ANNEX SUMMING UP BY THE ACTING CHAIR

The following remarks by the Acting Chair were made at the conclusion of the Executive Board's dicussion of the Global Financial Stability Report *on March 26, 2004.*

Executive Directors welcomed the continued improvement in international financial market conditions and the brighter prospects for global financial stability going forward. The improved outlook is supported by a firming of the global economic recovery, rising corporate earnings, and a strengthening of corporate balance sheets. Emerging market borrowers, many of whom have taken steps to put their public finances on a sounder footing and improved the structure of their domestic and external debt, are benefiting from higher export demand and commodity prices.

Global Financial Market Surveillance

Directors noted that, in response to this improved outlook and the exceptionally low short-term interest rates, global financial markets staged a strong, broad-based rally in 2003. While low short-term interest rates are continuing to influence investor behavior and are in some cases encouraging increased risk taking in a search for yield, most mature and emerging market indices appear recently to be pointing to a period of consolidation, with investors showing renewed caution and increased discrimination.

Directors emphasized that the improved outlook for financial stability is not without risks. These risks will require continued vigilant monitoring, not least in view of their interconnected nature. A first set of issues, discussed by Directors, arises from the environment of prolonged low interest rates and abundant liquidity. In this environment, asset valuations may be pushed beyond levels justified by fundamental improvements. A transition to higher interest rates in mature markets will eventually need to take place. This may have broader ramifications, including increased bond market volatility if investors were to revise their interest rate outlook abruptly—as they did during the 1994 sell-off in global fixed income markets—or if asset valuations that were predicated on an unusually low level of risk-free rates were corrected abruptly. To guard against these risks, Directors encouraged policymakers to develop timely and forward-looking communication strategies that encourage investors to base their decisions on fundamentals rather than on the expectation that interest rates will be kept indefinitely at very low levels. Directors noted that the potential effects of higher interest rates on emerging market economies are being mitigated due to the progress that many of them have made in reducing vulnerabilities, while stronger world growth will also help offset the impact of higher interest rates.

Directors also discussed the potential for market instability arising from the large global external imbalances, including the possibility that adverse developments in the currency markets might spill over into other asset markets. They noted that the depreciation of the U.S. dollar against other major currencies has so far been orderly. Most Directors considered that, in view of the substantial capital flows that the U.S. economy will continue to need to attract, the risk of a pronounced currency depreciation—possibly resulting in higher U.S. dollar interest rates and a correction in

asset valuations—can nevertheless not be dismissed. Directors reiterated, in this context, that a strong and sustained cooperative effort—aimed at ensuring a smooth adjustment of global imbalances over the medium term—will remain a key policy priority for the international community in the period ahead.

Directors welcomed the improved external financing environment for emerging market borrowers. They noted that the improved credit quality of many emerging market borrowers and low interest rates in the major financial centers contributed to the impressive compression of spreads on emerging market bonds last year. Directors commended the steps taken by many emerging markets in the current favorable market environment to meet a substantial part of their borrowing needs, improve their debt structures, and extend maturities. The correction of the downward exchange rate over-shooting that occurred in 2003 in many Latin American economies should further help enhance debt sustainability in these countries. Directors also welcomed the trend toward making the inclusion of collective action clauses (CACs) in sovereign bond issues an industry standard. Notwithstanding this encouraging aggregate performance, Directors noted that some countries appear to have relaxed their fiscal and structural reform efforts. Unless they take timely corrective action, these countries face a heightened risk of exposing their underlying vulnerabilities in the event of a turnaround in the current favorable external financing environment.

Directors welcomed the continued strengthening of the balance sheets of the household, corporate, and bank sectors over the course of 2003, as corporate and household sectors continued to build up liquidity and rising asset values strengthened net worth. Nevertheless, rising interest rates may increase the debt service burden, particularly in a number of European countries where debt levels of the corporate sector remain high. Directors noted that the recent fall in long-term yields has increased refinancing activity in the U.S. mortgage market and reopened the possibility of hedging activity that might amplify yield movements. They welcomed, in this context, recent proposals to strengthen the regulation of the U.S. mortgage agencies and address the implicit government guarantee.

Directors emphasized that the relatively benign overall conditions in mature and emerging markets provide an advantageous window of opportunity to focus policy attention on several key structural reforms to underpin financial stability over the longer run. In mature markets, recent scandals in the mutual funds industry and some companies, such as Parmalat, have again underscored the need to build on ongoing efforts to improve corporate governance and strengthen market foundations. In particular, steps should be taken to strengthen scrutiny by investors and regulators of firms with complex ownership and capital structures, as well as to enhance public oversight of auditing practices. Priorities on emerging countries' agenda going forward should include further reductions in the level and vulnerability of public debt, development of local capital markets, and continued strong efforts to improve the climate for foreign direct investment, which has remained at disappointingly low levels in spite of the general rebound in capital flows.

Risk Transfer and the Insurance Industry

Directors welcomed the work being undertaken in the context of the current and forthcoming issues of the GFSR on the range of regulatory and disclosure issues raised by the transfer of risk from banking to nonbanking institutions in mature markets. A prominent example is the rapid growth of the hedge fund sector where, despite closer counterparty and investor monitoring, there appears to be a need for broader and more systematic transparency of exposures and practices. Directors noted that future staff work will

focus on the hedge fund and pension fund industries.

Directors welcomed the conclusion of the staff's analysis that the reallocation of credit risk to the insurance sector, together with improvements in risk management in the sector, appears to have contributed to enhanced overall financial stability. Moreover, by allocating a greater share of their portfolio to credit instruments, many life insurers avail themselves of a more predictable return. While the investment in credit instruments by insurers deserves to be supported, Directors stressed that this will need to go hand in hand with continued efforts to improve risk management and regulatory oversight of the sector. Areas for improvement highlighted by Directors include: wider implementation of risk-based capital standards by regulators; enhancement of supervisory resources in many mature market jurisdictions; increased information sharing among supervisors; and strengthened disclosure requirements. Directors welcomed the current debate on international accounting standards for insurers, and looked forward to the development of converging standards that provide an accurate reflection of insurance companies' financial position. To be adequate, disclosure should be comprehensive, and include information on sensitivities and risks. While rating agencies play a helpful role in disseminating information on risks, Directors cautioned that they should not be relied upon as a substitute for appropriate supervision.

Institutional Investors in Emerging Markets

Directors welcomed the discussion of the institutional investor base for claims on emerging markets. They saw the development of a stable investor base as a key element in reducing the volatility of capital flows to emerging markets. While ongoing changes are contributing to a welcome broadening and diversification of the investor base, Directors observed that the decline in dedicated, relative to crossover, investors may also have increased the volatility of capital flows. Another source of potential volatility arises from the impact that even small changes in the portfolio positions of institutional investors can have on emerging markets, given the large size of the assets under management of these investors. Directors agreed that the factors influencing the changing nature of the investor base, as well as their policy implications—including for debt management policies and practices in emerging markets—will require continued careful analysis. They emphasized the importance of adequate transparency and disclosure regarding both government policies and corporate developments, with investor relations programs being a particularly useful instrument. In addition, the development of an efficient market infrastructure within emerging markets will be helpful in attracting institutional investors from both mature and domestic markets.

Directors also commented on the supervisory and regulatory implications of the expanding portfolios of nonbank institutional investors in emerging markets, in particular the rapid growth of pension funds. They noted that, in view of the growing imbalance between the assets under management of these funds and the available securities, close coordination will be required between changes in the regulatory framework, the development of local capital markets, and the gradual easing of limits on foreign investments by pension funds to increase their opportunities for portfolio diversification. Directors viewed the development of local securities markets as key to ensuring proper risk management by the insurance industry. In view of the rapid growth and increasing sophistication of the activities of local institutional investors involved in both local and international markets, it will also be important to persevere with strong efforts to enhance the risk management skills of both investors and regulators.