Directors welcomed the balanced, in-depth analysis and discussion of financial risks in the Global Financial Stability Report (GFSR). They agreed that global financial stability continues to be underpinned by solid economic prospects, although downside risks have increased somewhat in a few areas.

Assessing Global Financial Stability Risks

Directors considered that a number of market developments warrant increased attention, reflecting a shift in underlying financial risks and conditions since last September’s GFSR. While none of the identified short-term risks constitutes, in and of itself, a threat to financial stability, adverse events in one area can lead to a reappraisal of risks in other areas—with possible broader implications for the economy. The recent market turbulence validates this assessment, and serves to remind market participants that such reevaluations can occur quite rapidly.

Directors agreed with the general assessment portrayed in the global financial stability map presented by the staff, namely, that macroeconomic risks as well as those faced by emerging markets have eased marginally since September, but that market and credit risks have risen, albeit from relatively low levels. This has occurred against the backdrop of relatively benign monetary and financial conditions and a continued increase in investors’ appetite for risk.

Directors welcomed the global financial stability map as a useful tool for visualizing changes in the main near-term risks. They considered that further staff work on the analytics underpinning the map and their integration with the GFSR should serve to strengthen the framework for assessing financial stability.

Directors had a wide-ranging discussion of the near-term risks to the global financial system. Some Directors felt that the risks of a possible spillover of the deterioration of credit quality from the U.S. subprime mortgage segment to broader market segments were relatively minimal, given the underlying support provided by the strong household income growth and the low unemployment rate, as well as the relatively small size of the subprime segment and the concentration of problem loans in states with weak employment. However, most Directors expressed varying degrees of caution or concern going forward. Mortgage securities are now held more widely by both public and private international investors as a result of wider securitization. Directors noted that the risk has been distributed more widely, thereby enhancing the resiliency of financial markets. At the same time, the identification of the ultimate holders of risk in the mortgage-related derivatives market has become more complex, and many Directors called for more focused attention to the possible spillover effects of an unwinding of risky positions on other asset classes or on U.S. consumer confidence.

Directors observed that the wider use of leveraged buyouts and the heavy flows into private equity have increased the risks to the corporate sector, but agreed that this is not yet worrisome. At the same time, continued supervisory vigilance and scrutiny of credit discipline and lending standards will be required. A few Directors noted possibly longer-term effects on corporate leverage, with newly acquired companies with...
very high leverage ratios potentially experiencing difficulties if the current benign financing conditions change. Moreover, developments in the leverage loan market suggest some relaxation of credit discipline that could weaken overall corporate credit quality. A key question is whether the possible reactions of investors in credit risk transfer markets to changing circumstances could give rise to wider financial stability concerns. A promising area for further research is the medium-term ramifications of private equity activity, including the extent to which regulatory costs may be a factor in encouraging a shift from public to private companies.

Directors noted that although the risks of a disorderly unwinding of global imbalances have eased somewhat, they remain a concern, and require the pursuit of appropriate policies. Large inflows are still needed to finance the U.S. current account deficit. Directors underscored that fixed-income inflows have become more dominant and more sensitive to interest rate differentials between various countries and the United States. Many Directors noted that the increased sensitivity could make attracting inflows more susceptible to changes in investor sentiment, pointing to the need to pay continued attention to the role of shifting exchange rate expectations in the demand for U.S. fixed-income securities.

Directors generally agreed that risks and vulnerabilities in emerging markets have broadly declined, reflecting improved economic fundamentals, sound macroeconomic policies, and prudent debt management. Combined with investors’ search for yield, this has resulted in large capital inflows in a number of countries, posing challenges to policymakers. Directors observed that an investment environment conducive to the maintenance of confidence, the efficient use of capital, and the development of local financial markets should help emerging markets reap the benefits of foreign capital. At the same time, they called on staff to continue to work toward identifying measures and strategies that would help mitigate the adverse effects of rapid capital inflows or possible reversals.

Directors discussed the relative contributions of structural and cyclical factors in bringing about the current low financial market volatility and historically tight risk spreads, which have encouraged risk-taking. Some concern was expressed that investors may be giving insufficient weight to downside risks, particularly the prospect of near-term reversal of the cyclical factors contributing to the low volatility environment—abundant global liquidity, still low corporate leverage, and high risk appetite. At the same time, it was suggested that market participants generally understood the risk outlook, and that the recent turbulence was evidence that rapid price changes can be absorbed easily. In this regard, while carry trades are a natural outcome of the current set of interest rates and low volatility in foreign exchange markets, some Directors expressed concern about the possibility of large currency swings if investors attempted to unwind carry trade positions suddenly in response to an increase in underlying volatility. Directors noted that hedge funds have played a constructive role in improving market efficiency and stability, but cautioned that their size and complex risk structure can lead to increased transmission or amplification of shocks. They underscored the importance of greater transparency to investors and counterparties for monitoring hedge fund activities as a means to support financial stability. Some Directors emphasized that indirect monitoring of hedge fund activity is likely to remain the most effective and practical approach. Directors noted the work and analysis under way both nationally and internationally, including at the Financial Stability Forum, and some Directors also saw a positive role for the IMF in the design of constructive solutions for hedge fund regulation or monitoring.

Changes in the International Investor Base and Implications for Financial Stability

Directors observed that the increased diversity of assets, source countries, and investor
types contributes to a globalized financial system which, by allowing capital to flow freely, should enable a more effective diversification of risks, enhance the efficiency of capital markets, and support financial stability. They underscored the importance for market participants to bear the risk of their positions, while policymakers should underpin the strength of the financial system through structural reforms and strong macroeconomic policies. Directors also stressed the need to devise mechanisms to deal with the considerable gaps in information concerning global financial flows.

Directors believed that the larger global diversity of investors and the increase in institutional investors with longer investment horizons should support financial stability. However, several Directors expressed concern that in some countries increased demand has outpaced the availability of domestic financial assets, leading to a sharp increase in asset prices, rapid credit growth, and currency appreciation.

Directors noted that the development and improved functioning of domestic financial markets can help reduce the likelihood of foreign investors withdrawing their funds. Directors acknowledged that facilitating capital outflows to allow domestic investors to better manage risks and help mitigate strong inflows may be of particular relevance for certain emerging market economies. At the same time, Directors underscored the importance of gradual and carefully sequenced liberalization of financial markets, and several Directors observed that economic efficiency, rather than conjunctural factors such as the need to reduce pressures on asset prices and currencies from rapid inflows, should be the main rationale for outward capital account liberalization.

**Globalization of Financial Institutions: Financial Stability Implications**

Directors noted the accelerating trend toward the globalization of financial institutions—which is most evident for banks, but also present in the asset management, insurance, and reinsurance industries. Directors considered that the process of globalization has generally improved financial stability, although some Directors cautioned that it cannot be taken for granted that global financial systems as a whole are more resilient in the face of extreme events. In this respect, some Directors noted that increased international linkages within and across countries may make crises more broad-ranging and complicated to deal with.

Directors welcomed the contribution being made by the GFSR to financial sector surveillance, including in encouraging national legal, regulatory, and supervisory systems to adjust to the more globalized financial environment. In this respect, Directors favored improved mechanisms for multilateral collaboration, specifically for strengthening ongoing supervisory coordination, including through better application of well-established international standards and further work on crisis management and resolution arrangements. Overall, Directors thought that even relatively modest but practical steps to make progress on domestic policies and procedures, while enhancing cross-border cooperation and coordination, will increase the benefits of globalization while mitigating some of the potential risks to financial stability.