ANNEX CONCLUDING REMARKS 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 March 14, 2003.*

Executive Directors welcomed the first in the new series of semiannual Global Financial Stability Reports (GFSRs). They appreciated the strengthened analytical content of the GFSR, including the analysis of financial soundness indicators and the increasing focus on policy implications, and looked forward to its further development as a key instrument of multilateral surveillance.

Directors observed that the global financial system has remained resilient, despite significant geopolitical uncertainties and a hesitant and uneven global economic recovery. Markets continue to work off the excesses of the equity asset price bubble. Directors noted that the bursting of the bubble has revealed underlying structural weaknesses, which require carefully crafted policy responses.

Directors noted that, in the current unsettled international environment, consumers, businesses, and investors remain on the sidelines. They felt that this uncertainty could well persist for some time, going beyond immediate geopolitical concerns. Directors stressed that, in this difficult environment, policies to improve market confidence on a sustained basis remain of critical importance. They underlined their endorsement of continued supportive macroeconomic policies and wide-ranging measures in the structural area to address underlying market vulnerabilities.

Key Developments and Sources of Financial Risk in the Major Financial Centers

Directors noted that a gradual improvement of financial conditions in mature markets has recently begun to take hold and, in particular, U.S. household and corporate sectors' balance sheets have strengthened somewhat. They cautioned, however, that this progress is still fragile, and that underlying vulnerabilities will require continued vigilance and policy attention. The corporate sector in a number of countries faces growing funding gaps in defined-benefit pension plans, as a result of lower equity prices and higher present values of pension liabilities due to lower interest rates. The improvement in the U.S. household sector's balance sheet rests crucially on continued strength in the housing market.

Directors noted that the financial sector in the mature economies presents a mixed picture. While banks with a strong retail franchise have performed reasonably well, wholesale and investment banks have been hard hit. Despite the authorities' renewed initiative to tackle the situation, the persistent weaknesses of Japanese banks remain a matter of concern. A number of Directors also highlighted the difficult situation facing the German banks in a context of low earnings, high costs, a deterioration in loan quality, and an erosion of hidden reserves as a result of the decline in the German equity market. Directors called for close monitoring of the deteriorating financial condition in the insurance sector in several European countries. The protracted weakness of equity markets has resulted in lower returns on assets and prompted sales of equity holdings, in some cases, to comply with solvency regulations.

Directors noted that the tendency of investors to remain on the sidelines has resulted in a significant accumulation of high-quality, short-term cash balances by retail and institutional investors. They saw the potential for deployment of these balances into more productive assets once investor sentiment recovers as a generally positive factor in the outlook. At the same time, a number of Directors cautioned that a sudden shift in asset preferences and prices could expose the unhedged positions of commercial banks and broker-dealers to considerable interest rate risk. A number of Directors expressed concern about the capital strength of the government-sponsored mortgage agencies in the United States. A number of Directors also pointed to the increased sensitivity to interest rate differentials resulting from the sizable reallocation of net capital flows to the United States away from equities and direct investment toward fixed-income securities.

Emerging Market Financing

Directors noted that an unsupportive external environment, together with investor concerns over the risk of policy discontinuity in key emerging market borrowers, had limited the availability and raised the cost of capital for most emerging market borrowers throughout most of last year. They were encouraged that the easing of global financial market conditions in the fourth quarter had led to a reopening of capital markets to many issuers, and that investor concerns about the direction of future polices in some major emerging market economies had abated. It was noted, however, that this recent development should be seen against the backdrop of the longer-term decline in capital flows to emerging market borrowers, which deserves further attention. Directors considered that the continued "feast or famine" dynamic in the primary market for emerging market bonds highlights the importance of self-insurance to mitigate—through sound economic frameworks and institutions—externally induced market volatility.

Many Directors saw the recent market developments as providing evidence of increased investor discrimination responding positively to the sustained pursuit of sound policies. Going forward, it will, nevertheless, remain important to consolidate this encouraging development and further reduce risks of contagion. Directors highlighted, in particular, the importance of further efforts, including by the IMF, to help investors distinguish among borrowers, and of policies aimed at promoting financial stability. They welcomed the improvements in banking sector regulation and capitalization in many emerging markets. They noted, however, that progress has varied by region, and that further measures are needed to bolster domestic banking systems. Directors also welcomed the recent issuance by Mexico of a bond that includes Collective Action Clauses (CACs) and encouraged other issuers to include CACs in future bond placements. They encouraged the staff to provide members with necessary advice to further this aim.

Measures to Improve Market Confidence

Against the backdrop of these adjustments in global financial markets in a difficult international environment, Directors saw a continued need for strong confidence-building measures. Macroeconomic policies in the major economies need to continue to respond flexibly to signs of an economic downturn. In particular, a continued supportive monetary stance would facilitate the process of balance sheet strengthening in the financial sector. In the structural area, Directors highlighted the need for legal and regulatory frameworks to support corporate and financial sector restructuring. In the case of Japan, the low profitability of Japanese financial institutions and the problem of nonperforming loans need urgent corrective action. German banks will need to address their low earnings through cost reduction measures, including consolidation.

Directors underscored the need for timely and sustained action to address the challenges facing insurance companies and the sponsors of defined-benefit pension funds. In the insurance sector, this will require intensified regulatory efforts to encourage sounder asset risk management practices, and, possibly, judicious adjustments to solvency standards to reduce the need to sell equities into a declining market. In the case of defined-benefit pension schemes, Directors highlighted the need to address the long-standing mismatch between pension fund assets and liabilities. It will also be important to adopt realistic actuarial assumptions for portfolio returns, while avoiding precipitous regulatory changes that could trigger a self-reinforcing decline in equity markets. Directors considered it especially important in the current environment to reassure investors that they face a level playing field in the financial markets and that they have access to full and accurate information on the health of publicly traded firms. The continuation of ongoing efforts to improve corporate governance, accounting, auditing, and investment banking practices therefore remains a high priority.

Directors observed that the "feast or famine" dynamic in emerging market financing and persistent credit tiering underscore the need for the consistent implementation of sound macroeconomic policies. In addition, they encouraged continued measures to deepen local securities markets, which can help provide a buffer against changing global financial conditions.

Measures to Promote Local Securities Markets

Directors welcomed the discussion in the GFSR of key policy issues related to the role that local securities and derivatives markets can play in strengthening the emerging markets' capacity to better weather global financial volatility. They noted that these markets can provide an additional and possibly more stable source of funding for domestic corporations and the public sector, and stimulate domestic savings by broadening the set of investment opportunities. Among the core policies to promote the development and ensure the smooth functioning of local securities markets, Directors highlighted measures to improve market infrastructure and transparency, strengthen corporate governance, develop liquid benchmarks, and promote a domestic institutional investor base. A few Directors noted the supportive role that foreign direct investment in the financial sector can play in this regard. Directors stressed that steps to develop local securities markets need careful sequencing, with the development of money markets typically being a crucial first step in developing bond and derivatives markets. In this connection, a suggestion was also made that country case studies could help guide the development of local securities markets.

Directors cautioned against heavy resort to bonds indexed to foreign currencies, which could increase vulnerability to external shocks and contribute to unstable debt structures. However, inflation-indexed bonds can be a useful instrument to deepen local bond markets. While local derivatives markets can facilitate the management of financial risk, Directors stressed that the development of such markets needs to be based on a strong supervisory and regulatory foundation.

Although local securities and derivatives markets have grown substantially over the last years, Directors observed that they have not yet developed enough to provide full insurance against the closure of banking or international markets, which in many cases may remain a remote prospect. Directors supported continued efforts to develop these markets given their potential to improve emerging markets' resilience.