Assessment of Financial Stability and Policy Implications

Directors welcomed the continued resilience of the global financial system, which has been supported by solid global growth, low inflation, abundant liquidity, and flat yield curves. They considered that financial conditions will likely remain benign in the most likely scenario of continued growth, contained inflation, and stable inflationary expectations. At the same time, Directors noted that the global financial system faces a number of challenges, in particular rising interest rates and a turn in the credit cycle for both the corporate and household sectors. Given the strengthened resilience of the financial system, most Directors considered that financial markets should be able to deal quite well with the envisaged cyclical risks. A number of Directors, however, cautioned that medium-term risks to financial stability may have increased somewhat in the past six months, given the growing global imbalances, the higher debt levels in the household sector, and possible under-pricing of risk by investors in certain asset classes. Directors urged national authorities to underpin the strength and resilience of the financial system by pursuing macroeconomic policies that aim for solid and well-balanced growth, while strengthening the effectiveness of supervisory and regulatory oversight.

Directors noted that the turn in the corporate credit cycle increases the chances for idiosyncratic risks leading to a widening of credit spreads for specific firms. They agreed, however, that overall corporate sector balance sheets remain healthy, and moderate changes in the broad corporate spreads should enable self-correcting forces to operate. Several Directors suggested that the potential implications for financial stability of the recent surge in leveraged buyouts warrant attention.

Directors commented that housing and mortgage markets also point to a turn in the credit cycle, particularly in the United States where housing activity has moderated in recent months. In particular, higher interest rates could raise the debt servicing burden of households, already at high levels, worsening the credit quality of mortgage markets and causing losses to lending institutions. This risk, however, is mitigated by the fact that the majority of U.S. mortgages are at long-term fixed rates. Directors considered that, while the large prime mortgage market still enjoys good credit quality, the main area of concern may lie in the sub-prime segment of the housing and mortgage market, where marginal borrowers are exposed to the risks of rising interest rates and a stagnation or decline in house prices.

Directors remarked that despite the rise in policy rates by the U.S. Federal Reserve, spreads for emerging market external bonds are at record low levels. They considered that fundamental improvements have underpinned this performance, including surpluses in the current account and strong capital inflows, strengthened debt structures and large reserve cushions, accompanied by strong macroeconomic policies and performance. Emerging markets will likely be tested by less favorable external conditions as liquidity conditions tighten further. Nevertheless, Directors concurred that emerging markets are likely to

The following remarks by the Chairman were made at the conclusion of the Executive Board’s discussion of the Global Financial Stability Report on March 27, 2006.
show continued resilience, and though spreads could well widen in a correction, markets should remain well anchored by fundamentals and reduced vulnerabilities.

Directors noted that a disorderly unwinding of global imbalances remains a risk to financial stability. So far, structural and cyclical factors have combined to allow financial markets to intermediate smoothly between surplus and deficit countries. In a globalized financial market, the U.S. capital market offers international investors unparalleled depth, sophistication, and flexibility, and investment in U.S. dollar assets remains attractive due to strong U.S. economic performance. Looking ahead, Directors noted that the prospect of a smooth adjustment in the pattern of accumulation of U.S. dollar assets would be facilitated by the willingness of key countries to take cooperative policy measures aimed at reducing global imbalances over the medium term.

Directors considered that, while cyclical changes could well expose weaker segments and pockets of financial markets, these are unlikely to pose systemic risks. Against this backdrop, many Directors urged regulators to pursue a firm “no-bailout” policy, which would work to contain risks of investor complacency. Broadly, regulators should place greater reliance on the self-correcting forces of financial markets, while focusing attention on ensuring robust market infrastructures, particularly for credit derivative markets. In particular, Directors emphasized that financial regulators should require that rigorous risk management practices are in place. Directors also urged regulators to provide guidance on the content of business continuity plans to address possible vulnerabilities related to event risks, such as an avian flu pandemic.

The Influence of Credit Derivative and Structured Credit Markets on Financial Stability

Directors noted that the rapid growth of credit derivative and structured credit markets in recent years, particularly among more complex products, has facilitated the dispersion of credit risk by banks to a broader and more diverse group of investors. They concurred that credit risk dispersion has helped to make the banking and overall financial system more resilient and stable. However, Directors observed that these markets have grown rapidly in a relatively benign environment, and market liquidity and certain aspects of the market infrastructure have not been fully tested by a severe or prolonged credit downturn. Directors also viewed the paucity of information to assess quantitatively the degree of risk reduction among banks and to monitor effectively the destination of risks as a major challenge for policymakers and supervisors.

Directors noted that credit derivative and structured credit markets present new challenges and vulnerabilities that need to be understood and carefully monitored. In particular, they stressed that market liquidity—including secondary market liquidity—is an important ingredient for financial stability. Policymakers should encourage the participation of an increasingly diversified investor base, with different investment and trading strategies, as a key element of more liquid and robust markets. Directors noted that a diverse investor base depends on a number of factors, including various important influences on market behavior, such as regulatory and prudential frameworks, accounting, rating agencies, and the broader market structure. In this regard, policymakers should develop or strengthen the institutional, legal, and regulatory infrastructures needed to attract a diverse and dedicated investor base, and to ensure the open and orderly flow of capital within and among markets.

Directors encouraged industry representatives, regulators, and supervisors to push ahead with ongoing efforts to mitigate operational risks in credit derivative markets, including by reducing the backlog of unconfirmed trades and implementing a clear and
acceptable method for re-assigning transactions. They also encouraged policymakers and industry representatives to continue to seek resolution on a generalized settlement protocol.

Directors called on supervisors to require that financial institutions have in place the risk management systems and skills needed to manage their exposure in credit derivative markets, so that the benefits from risk dispersion are realized. Directors welcomed the increased supervisory dialogue and surveillance in the United States and the United Kingdom regarding bank and dealer counterparty risk management related to hedge funds, and stressed that enhanced monitoring of counterparty risk should become a higher priority for market participants and supervisors in all jurisdictions.

Directors noted that credit derivative markets provide useful information for supervisors to monitor credit quality across sectors and credit risks within institutions, and encouraged supervisors to use this information to enhance financial sector surveillance. Directors also encouraged national authorities and relevant international agencies to improve and coordinate their collection of credit derivative data—focusing on obtaining better information, rather than simply more data and reporting.

Directors noted that the dynamics of credit cycles may be influenced by deeper, more efficient, and more liquid credit markets. As credit derivatives make the pricing of risk more transparent, the ensuing proactive and potentially more gradual portfolio adjustments, particularly by banks, may help to dampen the credit cycle. A number of Directors cautioned, however, that robust data are lacking and, accordingly, this conclusion can only be tentative. In addition, the development of credit derivatives implies that market surveillance must also adapt to recognize better how the flow of risks may change in response to financial innovations and structural developments. Most Directors observed that these innovations and developments should improve the risk management focus of major lending institutions, thereby contributing to reduce procyclical adjustments that have previously amplified cycles. Some Directors questioned, however, whether the increasing complexity of credit derivatives could magnify risks. Directors encouraged the staff to conduct further research on how financial innovations may influence credit cycles and the provision of credit, as well as the transmission of monetary policy.

Directors agreed that the IMF, together with national authorities and other international financial institutions, should continue to monitor and evaluate market developments from a global financial stability perspective, including the effectiveness of policies directed at mitigating systemic risk. Provision of more cross-country comparisons and microeconomic analysis to policymakers, supervisors, and regulators should contribute to enhanced supervisory understanding of market developments.

**Structural Changes in Emerging Sovereign Debt and Implications for Financial Stability**

Directors discussed the implications of the recent improvements in debt management, debt structure, and diversification of the investor base in key emerging market countries. They noted the significant improvement in the macroeconomic performance of many emerging market countries since the Asian crisis. Most countries have adopted more flexible exchange rate regimes, gained credibility in managing inflation, strengthened economic, fiscal, and current account performance, and accumulated significant foreign exchange reserves. These developments have contributed to significant rating upgrades and improved returns on emerging market asset classes. Directors recognized that many emerging market sovereigns have also used the current favorable global environment to
improve their overall debt structure and debt management capacity.

Directors generally expected continued positive developments in emerging market countries’ economic performance and debt management, which would provide a buffer against an expected moderate deterioration of external financing conditions. In particular, the large current account surpluses and reserves buildup of emerging market countries as a group, including most of the systemically important countries, should reduce the need for external borrowing and provide a cushion against any deterioration in external financing conditions. Directors also noted that the composition of the emerging market investor base is becoming more diverse, with the increased presence of strategic and long-term investors enhancing the prospect of greater stability in the emerging market sovereign asset class. At the same time, Directors cautioned that a sharp rise in global interest rates could negatively impact emerging market countries.

Notwithstanding the overall positive outlook for emerging market countries as a group, Directors cautioned that vulnerabilities remain for several emerging market countries, especially those with weaker fiscal positions, high debt and debt service burdens, large current account deficits, or heavy dependence on a few key commodities. They also noted that many countries with improved external positions due to increases in commodity prices had postponed needed structural reforms.

Finally, Directors stressed that emerging market countries must continue to build on the recent successes, and generally positive external scenario, to mitigate remaining vulnerabilities. They stressed that sound macroeconomic policies and continued pursuit of structural reforms will be essential to reduce vulnerabilities. Also important will be emerging market countries’ efforts to continue to strengthen their public debt management, develop local capital markets, and broaden the investor base.