Global Financial Stability Report

Financial system is resilient, but more can be done

During the second quarter of 2002 and into August, a sharp erosion of investor confidence, increasing risk aversion, and growing concerns about the strength and durability of the economic recovery and the pace and quality of corporate earnings had repercussions in all the major equity, credit, and foreign exchange markets. Still, the global financial system displayed resilience, according to the IMF's latest *Global Financial Stability Report*, which concludes that "the most likely outcome is that financial resilience and stability will be maintained."

This resilience reflects three factors:

• First, the global economy appears to be improving, albeit at a slower-than-expected pace.

• Second, equity market corrections reduced some of the unrealistically high equity valuations that were once a source of risk (see chart). For example, as of early August, valuations in U.S. and European equity markets had moved closer to long-term averages from high levels.

• Third, risk has become more widely distributed in recent years, with households playing a bigger role in bearing financial market risks.

Potential risks

The report, produced by the IMF's International Capital Markets Department, is intended to highlight potential risks and vulnerabilities in the international financial system. For the second quarter of 2002, it identifies three potential sources of risk:

• A generalized reduction in risk appetite on the part of global investors could result in downward pressure on the prices of financial assets. In the extreme, where investors withdraw en masse from financial and economic risk-taking, further selling of riskier assets could depress prices even more and adversely affect some financial institutions.

• Accumulated losses could impair key financial institutions, or a number of smaller ones, significantly reducing their resilience. This is a particular concern in Europe, where insurance and reinsurance companies have fared poorly, and where bank stocks have declined sharply.

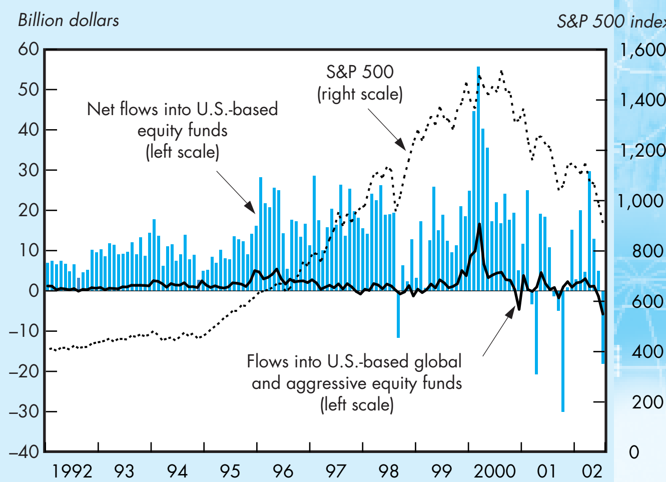
• Net capital flows into the United States could slow rapidly, potentially putting downward pressure on the U.S. dollar and U.S. asset prices. The effect could be muted to the extent that investors might not see more desirable places to invest, at least until there are clearer signs of higher growth elsewhere.

In light of these risks, policymakers could take specific steps to promote the stability of the international financial system.

Promoting stability

In all countries, the report argues, those in charge of financial stability should increase their vigilance, notably with regard to market surveillance, prudential supervision, and financial regulation, keeping careful watch for signs of further weaknesses in key institutions and markets. In particular, the report suggests that oversight and corporate governance that ensure that risks in unfamiliar noncore businesses are well managed might help to bolster financial soundness. It also notes that governments can complement these actions by participating in the IMF's Report on Observance of Standards and Codes for corporate governance, accounting and auditing, and by subscribing to the OECD's principles of corporate governance.

Doubts have prompted recent equity sell-offs



Data: IMF, *Global Financial Stability Report*, September 2002

The report suggests that the advanced economies adopt macroeconomic policies that support economic activity and foster an orderly reduction in global imbalances, such as a gradual unwinding of the current account deficit in the United States. Additional efforts to improve corporate governance, accounting, disclosure, and transparency will most likely be needed to strengthen the self-correcting forces of the market. In particular, the report urges policymakers to provide greater incentives for firms to adopt prudent accounting and reporting practices.

Emerging market countries would benefit from the consistent implementation of strong policies aimed at bolstering macroeconomic and financial stability. These policies would not only promote growth but would also provide investors with a means to better discriminate between countries as investment destinations. In countries where domestic saving rates are low and the need for external financing is high, policymakers should encourage greater domestic saving. In addition, authorities should encourage sound and diversified financial systems by promoting the development of local bond markets to supplement external market financing. ■

Copies of the *Global Financial Stability Report* are available from IMF Publication Services for $42.00 (academic rate: $35.00) each. See page 285 for ordering information.