EXECUTIVE SUMMARY

Favorable global economic prospects, particularly strong momentum in the euro area and in emerging markets led by China and India, continue to serve as a strong foundation for global financial stability. However, some market developments warrant attention, as underlying financial risks and conditions have shifted since the September 2006 *Global Financial Stability Report* (GFSR).

Through the use of a new global financial stability map, Chapter I charts principal near-term risks. Chapters II and III examine the financial stability implications of two longer-term trends: the changing investor base from which global capital flows are sourced, and the globalization of financial institutions, particularly banks.

The changing mix of assets, source countries, and types of cross-border investors identified in Chapter II should, for the most part, help to stabilize global markets. But the secular trend has been reinforced by low interest rates and by low volatility in many mature markets, with investors seeking higher-yielding assets in some emerging markets and other mature markets. Chapter I examines this investor strategy—the carry trade—noting that while countries' fundamentals have improved and sovereign external debt has become less risky, international issuance of corporate debt and equities has risen rapidly to accommodate investor demand.

A theme of Chapter III—that the globalization of banks may help reduce individual bank risk but may not necessarily enhance the resilience of financial systems as a whole—is also echoed in Chapter I, which examines possible spillovers from a deterioration in credit quality in the U.S. subprime mortgage market.

Chapter I identifies several short-term risks. First, the subprime segment of the U.S. housing market is showing signs of credit quality deterioration. While the fallout to date has been limited, there is scope for it to deepen and spread to other markets, possibly to structured mortgage credit products held by a variety of global investors. Fortunately, the economic impact of the housing market slowdown has been limited and some market indicators have begun to stabilize, suggesting that the financial effects may also be contained.

Second, low interest rates and healthy corporate balance sheets have spurred an increase in private equity buyouts. This has led to a substantial rise in leverage in the acquired firms, potentially making such firms more vulnerable to economic shocks. The increased use of leveraged loans as part of financing also poses risks to some intermediaries that provide bridge financing to leveraged-buyout transactions. The situation bears careful attention, especially if a large high-profile deal runs into difficulty, as this could trigger a wider reappraisal of the risks involved.

Third, capital inflows to some emerging markets have risen rapidly, in part reflecting improved economic fundamentals, but also reflecting the search for yield given low interest rates in most mature markets. In general, strong private capital inflows are to be welcomed, as they reflect a reallocation of capital to more productive investments. However, the shift to private sector debt flows, especially bank-based flows into emerging Europe and portfolio flows into other regions, including sub-Saharan Africa, shows that foreign investors are taking more risk and an abrupt reversal cannot be ruled out.

Finally, while the downside risk from a possible disorderly unwinding of global imbalances has receded somewhat, it remains a concern. The larger role of fixed-income inflows in financing the U.S. current account deficit indicates that inflows into U.S. bond markets may have become more sensitive to changes in world interest rate differentials.

Against the backdrop of continued global growth, none of the individually identified risks by themselves threaten financial stability. However, with volatility across asset classes close to historic lows and spreads on a variety of credit instruments tight, investors may not have adequately factored in the possibility that a "volatility shock" may be amplified given the increased linkages across products and markets. Institutions may well be acting in accordance with their own incentives, but collectively their behavior may cause a buildup of investment positions in certain markets, possibly resulting in a disorderly correction when conditions change. For instance, the rapid growth of some innovative instruments, the rise in leverage in parts of the financial system, and the growth of carry trades suggest that market participants are expecting a continuation of the low volatility environment and that a sustained rise in volatility could perturb a wide range of markets.

Chapter II examines the recent acceleration in the accumulation of international assets as well as the investors behind rising cross-border flows. As noted above, flows and stocks of cross-border claims have increased both in absolute size and relative to the volume of domestic economic activity. The diversity of assets, source countries, and investor types now involved in cross-border asset accumulation suggests more stable flows. However, for some countries, the sharp increase in capital inflows has contributed to rapid credit growth and asset price inflation, at times complicating the conduct of policies. Furthermore, foreign investors have been venturing into markets previously regarded as excessively risky for outsiders, encouraged by the generally benign financial environment.

Policymakers can take advantage of these secular changes and at the same time minimize pockets of vulnerabilities that have become apparent. Recipient countries have to continue to establish a track record of credible macroeconomic policies. Vulnerabilities can be reduced by promoting efficiency, stability, and the effective regulation of domestic capital markets (including the development of local debt markets) so as to increase their attractiveness to a stable investor base. Liberalization of capital outflows from domestic investors, though not a panacea, may help balance the effects of capital inflows and allow domestic investors to better manage their risk.

Chapter III examines the implications of the accelerating globalization of financial institutions—particularly banks—for global financial stability. The institutional and regional pattern of globalization is remarkably varied. For large banks, greater geographical dispersion of assets and revenues tends to be associated with better share price performance and lower default risks. However, while cross-border diversification seems to be associated positively with the stability of the individual institution, the financial system as a whole may not be more stable, with the potential for linkages among markets and activities having increased. This is an especially important result for countries in regions with heavy foreign bank penetration across correlated economies.

The chapter highlights two clear priorities to help to contain the potential contagion risk arising from institutional globalization while maximizing its benefits. First, supervisors need to collaborate ever more closely in the oversight of cross-border institutions. Second, authorities need to continue improving crisis management procedures with the counterparts with whom they share the greatest overlapping responsibilities and interests. While the jurisdiction of supervisors and regulators remains predominantly domestic, at odds with the scope of activities of global institutions, these practical steps can go some way toward addressing the challenges to financial stability posed by institutional globalization.