Assessment of Financial Stability and Policy Implications

Directors welcomed the concise and focused analysis of the Global Financial Stability Report (GFSR). The staff’s assessment was seen as balanced, pointing to both the resilience of international financial systems and the downside risks to the baseline scenario of continued strong growth.

Directors noted that increased uncertainty about the sustainability of current global growth amid rising inflationary pressures, persistent global imbalances, and a weakening U.S. housing market had triggered a bout of volatility in mature markets and turbulence in emerging markets (EMs) during May and June 2006. Global financial markets calmed subsequently as inflation fears declined, as the likelihood ebbed that key central banks would tighten more significantly, and as some EMs were seen as correcting from lofty valuations. Directors considered that markets remain underpinned by a favorable overall outlook for the global economy, and that recent market volatility does not foreshadow a sustained downturn in global growth. Corporate balance sheets and profitability are strong and financial institutions are healthy, supporting the resilience of international financial systems.

However, Directors agreed that international financial markets face risks—tilted to the downside—to the World Economic Outlook baseline scenario. These risks are an intensification of inflation pressures requiring more monetary tightening than currently expected; further increases in oil prices due to geopolitical uncertainties; and a more pronounced slowdown in the U.S. economy, led by a rapid cooling of the housing market. Also, a rapid unwinding of global economic imbalances, although unlikely, could be accompanied by financial turbulence. Several Directors cautioned that standard measures of expectations indicate that financial markets may not be factoring in potential greater uncertainty, increasing the risk that market movements could be amplified in the event of unexpected shocks. A number of Directors commented that while the development of credit derivative and structured credit markets have been, on balance, supportive of a diversification of credit risks, the rapid growth of hedge funds and credit derivative mechanisms in recent years adds to uncertainty, and that they merit further analysis. They stressed the importance of being able to anticipate how these entities will react in the event of market turbulence and the systemic impact.

Directors concurred with the staff’s conclusions regarding policies for sustainable capital flows and the orderly adjustment of global economic imbalances. The depth, liquidity, and breadth of U.S. financial markets have played an important role in attracting capital inflows from both the foreign official and private sectors. At the same time, most Directors considered that these comparative advantages may diminish over time as the demand for foreign holdings of U.S. assets approaches its limits, and as structural improvements are made in competing international financial markets. Most Directors noted that growing liberalization of private capital outflows and the diversification of the investment of official reserve holdings support the smooth adjustment of global financing flows. Nevertheless, although considered unlikely, the
risk cannot be ruled out that a dollar decline could create financial turbulence, given that foreign investors’ exposures to losses from such a decline are large and growing.

Directors agreed with the staff’s assessment that the recent turbulence in EMs reflected corrections in the wake of substantial past investment inflows and price increases, rather than a reassessment of EM fundamentals. The resilience of EM sovereign bond and credit risk spreads reflects investors’ perceptions of improved fundamentals in many EMs, including lower current account and fiscal deficits, higher levels of reserves, and improved public debt structures. Nonetheless, Directors agreed that the correction also underscored that some EMs remain susceptible to a retrenchment by foreign investors because of greater uncertainty in the external environment. In particular, those countries with large balance of payments needs, coupled with excessive reliance on portfolio inflows, and/or where monetary and fiscal policy credibility is less well established, are more vulnerable. Directors noted that private sector debt inflows have increased sharply in recent years and may require close monitoring, particularly bank flows to private borrowers—including to households—in Central and Southeastern Europe.

Directors observed that policymakers in both mature and emerging markets face renewed challenges in ensuring balanced economic growth and financial stability, against the backdrop of heightened uncertainty and downside risks to the global economic outlook. Country authorities need to work cooperatively so that policies reinforce an orderly adjustment of global imbalances and prevent the emergence of disruptive market conditions. Supervisors and important financial institutions need to intensify their efforts to monitor and manage risks in the financial system. EMs will need to continue to reduce their vulnerabilities, particularly those with macroeconomic imbalances and a heavy reliance on external financing. Directors endorsed the continuation of debt management policies to further improve public debt structures, and the strengthening of local markets to help them absorb smoothly inflows from foreign investors and reduce their exposure to foreign currency financing.

### Household Credit Growth in Emerging Market Countries

Directors welcomed the opportunity to review household credit in EM countries. Household credit can have important benefits for borrowers, lenders, the financial system, and the economy, and the sound development of this sector should be encouraged. Directors considered that in most EM countries, retail credit expansion has been from relatively low levels and does not pose a threat to financial stability.

Directors cautioned that the growth of EM household credit in recent years has occurred in a benign environment of low interest rates in mature markets, falling EM interest rates, ample liquidity, and rising incomes and housing prices. The monetary tightening by many mature market and EM countries since the first quarter of 2006 could yet reveal weaknesses in the household credit sector in some EM countries. These countries should work to manage the risks and vulnerabilities through prudent macroeconomic management, sound prudential regulations, a supportive legal environment, and robust banking and financial data systems.

Directors emphasized that prudent macroeconomic management is the key to minimizing the buildup of interest and exchange rate risks. Appropriate fiscal and monetary policies will help prevent excessive credit growth, which can result in unsustainable consumption levels, current account imbalances, and property boom-and-bust cycles. Directors warned that credit financed predominantly by external capital inflows heightens the vulnerability to sudden stops and financial crises, and needs to be managed carefully.

Directors agreed that informed prudential regulation is essential to ensure healthy household credit growth. They suggested supplementing the standard prudential mechanisms with ex
ante provisioning, given the pro-cyclical nature of household credits. Also, regulators should promote conservative origination standards, but refrain from direct intervention in product design. For countries such as those in emerging Europe, where household credits are materially dependent on cross-border capital inflows, regulators should improve their dialogue and coordination with home-country regulators of large foreign banks, to ensure that the possibility of a sudden capital flow reversal is adequately guarded against. A number of Directors advised that direct controls on lending be considered only when the lending presents large systemic risks.

Directors recommended that, to improve the legal environment and infrastructure to support household credit and risk management, enabling reforms be implemented in the areas of securitization, the enforcement of collateral, the sharing of credit information, rating agencies and credit bureaus, transparency in lending, and consumer protection and education. Directors encouraged member countries to facilitate cooperative efforts to develop good product standards, fair marketing practices, and information sharing.

Directors noted the importance of improving data availability for effective monitoring and management of potential vulnerabilities. Increased efforts are needed to monitor and assess the buildup of credit, interest, rollover, and exchange rate risks in household credit portfolios, which may require upgrading the analytical capacity of regulators and supervisors. Directors recommended that risk measurement based on bank reporting be complemented with improved measuring and monitoring of asset prices and of household debt and net worth, and with stress testing of specific shocks.

Directors pointed to the possible constraints on the use of traditional policy measures in case of systemic distress affecting a large number of households. A situation in which household bankruptcies become commonplace may be quite different from a situation of large-scale corporate distress, as political pressures may make conventional crisis management tools difficult to use. For this reason, Directors suggested that countries in which the interest and exchange rate exposure of households is large should maintain adequate reserves and set in place contingency plans to confront large interest and/or exchange rate movements.