increases, rather than a reassessment of EM fundamentals. The resilience of EM sovereign bond and credit risk spreads reflects investors' perceptions of improved fundamentals in many EMs, including lower current account and fiscal deficits, higher levels of reserves, and improved public debt structures. Nonetheless, Directors agreed that the correction also underscored that some EMs remain susceptible to a retrenchment by foreign investors because of greater uncertainty in the external environment. In particular, those countries with large balance of payments needs, coupled with excessive reliance on portfolio inflows, and/or where monetary and fiscal policy credibility is less well established, are more vulnerable. Directors noted that private sector debt inflows have increased sharply in recent years and may require close monitoring, particularly bank flows to private borrowers—including to households—in Central and Southeastern Europe.

Directors observed that policymakers in both mature and emerging markets face renewed challenges in ensuring balanced economic growth and financial stability, against the backdrop of heightened uncertainty and downside risks to the global economic outlook. Country authorities need to work cooperatively so that policies reinforce an orderly adjustment of global imbalances and prevent the emergence of disruptive market conditions. Supervisors and important financial institutions need to intensify their efforts to monitor and manage risks in the financial system. EMs will need to continue to reduce their vulnerabilities, particularly those with macroeconomic imbalances and a heavy reliance on external financing. Directors endorsed the continuation of debt management policies to further improve public debt structures, and the strengthening of local markets to help them absorb smoothly inflows from foreign investors and reduce their exposure to foreign currency financing.

Household Credit Growth in Emerging Market Countries

Directors welcomed the opportunity to review household credit in EM countries. Household credit can have important benefits for borrowers, lenders, the financial system, and the economy, and the sound development of this sector should be encouraged. Directors considered that in most EM countries, retail credit expansion has been from relatively low levels and does not pose a threat to financial stability.

Directors cautioned that the growth of EM household credit in recent years has occurred in a benign environment of low interest rates in mature markets, falling EM interest rates, ample liquidity, and rising incomes and housing prices. The monetary tightening by many mature market and EM countries since the first quarter of 2006 could yet reveal weaknesses in the household credit sector in some EM countries. These countries should work to manage the risks and vulnerabilities through prudent macroeconomic management, sound prudential regulations, a supportive legal environment, and robust banking and financial data systems.

Directors emphasized that prudent macroeconomic management is the key to minimizing the buildup of interest and exchange rate risks. Appropriate fiscal and monetary policies will help prevent excessive credit growth, which can result in unsustainable consumption levels, current account imbalances, and property boom-and-bust cycles. Directors warned that credit financed predominantly by external capital inflows heightens the vulnerability to sudden stops and financial crises, and needs to be managed carefully.

Directors agreed that informed prudential regulation is essential to ensure healthy household credit growth. They suggested supplementing the standard prudential mechanisms with ex ante provisioning, given the pro-cyclical nature of household credits. Also, regulators should promote conservative origination standards, but refrain from direct intervention in product design. For countries such as those in emerging Europe, where household credits are materially dependent on cross-border capital inflows, regulators should improve their dialogue and coordination with home-country regulators of large foreign banks, to ensure that the possibility of a sudden capital flow reversal is adequately guarded against. A number of Directors advised that direct controls on lending be considered only when the lending presents large systemic risks.

Directors recommended that, to improve the legal environment and infrastructure to support household credit and risk management, enabling reforms be implemented in the areas of securitization, the enforcement of collateral, the sharing of credit information, rating agencies and credit bureaus, transparency in lending, and consumer protection and education. Directors encouraged member countries to facilitate cooperative efforts to develop good product standards, fair marketing practices, and information sharing.

Directors noted the importance of improving data availability for effective monitoring and management of potential vulnerabilities. Increased efforts are needed to monitor and assess the buildup of credit, interest, rollover, and exchange rate risks in household credit portfolios, which may require upgrading the analytical capacity of regulators and supervisors. Directors recommended that risk measurement based on bank reporting be complemented with improved measuring and monitoring of asset prices and of household debt and net worth, and with stress testing of specific shocks.

Directors pointed to the possible constraints on the use of traditional policy measures in case of systemic distress affecting a large number of households. A situation in which household bankruptcies become commonplace may be quite different from a situation of large-scale corporate distress, as political pressures may make conventional crisis management tools difficult to use. For this reason, Directors suggested that countries in which the interest and exchange rate exposure of households is large should maintain adequate reserves and set in place contingency plans to confront large interest and/or exchange rate movements.