ANNEX

CONCLUDING REMARKS 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 August 22, 2003.*

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

Recent Developments and Risks

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

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

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

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

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

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

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

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

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

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

Policy Implications of Recent Mature Market Developments

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

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

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

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

Policy Lessons from Past Episodes of High Volatility

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

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

Policy Implications for Emerging Market Countries

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

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

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

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