Executive Directors had a wide-ranging discussion of financial market developments, prospects, and risks as part of the IMF’s surveillance over global financial stability. They welcomed the further strengthening of global financial stability and of key financial intermediaries in the past six months. Directors considered that the combination of broadening global economic growth and low inflationary expectations has created a favorable environment for financial markets. Strong economic growth has boosted corporate and banking sector earnings, facilitated further balance sheet strengthening, and improved credit quality. At the same time, subdued inflationary pressure has contributed to stability and relatively low yields in the major bond markets. This environment has also benefited emerging markets, boosting their growth prospects and credit quality, and facilitating the availability of external financing at relatively low cost. Notwithstanding these favorable developments, Directors noted a number of important risks that remain, suggesting that there is no room for complacency.

Global Financial Market Surveillance

Directors noted that financial markets are adjusting well to the interest rate tightening cycle in mature markets. Markets had been fully prepared for, and responded calmly to, the gradual increases in the U.S. Federal funds rate in June and August 2004. The clear communication by the U.S. Federal Reserve Board of its intention to raise rates contributed to an orderly and timely reduction of speculative leveraged positions that had been built up during a period of exceptionally low interest rates and a relatively steep yield curve. The widespread expectation that continued low inflationary pressure would permit a gradual pace of tightening has also promoted market calm, and volatility across a wide range of assets has remained quite low.

Directors welcomed the further strengthening of corporate, financial, and household sector balance sheets. Increased corporate earnings have contributed to reduced leverage and the accumulation of cash balances in the corporate sector, especially in the United States. Financial intermediaries in the major financial centers have increased their ability to absorb shocks, thus contributing to the improved outlook for financial stability. Although balance sheets of households have strengthened, their debt burden remains high, and Directors noted the possibility that this indebtedness could increase the sensitivity of households to economic shocks and amplify any future economic downturn.

Directors noted that the combination of broadening global economic growth, gently rising interest rates, and continued investor appetite for risk have sustained a favorable external financing environment for emerging market countries. Despite some limited turbulence in April and May as markets adjusted to the prospect of higher U.S. interest rates, emerging markets also appear to be taking the transition to tightening in stride. Spreads on emerging market bonds remain at low levels and the appetite for new emerging market
issuance is strong, while markets are differentiating more based on fundamentals. Many emerging market borrowers have appropriately taken advantage of the receptive external environment to meet the bulk of their financing needs for 2004 and to begin prefinancing for 2005. Directors welcomed steps taken by several emerging markets to strengthen their public finances and improve the structure of public debt. Directors also noted that banking systems in the major emerging markets have continued to recover, with generally improving capital positions, asset quality, and earnings.

Directors identified several remaining risks to the outlook for financial stability. An unanticipated increase in inflation could transform the market’s assumptions about the likely pace of tightening, and result in market turbulence. In that event, bond yields and credit spreads in the United States and elsewhere could overshoot, and hedges against interest rate increases adopted by investors and banks would be tested. Rising interest rates in the major financial centers could also result, as they have in the past, in a less hospitable financing environment for emerging markets. Directors noted, however, that the effective communication strategy pursued so far by the U.S. Federal Reserve Board has helped manage market expectations and limit market volatility. Moreover, the monetary authorities in several mature markets have appropriately indicated that they will respond in a timely way to conditions that potentially threaten price stability. Directors called for close monitoring of the potential impact of continued high oil prices on bond and equity markets.

Directors also discussed the potential for market instability arising from the continued large global external imbalances. Most Directors considered that the persistence of these imbalances and the magnitude of the flows involved remain a potential source of vulnerability in currency markets that could spill over to other asset classes. Directors reiterated that a key policy priority for the international community will remain the pursuit of a cooperative international effort to reduce these imbalances over the medium term.

Directors stressed that emerging market countries should use the current favorable financing environment to increase their resilience to future external shocks and press ahead with growth-enhancing structural reforms. Measures to reduce public debt to manageable levels and to improve the structure of public debt remain key priorities for many emerging markets.

Directors welcomed the opportunity to review several structural issues affecting financial stability. They welcomed staff’s work to develop market and credit risk indicators for the mature banking system, assess the linkages of energy trading markets with other financial markets and with underlying supply and demand conditions for energy products, and review the various channels through which financial risk is being transferred from the banking sector to nonbanking institutions.

Directors noted that large capital inflows into hedge funds in recent years, particularly by institutional investors, indicated that hedge funds are an important investor group in global financial markets. Hedge funds are a heterogeneous group engaged in a wide range of dynamic investment strategies. Counterparty risk management by large banks and prime brokers with regard to hedge funds has strengthened in recent years, and hedge fund leverage is currently at relatively moderate levels. Nonetheless, most Directors agreed that more information about hedge funds and their market activities would be helpful in addressing questions about how this important investor group can affect market stability. Several Directors considered that improved transparency and disclosure by hedge funds to investors and counterparties would serve to further strengthen market surveillance and stability. A number of Directors also saw room for closer monitoring of hedge funds by the official sector to achieve a better understanding of hedge funds, their market activities,
and potential impact on financial stability, with a few considering that some form of regulation of the industry is unavoidable.

Risk Management in the Pension Fund Industry

Directors continued their review of issues raised by the transfer of risk in mature markets from banking to nonbanking institutions, and welcomed the staff’s analysis of the pension fund industry. The size and projected growth of pension funds highlight their growing importance for international capital markets and financial stability and their role as a long-term institutional investor. Directors acknowledged that the roles of state pensions, pension plans in the workplace, and individual savings plans in contributing to retirement pensions vary from country to country.

Among workplace pension plans, well-designed defined benefit, defined contribution, and hybrid plans can all continue to play a role in encouraging efficient savings for retirement.

Directors agreed that, while the 2000–02 market downturn had exposed longer-term vulnerabilities at many pension funds, the recent partial recovery in funding ratios provides a window of opportunity for policymakers to introduce measures to encourage better risk management practices and more stable funding strategies. Among such measures, Directors emphasized the development of deeper markets for long-term fixed-income and index-linked instruments to allow pension funds to better match assets and liabilities; regulatory policies that are more closely aligned with the purpose and liability structure of pension funds; the removal or reduction of tax or regulatory obstacles to prudent, continuous funding policies; the development of risk-based approaches to supervision and to guarantee fund premiums; and the promotion of international diversification of pension assets. Directors welcomed the current debate on international accounting standards for pension assets and liabilities, and agreed that accounting standards should provide an accurate reflection of the financial condition of companies, including their pension plans. Disclosure should be comprehensive, and should include information on sensitivities and risks.

Directors noted that employers and governments have become more aware of the funding challenges pensions face from aging populations and the investment risks involved in funded pension plans. They underscored the importance of effective communication of pension challenges and policy priorities to ensure broad-based public understanding and support of pension reform efforts. In many countries, reductions in state pensions and movements from defined benefit to defined contribution or hybrid pension plans by employers are increasingly transferring risks—including market and longevity risks—to the household sector. This raises the question of how well equipped households are to bear such risks. Directors looked forward to discussing the fund management industry and risk transfer to the household sector in the next issue of the GFSR.

Emerging Markets as Net Capital Exporters

Directors welcomed the discussion of emerging market countries as net capital exporters, in light of the conventional wisdom suggesting that capital normally flows from capital-rich mature markets to capital-scarce emerging markets. They found useful the emphasis placed on financial and balance sheet issues in the staff’s analysis of the current episode of net capital outflows, which follows a series of financial crises in emerging markets, as well as changes in global asset allocations and macroeconomic imbalances.

Directors noted that the post-crisis adjustment process in many emerging markets involved substantial restructuring and strengthening of balance sheets in the private
and official sectors. In particular, the period 2000–01 was characterized by an important reduction of external liabilities. The reversal in capital inflows and the ensuing external deleveraging process were particularly costly, and Directors stressed the need to improve mechanisms for post crisis balance sheet adjustments—including those that facilitate the transfer of corporate ownership and control, and improve the environment for domestic and foreign investment as well as the functioning of markets for distressed debt.

Directors noted that the shift of emerging markets as net capital exporters during 2002–04 was associated with an unprecedented increase in their net international reserves. This in turn was related to their pursuit of export-led growth policies, supported by competitive exchange rates. Directors acknowledged the challenges involved in establishing a general benchmark for what constitutes a desirable level of international reserves, as circumstances and vulnerabilities differ from country to country. In some cases, the official sector built up reserves beyond pre-crisis levels for precautionary or self-insurance reasons. More generally, Directors considered that policymakers should continue to explore alternative methods to self-insure against sudden reversals in capital flows, including through financial sector reforms and the development of local securities markets, as well as ways to improve the management of international reserves. Several Directors reiterated their call for the IMF to continue to explore the development of effective lending instruments for crisis prevention.

Directors also noted that as emerging market securities become mainstream assets in global portfolios, global factors such as risk-adjusted returns in competing assets, and macroeconomic imbalances in mature markets, are likely to be key determinants of flows. Directors called on emerging market countries to establish a track record of consistently strong policies and reforms to enhance their risk-adjusted returns in order to attract stable inflows. Directors also noted that an orderly resolution of global current account imbalances will contribute to an environment that is conducive to sustained private capital flows to emerging markets.