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 August 29, 2005.*

General Remarks on the GFSR

Executive Directors took the opportunity of the Board discussion to take stock of the *Global Financial Stability Report* (GFSR) after three years in existence. They noted that the GFSR has become an important instrument of multilateral financial sector surveillance by the Fund, complementing the *World Economic Outlook* (WEO). It has established the IMF as a leader in global financial stability work and has made the IMF a major contributor to international regulatory debates. At the same time, many Directors saw scope for improving the GFSR by making it more concise, sharply focused, and policy-oriented. They also called for reduced overlap between the GFSR and the WEO where possible, and for the Fund's operational work to better integrate the GFSR's findings.

Global Financial Market Surveillance

Directors welcomed the continued improvement in global financial stability. The current configuration of solid growth, low inflation, low bond yields, flat yield curves, and tight credit spreads has supported international financial markets, helping to strengthen the resilience of the global financial system. Furthermore, the much improved balance sheets of the sovereign, corporate, and household sectors, together with structural changes such as the growing importance and diversity of institutional investors and their behaviors, have provided an important cushion to financial markets. However, Directors agreed that while the benign configuration just mentioned has reduced risk in the near term, it has stored up potential vulnerabilities for the medium term, mainly in the form of larger global imbalances and higher debt levels, particularly by the household sector.

Directors agreed that the search for yield remains a dominant theme in financial markets, leading to further narrowing of credit spreads and a greater investor focus on employing leverage and alternative investments to enhance returns. The search for yield continues to stem from low long-term interest rates in mature markets, which have been caused by a variety of reasons. These include the low level of investment that has resulted in an excess supply of global saving, a reduction in inflation risk premia due to greater central bank credibility, reserve accumulation by Asian central banks, and an ongoing shift in institutional investor portfolio preferences from equities to bonds. In part reflecting this last factor, equity earnings yields remain relatively high compared to risk-free government bond yields. The search for yield has also been stimulated by continued subdued volatility across most financial markets.

Directors noted the impact of the search for yield in credit and mortgage markets. Given the compression of spreads in credit markets, investors have increasingly turned to using leverage in various ways to enhance returns, including through a proliferation of structured credit products. They noted that the market quickly stabilized following disturbances in the credit derivatives market in April and May related to developments in the

U.S. auto sector, and the corporate credit market functioned surprisingly smoothly in absorbing downgrades in this sector. Directors observed that this likely reflected the relatively isolated nature of the difficulties as the corporate sector remains broadly healthy, with strong balance sheets and low default rates. However, they considered that the corporate credit cycle appears to be peaking as corporations have begun to increase balance sheet leverage in a variety of ways. This has increased the risk of specific corporate credit events causing corrections in credit derivative and collateralized debt obligation (CDO) markets in the period ahead.

Directors noted that the dollar rebounded against major international currencies despite the widening U.S. current account deficit, as investors focused on interest rate and growth differentials in favor of the United States. In this connection, the global appetite for U.S. assets has to date remained strong. However, the risk of increased exchange rate volatility and a related spike in U.S. bond yields due to a reduction in capital flow to the United States—while being a low probability event given the current economic and financial outlook—cannot be dismissed, and would carry large costs to economic growth and financial markets. Directors welcomed the initial moves by the Chinese and Malaysian authorities to make their currencies more flexible.

Many Directors expressed concern that low mortgage financing costs have induced substantial increases in household debt, particularly in the United States. Relaxation in credit standards and products such as interest-only and negative amortization mortgages may be adding to risks in mortgage markets, allowing households to take on larger levels of debt and giving increased access to marginal borrowers. However, household net worth has also risen due to increases in asset prices, particularly in the housing sector, though marginal borrowers remain particularly vulnerable to possible rises in interest rates and/or declines in housing prices.

Directors welcomed the evidence that emerging financial markets have become increasingly resilient to market disturbances, while cautioning that the positive global economic environment may to some extent be masking underlying vulnerabilities in some countries. Indeed, in recent months, political risks and market volatility have increased in a number of emerging market countries that bear watching. Nonetheless, it is encouraging that many emerging market countries have continued to build cushions against possible adverse developments, including by accumulating reserves, undertaking early financing of external needs, and improving debt structures. Directors took note of the ongoing broadening of the investor base for emerging markets and the extension of investor interest into local instruments. While the increased interest in local markets has to some extent been fostered by cyclical developments, there are also signs that local-currency bonds in particular are becoming an interesting asset class for foreign investors. This should, in turn, help deepen local markets and reduce emerging market vulnerabilities to currency risk. Overall, Directors considered that these developments have kept emerging bond markets resilient in the face of mature credit market disturbances and specific country problems.

Directors also welcomed recent improvements in the balance sheets of key sectors in mature market economies. Moreover, indicators of market and credit risk and financial strength underscore the resilience of the banking and insurance sectors in both mature and emerging markets. A number of Directors, however, stressed the need to guard against the potentially destabilizing effect of hedge fund operations and of the growing use of structured products, while preserving the benefits of these innovations in terms of market efficiency and liquidity.

While considering policy measures to mitigate risks, Directors stressed that ongoing risk management by individual financial institutions and supervisory scrutiny by regulators are the most important lines of defense. In particular, given the risk of corrections in credit derivative and CDO markets, regulators must ensure that financial institutions maintain robust counterparty risk management practices, not least to contain the spillover effect of market corrections should they occur. Directors also stressed the importance of disclosure and transparency to enhance the flow of information, of the Standards and Codes work to help improve regulatory frameworks, and of improving basic financial education especially among individual investors. In the context of rising household indebtedness, mainly in the mortgage market, Directors welcomed the warnings that regulators in some major countries have given to their lending institutions to tighten credit standards. For the medium term, the risk of growing global imbalances has to be addressed by a cooperative effort by the major countries, with each adopting policies appropriate to its circumstances.

Aspects of Global Asset Allocation

Directors welcomed the work undertaken by staff on global asset allocation and the increasing role of institutional investors in financial markets. They noted that a better understanding of the investment patterns of pension funds, insurance companies, mutual funds, and, increasingly, hedge funds would help anticipate the potential for abrupt changes in capital flows across borders and asset classes, with direct relevance to financial stability and to policymakers.

Directors considered the diversity of procedures followed by various institutional investors when allocating assets, reflecting their different time horizons, liability structures, and "cultural backgrounds," as well as external influences, such as accounting and financial reporting standards, tax rules, rating agencies, and the availability of financial instruments needed for adequate risk management. In this context, most Directors agreed that the increasing dominance of strategic asset allocations driven more by long-term economic fundamentals, including risk management objectives, was a positive development, as it helps reduce the volatility and "noise" in financial markets, and makes some asset classes, such as emerging market debt, less prone to boom and bust cycles. In particular, the continued growth of institutions with long-term liabilities, such as pension funds, brings benefits from the point of view of financial stability. Some Directors, however, noted that shifts in asset allocations by such institutions might unsettle emerging markets with relatively shallow financial markets, or amplify long swings and hinder market price discovery.

Directors noted the sustained decline in "home bias" on the part of institutional investors throughout mature economies over the past 15 years, particularly with regard to equity holdings. Directors agreed that major factors cited in the shift toward more internationalized portfolios included less strict investment restrictions, reduced information costs, and the spread of modern portfolio management practices. By raising average returns while reducing portfolio volatility, these developments have bolstered financial stability. However, Directors noted that the decline in home bias has also increased cross-border capital flows and has probably led to greater cross-border correlations among asset markets. Accordingly, Directors underscored that Fund surveillance has taken on even greater importance in a world in which institutional portfolios have become increasingly international. A few Directors expressed doubt about the report's findings that investors from major economies, like the United States and the United Kingdom, would have little to gain from further international diversification of portfolios.

Directors discussed the implications for financial stability of proposals and potential changes in accounting policy. They recognized the importance of international efforts to improve accounting principles in order to enhance the comparability and transparency of accounts and to strengthen market discipline. However, views differed on the impact of changes in accounting principles on financial market stability. A number of Directors agreed that accounting and financial reporting standards may influence market behavior and asset allocations by key institutional investors, including by potentially encouraging long-term investors to adopt short-term time horizons, or by reducing the diversity of market behaviors across institutional investor categories, particularly as it relates to their long-term, stable investment behavior. These Directors encouraged ongoing international efforts to preserve both the measurement benefits of using market or fair values, wherever possible, and secular gains in financial stability. A number of other Directors suggested that, while some issues exist as to fair valuation of assets and liabilities with thin markets, fair value accounting would strengthen transparency in financial markets, and would not lead to a shift to short-run strategies by major institutional investors.

Corporate Bond Markets in Emerging Market Countries

Directors welcomed the detailed study on corporate bond markets in emerging market countries. They observed that the achievement of macroeconomic stability by a number of emerging market countries suggests that the time may be right to press ahead with measures that contribute to the development of corporate bond markets. Directors called for continued efforts by emerging markets to facilitate the growth of institutional investors, and noted that medium- and small-sized corporations should adopt high standards of transparency and corporate governance to facilitate market access. Directors stressed that for the effective functioning of securities markets, the authorities should adopt a regulatory framework that ensures investor protection and market integrity and contains systemic risks.

Directors noted that emerging market countries should take measures that reduce the approval time and cost of issuance, including costs associated with discriminatory taxation. Directors stressed the importance of a well-developed secondary market in improving price discovery and liquidity while at the same time acknowledging that only a few industrial countries were able to achieve this goal. Directors also noted the complementary role of the development of a government bond market, and that regional cooperation may help promote the development of bond markets for countries that lack the minimum efficient scale needed for a deep and liquid bond market.

Directors stressed the role of corporate bond markets as an alternative funding source for corporations, noting that such markets could act as a buffer in the face of sudden interruptions in bank credit or international capital flows. However, several Directors cautioned against too rapid a growth of corporate bond markets in countries that lack the supporting financial infrastructure. In particular, the rapid growth in assets under management of institutional investors combined with excessive concentration in a few market participants could fuel asset price bubbles and cause financial market instability. Directors encouraged countries to take measures to prevent excessive concentration as well as to improve risk management practices and underscored the need for a balanced development of the required institutions, intermediaries, and market microstructure to reduce risks.

Directors offered several suggestions to take the GFSR to the next level of development after three years of publication, which staff will consider carefully going forward.