Executive Directors welcomed the further strengthening of the financial system in the past six months, supported by solid global economic growth and continued improvements in balance sheets of the corporate, financial, and household sectors in many countries. They also welcomed ongoing improvements in the fundamentals of many emerging market countries. Prospects for continued financial stability are underpinned by the still favorable outlook for the world economy, and by the growing sophistication in financial markets that has helped spread risk. Nonetheless, Directors noted that currently low long-term interest rates and credit spreads could mask underlying vulnerabilities and pose risks of market reversals, especially for less credit-worthy sovereigns and corporations. While these risks are generally expected to be manageable given the strength of financial institutions, Directors stressed the need for continued vigilant monitoring and timely policy measures.

Global Financial Market Surveillance

Directors noted that markets have remained orderly through the ongoing interest rate tightening cycle in mature markets, facilitated by the increasingly transparent communication strategies of major central banks. Still abundant global liquidity and improving credit quality have kept mature market bond yields and financial market volatility low. Other factors that have contributed to relatively low long-term bond yields include expectations that inflation will remain under control, low corporate demand for net credit, and growing demand for long-term bonds by pension funds and life insurance companies. More generally, low short-term interest rates have encouraged investors to use leverage and move out along the risk spectrum in their quest for yield, buoying asset valuations and compressing credit spreads.

Directors noted that the corporate balance sheet improvements in mature markets and the quest for yield have encouraged investors to increase their exposure to credit risk. This has contributed to falling corporate bond spreads, and possibly to reduced investor discrimination. Directors noted the growth of credit derivatives markets, which facilitate the trading and hedging of credit risks. At the same time, many Directors acknowledged that the derivatives markets’ expansion may expose some investors to the possibility of leveraged losses, which could be amplified by potential liquidity problems. Furthermore, risk management models designed to deal with these new and more complex financial instruments may have yet to be put to a significant live test. Several Directors also called for increased disclosure and continued monitoring of hedge fund activities. Directors appreciated the GFSR’s continued attention to developments in energy markets, and supported its call for more timely and reliable data on global demand and supply conditions.

Directors observed that, along with improvements in many emerging market countries’ fundamentals, abundant liquidity and quest for yield have been driving factors in recent developments in emerging financial markets.
Spreads on emerging market debt have narrowed to near record lows and investors’ appetite for emerging market financial assets has grown considerably. Ongoing, healthy market developments include the expansion of the investor base for emerging markets to include a more diverse universe of long-term investors; the increasing diversification of investor portfolios into local emerging markets; the extension of local government yield curves in a number of countries; and the inclusion of more local currency sovereign bonds in major benchmark global bond indices.

Directors generally expected financing prospects for emerging markets to remain solid, underpinned by benign financial market conditions and further improvements in the credit quality of emerging market borrowers. Most emerging market sovereign borrowers have used this period well, undertaking substantial prefinancing of their external financing needs, conducting debt management operations to improve the resilience of their balance sheets, and, in a couple of instances, issuing local currency bonds in global markets. Directors also welcomed broad-based improvements in the financial health of the domestic banking sector in emerging market countries, while encouraging authorities to continue structural reforms aimed at increasing their resiliency to potential shocks.

Turning to risks in the current environment, Directors noted that the long period of high liquidity and low volatility may have led to a sense of complacency on the part of some investors, and that compression of inflation and risk premia leaves little room for error in terms of asset valuations. Against this backdrop, the risk that long-term market rates might rise abruptly requires continued vigilance. While no single event may trigger such a rise, most Directors highlighted concerns about the possibility of a combination or correlation of events, noting the potential risks of a disorderly adjustment of global imbalances, possibly associated with a diversification of international investors away from dollar holdings, as well as the possibility of an unanticipated increase in inflation, particularly related to oil and other commodity prices.

Directors considered a number of steps to enhance global financial stability and mitigate potential risks. In particular, they reiterated their call for cooperative efforts and credible policy measures to enhance the market’s confidence that global imbalances will be reduced in an orderly manner. At a microeconomic level, supervisors and regulators should be vigilant to the risk profile of financial intermediaries, and their exposure to abrupt market price shocks. Emerging market country authorities should continue to adopt prudent macroeconomic policies that reduce financing needs, while taking advantage of the current benign conditions to fulfill their external financing requirements, improve the structure of their debt, and press ahead with efforts to develop local financial markets. In addition, structural reforms to enhance growth prospects remain a critical avenue for reducing debt-to-GDP ratios to more manageable levels.

**Household Balance Sheets**

Directors welcomed the staff’s study on the changing risk profile of the household sector resulting from the transfer, reallocation, and improved management of financial risks by banks, insurance companies, and pension funds. While households always have been the ultimate bearers of financial risks, through a variety of channels, these risks traditionally have been intermediated by governments and private financial and nonfinancial institutions. Directors supported the view that policies designed to improve the financial stability of systemically or otherwise important institutions should also consider the consequent flow of risks to households and their ability to absorb or manage such risks.

Directors observed that trends in the evolution of household balance sheets in different jurisdictions have benefited households in var-
ious ways, including through a significant growth in net worth relative to income, boosted by capital gains. At the same time, the shift away from bank and savings deposits to more market-sensitive assets has also exposed them to greater market risk. Directors considered that planned reforms of public and private retirement benefits may imply that households will have even more responsibility going forward in managing their financial affairs. Such reforms have brought benefits, such as the portability of defined contribution or hybrid pension plans. While they have reduced some risks, these reforms have also increased the direct exposure of households to investment and market risks, and possibly more challenging, longevity risk.

Directors observed that as more households rely primarily on defined contribution and other self-directed pension plans, there may be scope for incentives to educate households, and thereby increase their ability to manage these risks and to obtain better financial advice. These measures could also include developing new instruments to help households realize more easily long-term savings and make resources available for retirement. Several Directors highlighted the role of consistent government policies, including stable tax policies, in encouraging long-term savings strategies. A crucial element of household saving and investment planning is the uncertainty of life expectancy, and the ability to convert long-term savings into a dependable income stream. Directors suggested, in this context, that the issuance of long-dated, index-linked, and longevity bonds could facilitate the management of longer-term investments and obligations and the supply of annuity products.

Directors generally saw a role for governments in developing communication strategies to inform households about their retirement challenges, and in coordinating with the private sector to provide financial education. They welcomed the initiatives undertaken by organizations such as the OECD and several national authorities to foster the financial education of households. Directors noted the importance of increased efforts to improve the collection, timeliness, and comparability of data on the household sector for assessing the flow of financial risk through the financial system, and in particular the risk profile of households. More generally, they looked forward to keeping the systemic and policy implications of the flow of risks to households under review.

Corporate Finance in Emerging Markets

Directors welcomed the detailed study on corporate finance in emerging markets. They observed that it is unclear whether the decline in domestic bank lending to corporations (outside China and India) is a result of reduced external financing needs or constraints on the sources of funding. Nevertheless, Directors called for continued efforts by emerging markets to improve their institutional frameworks to facilitate corporates’ access to equity finance on appropriate terms. Directors saw a need to narrow gaps in the implementation and enforcement of widely accepted principles of corporate governance, disclosure and transparency, while recognizing the need to take into account country-specific legal and institutional circumstances as well as the stage of market development. Several Directors saw merit in integrating the analysis and discussion on corporate finance and bank disintermediation across mature and emerging markets, as common trends are likely in an integrated global economy.

Directors recognized the importance of assessing corporate sector financial fragilities, given the increased importance of corporates relative to sovereigns in international markets and the potential risks should market conditions become less benign. They underscored the desirability of an integrated approach to corporate sector vulnerability that would account for interactions between interest rate, foreign exchange and credit risks, as well as
linkages with the financial and government sectors. While the effort to develop new databases was welcomed, some Directors nevertheless cautioned that care should be taken in drawing inferences from dated and incomplete data. Some Directors encouraged the development of hedging instruments to address exposures to foreign currency risk, and also noted the important role of financial intermediaries, and their regulators, in monitoring balance sheet mismatches in the corporate sector.