

World Economic and Financial Surveys

Global Financial Stability Report
Market Developments and Issues

March 2003



International Monetary Fund
Washington DC

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Production: IMF Multimedia Services Division
Cover: Phil Torsani
Photo: Padraic Hughes
Figures: Theodore F. Peters, Jr.
Typesetting: Choon Lee

ISBN 1-58906-210-8
ISSN 0258-7440

Price: US\$49.00
(US\$46.00 to full-time faculty members and
students at universities and colleges)

Please send orders to:
International Monetary Fund, Publication Services
700 19th Street, N.W., Washington, D.C. 20431, U.S.A.
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The following symbols have been used throughout this volume:

. . . to indicate that data are not available;

— to indicate that the figure is zero or less than half the final digit shown, or that the item does not exist;

– between years or months (for example, 1997–99 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years (for example, 1998/99) to indicate a fiscal or financial year.

“Billion” means a thousand million; “trillion” means a thousand billion.

“Basis points” refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to $\frac{1}{4}$ of 1 percentage point).

“n.a.” means not applicable.

Minor discrepancies between constituent figures and totals are due to rounding.

As used in this volume the term “country” does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.



PREFACE

This issue of the *Global Financial Stability Report* (GFSR) marks the beginning of a new semiannual frequency for the publication. First launched in March 2002, the GFSR provides a regular assessment of global financial markets and identifies potential systemic weaknesses that could lead to crises. By calling attention to potential fault lines in the global financial system, the report seeks to play a role in preventing crises before they erupt, thereby contributing to global financial stability and to the sustained economic growth of the IMF's member countries.

The report was prepared by the International Capital Markets Department, under the direction of the Counsellor and Director, Gerd Häusler. It is managed by an Editorial Committee comprising Hung Q. Tran (Chairman), Donald J. Mathieson, David J. Ordoobadi, and Garry J. Schinasi, and benefits from comments and suggestions from Axel Bertuch-Samuels, Charles R. Blitzer, and David Cheney. Other contributors to this issue are Francesc Balcells, Gianni De Nicoló (of the IMF's Monetary and Exchange Affairs Department), Burkhard Drees, Martin Edmonds, Toni Gravelle, Janet Kong, Gabrielle Lipworth, Chris Morris, Jürgen Odenius, Li Lian Ong, Kazunari Ohashi, Lars Pedersen, Ramana Ramaswamy, Jorge Roldos, Calvin Schnure, Srikant Seshadri, Manmohan Singh, Mazen Mahmoud Soueid, and S. Kal Wajid (Monetary and Exchange Affairs Department). Silvia Iorgova, Anne Jansen, Oksana Khadarina, Yoon Sook Kim, Kalin Tintchev (Monetary and Exchange Affairs Department), and Peter Tran provided research assistance. Caroline Bagworth, Jane Harris, Vera Jasenovec, Ramanjeet Singh, and Joan Wise provided expert word processing assistance. Jeff Hayden of the External Relations Department edited the manuscript and coordinated production of the publication.

This particular issue draws, in part, on a series of informal discussions with commercial and investment banks, securities firms, asset management companies, insurance companies, pension funds, stock and futures exchanges, and credit rating agencies in Brazil, Chile, China, Hong Kong SAR, Hungary, Japan, Poland, Russia, Singapore, Thailand, the United Kingdom, and the United States. The report reflects mostly information available up to February 28, 2003.

The report has benefited from comments and suggestions from staff in other IMF departments, as well as from Executive Directors following their discussions of the *Global Financial Stability Report* on March 14, 2003. However, the analysis and policy considerations are those of the contributing staff and should not be attributed to the Executive Directors, their national authorities, or the IMF.

The adjustment in financial markets and the real economy following the bursting of the asset price bubble continues to influence developments. This is reflected in the hesitant and uneven pace of global economic growth and the reluctance of corporations to boost capital expenditure. Risk appetite has also been curtailed, contributing to the unwillingness of investors to support a recovery of equities in mature markets, to continued tiering in the mature and emerging credit markets, and to uneven flows to emerging market borrowers. The negative influence, however, appears to be waning. Household balance sheets in the United States appear to have stabilized, U.S. corporate balance sheets have strengthened somewhat, and financial institutions are showing tentative signs of being less hesitant to take on risk.

The supportive stance of monetary policy in the major economies, coupled with more risk-averse behavior by both institutional and retail investors, has contributed to a sizable buildup of cash positions. A partial mobilization of these cash positions in the fourth quarter of 2002 helped fuel a short-lived stock market rally, led to a narrowing of credit spreads on mature and emerging bonds, and contributed to an increase in flows to emerging market borrowers. The steep yield curves, particularly in the United States, have also allowed financial institutions to improve their earnings through traditional carry trades and maturity mismatches.

The gradual improvement of financial conditions in mature markets has reduced the perception of risk and probably the risk itself to global financial stability relative to that prevailing in September 2002 when markets hit a low. Normally, this would suggest the potential for a rebound in the economy and financial

markets once investor sentiment turns and the large pool of risk-capital waiting on the sidelines is reallocated back to risk taking. However, this potential is currently overshadowed by the intensified uncertainty about the prospect of war in Iraq and its repercussions on growth and stability.

While markets may have priced in a short and decisive war, any departure from this scenario could weaken confidence further. Moreover, markets may have not yet focused on the possibility that uncertainty could persist for some time. Indeed, uncertainty is increasing about a conflict with Iraq. Uncertainty could also persist despite a short and decisive military conflict owing to the potential for continued geopolitical instability and tangible threats of terrorism. Even those investors who take a rather optimistic view about geopolitical events prefer to see uncertainty removed first before they invest in riskier asset classes; they are unable to price uncertainty and therefore adopt a “wait-and-see” attitude. Consequently, prolonged uncertainty could keep risk aversion at a high level, depress financial markets, and reinforce the headwind against global economic recovery.

The reversal of the fourth-quarter equity market rally from mid-January to early March (see Table 1.1) highlights the continued fragility of investor sentiment and the urgent need for policies to foster market confidence, and for a resolution of geopolitical tensions.

Key Developments in Major Financial Centers

Major sectors in the global financial system have made some progress in correcting past excesses (see Chapter II). However, continued

Table 1.1. Financial Market Data
(Percentage change unless otherwise noted)

	Change to February 28, 2003 from				
	Peak (March 24, 2000)	2001		2002	
		September 11	December 31	September 30	December 31
Equity Market					
Major stock indexes ¹					
S&P 500	-44.9	-23.0	-26.7	3.2	-4.4
Nasdaq	-73.1	-21.1	-31.4	14.1	0.2
FTSE Eurotop 300	-53.7	-30.5	-39.1	-6.2	-10.4
Topix	-50.1	-22.6	-20.7	-11.1	-2.9
Bank indexes					
S&P 500 bank index	3.3	-3.5	-5.9	0.5	-2.1
FTSE Eurotop 300 bank index	-32.9	-25.0	-35.0	-1.4	-9.3
Topix bank index	-64.8	-50.2	-31.5	-34.5	-8.8
Bond Market					
U.S. corporate bonds					
Yields (level change; basis points)					
AAA	-180	-111	-78	-26	-26
BAA	-141	-87	-100	-47	-39
High-yield bonds	-49	-112	-126	-214	-71
Spreads (level change; basis points) ²					
AAA	70	-3	58	-36	-14
BAA	109	21	36	-57	-27
High-yield bonds	201	-4	10	-224	-59
U.S. corporate bond price indexes ³					
AAA	...	6.6	7.3	1.4	1.1
A	...	6.0	7.1	2.0	1.3
BBB	...	-0.5	1.4	4.3	1.7
European corporate bond spreads ⁴					
AA	3	-1	0	-10	-4
A	10	-20	-2	-13	3
BBB	87	-19	18	-62	-2
Japanese corporate bond spreads ⁴					
AA	-10	-2	-5	-1	0
A	5	1	-22	-4	-5
BBB	-9	17	-20	-30	-9
Government bond yields (level change; basis points) ⁵					
United States	-250	-108	-136	10	-12
Germany	-133	-89	-108	-35	-29
Japan	-108	-63	-58	-40	-12
Government bond price indexes ⁶					
United States	17.8	8.3	11.8	0.2	1.7
Germany	12.2	11.0	9.6	2.5	1.8
Japan	14.6	10.8	9.7	6.9	2.7
Exchange rates					
Euro/U.S. dollar	-9.5	-15.5	-17.7	-8.7	-2.9
Yen/U.S. dollar	10.5	-1.1	-10.3	-3.0	-0.6
Trade-weighted nominal U.S. dollar	-0.4	-8.6	-12.2	-5.6	-2.8

Sources: Bloomberg L.P.; and Datastream.

¹In local currency terms.

²Spread over a 10-year U.S. treasury bond.

³Merrill Lynch corporate bond indexes.

⁴Merrill Lynch corporate bond spreads; level change, in basis points.

⁵Ten-year government bonds.

⁶Merrill Lynch government bond indexes, 10+ years.

progress is not yet assured and remains vulnerable to reversal as market sentiment is overshadowed by heightened geopolitical concerns.

- Notwithstanding continued equity and corporate bond market volatility, the U.S. household sector's balance sheet appears to have stabilized.
- The balance sheets of U.S. corporations seem to be improving slowly, as reflected in the sharp increase in the ratio of broad liquid assets to short-term debt.
- Large internationally active banks remain reasonably well capitalized and liquid. At this point they are not likely to pose systemic risks, despite large write-offs that have cut into earnings. But a deterioration in the global economy or further revelations of hidden corporate losses could lead to problems. The financial condition of most European banks appears to be well supported by the underlying earnings power in their home markets. Given the currently limited earnings power in a fragmented home market, however, the financial condition of German wholesale banks needs to be improved. Japan's banking system has deteriorated in an environment of continued deflation and limited corporate restructuring, despite recent efforts by banks to raise capital. Reforms aimed at corporate and financial sector restructuring continue to be urgently needed.
- Some European insurance companies have been weakened substantially as a result of equity and corporate bond price declines. Problems are particularly acute in the U.K., German, Dutch, and Swiss insurance sectors, where life insurance companies have been forced to reduce their equity holdings into declining markets. The United Kingdom initiated some regulatory adjustments in January 2003 to remove such selling pressure. Japan's life insurance companies have been under intense pressure for some time.
- Available data indicate that corporate defined-benefit pensions in the United States, the United Kingdom, the Netherlands, and Japan are experiencing sizable funding gaps. While precise data are not widely available, such funding gaps are likely to exist elsewhere in Europe. Unless equity and corporate bond markets recover soon, these funding gaps are expected to weigh on corporate profitability and contribute to market uncertainty in estimating future earnings.
- The dollar has weakened noticeably against major currencies in the period under review. However, history has demonstrated the ability of markets to absorb wide swings in the value of the dollar in response to adjustments to fundamental disequilibriums. But a precipitous fall in the dollar could also have potentially destabilizing consequences, given the buildup over time of large holdings by foreigners of U.S. financial assets. The composition of these holdings and capital flows has changed over time from equity and foreign direct investment to fixed-income securities, including in particular U.S. treasury and agency securities. When investors focused on equities, growth differentials and relative productivity improvements—which have favored the United States—were at the forefront of their concerns. Now, however, given investor disillusionment with equities and their refocus on fixed-income securities, interest rate differentials have become paramount. Consequently, the decline in U.S. yields to levels below those in Europe has reduced the attractiveness of the U.S. fixed-income market and thereby contributed to the dollar's decline.

On a more positive note, monetary easing in the major economies and the accumulation of cash balances by households and institutions have contributed to improved balance sheet strength, and to the possibility that cash holdings will be productively deployed as uncertainties abate and investor sentiment

improves. Yet even in this positive scenario, caution is needed. When growth prospects improve and investors shift to higher-risk assets, short- and long-term interest rates will likely rise. This interest rate risk is significant at this juncture, as financial institutions have invested substantially in long-term treasury and agency securities, funding these positions with short-term money to benefit from the steep yield curves. Market sources suggest that most of these positions are unhedged, as the cost of hedging would erode much of the interest rate differential benefit. Investors in the U.S. mortgage-backed securities market are even more vulnerable to interest rate risks, given the negative convexity of these instruments (see Chapter II for a more detailed discussion). Consequently, the potential for sizable losses could exist for some market participants, on top of losses experienced since the bursting of the equity price bubble and the ensuing flight from corporate risk.

Emerging Market Financing

The “feast or famine” dynamic of emerging market financing was evident again last year (see Chapter III), as countries at the low end of the credit rating spectrum—especially in Latin America—experienced difficult access to capital markets and high funding costs. Easing global financial market conditions in the fourth quarter of last year—characterized by a stock market rally, sharply narrowing corporate bond credit spreads, and a marked decline in actual and expected volatility—led to a reopening of capital markets to many, but not all, issuers.

Investors last year were keenly focused on the sustainability of policies in making investment decisions, and this focus contributed to marked tiering by credit quality. The possibility of policy discontinuity in Brazil contributed to mounting investor anxiety and rising credit spreads in the run-up to elections; these were eased by the initial cabinet

appointments and policy pronouncements of the new administration. While investor sentiment toward Brazil improved markedly in the fourth quarter—contributing to a large narrowing of credit spreads and a significant strengthening of the *real*—domestic borrowing costs remain quite high and the spreads on foreign bonds have not yet fallen to a level that would permit renewed sovereign access to the primary market.

The markets continued to differentiate borrowers by perceived credit quality, with some countries in Latin America continuing to face high yield spreads, while Asian and Eastern European borrowers benefited from near record low credit spreads. Asian markets, except for the Philippines, are supported by strong growth and macroeconomic fundamentals, regional liquidity, and a solid investor base. Similarly, Eastern European countries have attracted investor interest in anticipation of further credit upgrades stemming in part from progress on their accession to the European Union. Investors’ confidence in Russia has continued to improve based on its strong fiscal position and growth performance, both of which have been supported by high oil prices.

The performance of banking sectors across major emerging markets has also been mixed in recent years. Indicators of financial health show substantial improvement in the emerging market countries of Europe, facilitated by considerable bank restructuring efforts and the entry of foreign banks in several of these countries. A similar improvement is evident in Asia, although progress has been slower and weaknesses persist in some countries, mainly because of lagging bank and corporate restructuring. In contrast, banks in some Latin American countries remain in distress, as long-standing weaknesses have been aggravated by recent economic and financial turmoil. In other countries in the region, banks have realized stronger financial results, reflecting more favorable initial conditions and economic performance.

Measures to Improve Market Confidence

As financial markets and the real economy continue to make progress in ameliorating the excesses of the bubble years, policies must continue to boost consumer, business, and investor confidence. Improved market confidence would allow the gradual strengthening of financial conditions to support investment activities, which in turn would underpin financial market and economic recoveries. Subject to geopolitical developments, the improvement of confidence could best be achieved through continued sound macroeconomic policies and a flexible response to renewed signs of an economic downturn. It will also require the consistent implementation of steps to address the deficiencies in corporate governance, financial market practices, and accounting standards, which were starkly revealed with the bursting of the asset price bubble.

First, on the macroeconomic front, the current accommodative stance of monetary policy in the major economies is appropriate, notwithstanding the buildup of cash positions. The supportive stance is needed to forestall faltering consumer and business confidence and to give a respite to financial markets. More generally, the supportive monetary stance has facilitated the gradual improvement in the financial conditions of key sectors of the economy, and the sizable buildup in liquidity positions among households and financial intermediaries. Specifically in Europe, a steepening of the yield curve would contribute substantially to financial intermediaries being able to improve their earning power, in order to digest losses in various segments of their businesses. The Japanese authorities need to act decisively to reverse years of economic decline and falling prices.

Second, renewed efforts to implement corporate and financial sector reforms are urgently needed in Japan. To improve their financial conditions, many Japanese financial institutions need to address their loan-loss provisions more resolutely and their high cost base more generally. They also need to strengthen their

capital bases. A corporate sector reinvigorated by successful restructuring is crucial for allowing Japanese financial institutions to improve their earnings.

In Germany, a better capitalization of small and medium-sized companies would help reduce the current substantial amount of loan-loss provisions on the balance sheet of financial institutions. More important, however, a number of financial institutions need to significantly improve their earning power and reduce bloated cost bases through consolidation.

The general legal and regulatory framework in both Japan and, to a lesser extent, Germany needs to support the above restructuring efforts. Progress in these endeavors would help strengthen market sentiment and growth prospects in these countries.

Third, the process of post-bubble asset price adjustment has revealed specific vulnerabilities that need to be addressed in the insurance industry and in the funding of corporate pensions.

- Given the weakening condition of the insurance sector, insurance regulators must intensify efforts to encourage both sounder asset risk management at the micro level and a realigning of incentives—including regulatory rules for solvency and liquidity—that are consistent with fostering market stability. The recent measures taken by the U.K. authorities, such as relaxing the Regulatory Minimum Margin, are reassuring in this regard and others should consider proactive measures as well.
- The weaknesses in funding corporate pensions revealed by falling equity prices underscore the need to address the long-standing mismatch between pension assets (typically tilted toward equity investments) and pension liabilities (whose behavior typically mimics that of a bond). Furthermore, for many large corporations in the United States, the ratio of pension assets to market capitalization is more than 2 to 1. This illustrates the still high degree of leveraging in the U.S. corporate sector, as companies are

ultimately responsible for their pension obligations. Among the issues in pension accounting that need to be revisited, realistic actuarial assumptions underlying the measurement of funding adequacy are essential. Caution is needed, however, to avoid an immediate large drain on the earnings of companies that could trigger a self-reinforcing decline in equity markets.

Fourth, the process of improving corporate governance, accounting, auditing, and other investment banking practices, which is under way in the United States and other countries, must be sustained. This will reassure investors that they face a level playing field in the financial markets and that they will have access to full and accurate information on the health of publicly traded firms.

Fifth, the recent building up of cash balances necessitates vigilant risk management by private sector market participants. This is important for ensuring that the mobilization of cash balances, and the unwinding of positions now encouraged by the steepness of the yield curve, occur in an orderly fashion. A speedy return of market confidence and risk appetite would expose a significant amount of unhedged long positions in the markets for long-term government securities. This creates a potential for large losses. Consequently, national supervisors should make sure that these risk positions of financial institutions in their jurisdictions and of their hedging counterparties, irrespective of location and business sector, are properly managed.

Finally, the “feast and famine” dynamic in emerging market financing and the persistent credit tiering underscore the need to consistently implement sustainable policies to facilitate access to capital at reasonable cost. This is all the more compelling at present, as many sovereign borrowers continue to face unfriendly external financial conditions. In addition, continued efforts to develop local securities markets could eventually provide an alternative source of financing and help act as a buffer against changing global financial conditions.

Policy Issues in Developing Local Securities Markets

While establishing sound and sustainable macroeconomic policies is a necessary condition for strengthening domestic economic fundamentals and perceived creditworthiness, many emerging markets have taken additional measures designed to “self-insure” against volatile capital flows and asset prices. Most prominent among these measures is the effort to develop local securities and derivatives markets (see Chapter IV).

Local securities and derivatives markets have grown substantially over the last five years. Despite the rapid expansion of local markets—in particular, local bond markets—they have not yet developed enough to provide full insurance against the closure of banking or international markets. Nonetheless, continued efforts to develop these markets could eventually provide a significant cushion against future closures. In particular, these efforts should focus on continuing to adopt measures aimed at strengthening market infrastructure, developing benchmarks and local institutional investors, and improving corporate governance and transparency.

Moreover, despite the existence of ambiguities concerning some policies related to the development of local securities and derivatives markets, several measures can still be undertaken while continuing to monitor and control the potentially negative side effects. For instance, well-developed derivatives markets provide efficient instruments for risk management, and experience shows that sound macroeconomic and regulatory policies can mitigate to a large extent their potentially negative effects on financial stability. Similarly, the provision of inflation-indexed instruments contributes to increase duration in fixed-income markets, but excessive indexation to foreign exchange could lead to balance sheet mismatches and unstable debt dynamics and therefore should be discouraged.