

Over the past six months, the global financial system, especially the health of financial intermediaries, has been further strengthened by the broadening economic recovery. The financial system has not looked as resilient as it does in the summer of 2004, in the three years since the bursting of the equity bubble. Financial intermediaries, banks and non-banks alike, have strengthened their balance sheets to a point where they could, if necessary, absorb considerable shocks (see Chapter II, pages 64–73). While it is obviously feasible that one or the other financial institution, such as a hedge fund or even a bank, might succumb to serious mistakes in risk management or to outright fraud, such incidents should be isolated cases with limited, if any, contagion to the system as a whole. Short of a major and devastating geopolitical incident or a terrorist attack undermining, in a significant and lasting way, consumer confidence, and hence financial asset valuations, it is hard to see where systemic threats could come from in the short term. This positive assessment is focused on the financial sector, given its potential to create fast-moving knock-on effects through the wholesale markets. The household sector, in turn, could face certain financial problems going forward, despite its improved balance sheet position. However, from a systemic point of view, the household sector is the ultimate shock absorber.

Consequently, market players are relatively well prepared to deal with the long expected tightening cycle in monetary policy. As discussed in previous issues of the *Global Financial Stability Report* published during 2002, the financial system benefited crucially from two factors during the critical years 2001 and 2002: a strong capital base going into the recession and a preceding paradigm shift in

risk management, most clearly among the major internationally active banks. This trend toward risk diversification away from banks, indeed increasingly away from the financial sector as a whole, fundamentally helped the financial system to weather financial shocks. As discussed later in the chapter, this secular trend, while helpful for financial stability, may raise problems in the future. Over the last year or two, the gradually strengthening recovery of the world economy, as well as a steep yield curve, has sharply increased profitability within the financial sector and thus enhanced financial stability. Strong increases in gross revenues as well as a sharp reduction in corporate default rates and in nonperforming loans—both the result of the economic recovery—are providing a strong cushion of comfort for the financial sector (see Chapter II, pages 73–79).

Hence, this *Global Financial Stability Report*, and hopefully the next ones, will focus even more on medium-term structural issues in the financial system. Avoiding complacency, we are looking for fault lines that could ultimately translate into serious financial stresses some time in the future, if and when another downturn in economic activity were to occur.

Over the past two quarters, corporations and financial institutions have generally reported robust earnings. Increases in sales revenues combined with the results of ongoing cost-cutting efforts have produced impressive earnings growth in some countries. Consequently, the balance sheets of the corporate and financial sectors have improved further, with many institutions posting high levels of liquid assets. Insurance companies, especially in Europe, have also taken steps to strengthen their risk management capability and strengthened their capi-

tal base. By and large, these developments have enhanced the resiliency of international financial institutions.

International financial markets have remained calm so far despite the transition to higher interest rates. During April–May, the unwinding of carry trades in anticipation of Fed tightening raised bond yields and widened emerging market bond spreads. Nevertheless, volatility remained low in major bond and equity markets. Despite reports of increased risk taking reflected in higher value-at-risk levels, many financial intermediaries seem to have been able, so far, to absorb the rise in market interest rates without visible impact on their profitability. This may be attributed to strengthened risk management at many institutions and also to the effective communication strategy by the Fed. This time around, market preparedness for a rate hike stands in sharp contrast to the surprise and volatility that accompanied the Fed’s tightening in 1994. By reducing liquidity in the financial system and hence the indiscriminate search for yield that can create financial excesses, the Fed’s plan to restore interest rates to a “normal” level could make the economic expansion and benign market situation more sustainable.

After the first hike in the Federal Funds rate in late June, economic data have led market participants to expect inflation to stay under control, allowing the Fed to remove monetary stimulus at a “measured” pace. Consequently, mature and emerging bond markets have recovered part of their earlier losses. Interest rates in forward markets suggest that future modest rate hikes could be absorbed without much negative effect. In particular, the need for potentially unsettling mortgage hedging, which may amplify volatility in long-term rates, is much reduced now, compared to the situation last

summer when U.S. bond yields rose abruptly. Basically, due to a record volume of refinancing in 2002 and 2003, most outstanding mortgages in the United States carry a coupon lower than the current long-term mortgage rate. Therefore, further rises in the mortgage rate will not change abruptly the prepayment risk facing mortgage investors, lessening their need to hedge duration risk.¹

External financing conditions facing emerging market countries have also returned to a healthy and more sustainable level. Even though financing costs have risen from the lows reached earlier this year, they remain much lower than the average for the past five years. After some difficulty in April–May—especially for sub-investment grade borrowers—emerging market borrowers have since gained access to the global capital markets. As about 80 percent of the external bond-issuing program of emerging market countries for 2004 has been completed, some sovereigns are expected to start prefinancing their 2005 needs if market conditions remain favorable.

Risks in the Period Ahead

Overall, when conditions are as benign as they are at the moment, the major risks—especially in the medium term—are on the downside.

The most immediate risk is that market participants may develop a sense of complacency, seeing how smoothly financial markets have adjusted to the initial moves to higher policy rates. This may be reflected in the low volatility observed in major stock and bond markets. Such complacency could lead to a return of indiscriminate risk behavior, due to a strong tendency to “search for yield.”

¹U.S. homeowners have increased the portion of variable-rate and interest-only mortgages in new borrowing, thereby taking on more interest rate risk. However, most outstanding mortgages are long-term fixed rate, making the U.S. household sector somewhat interest rate insensitive.

Naturally, if U.S. interest rates were to rise more substantially than currently discounted due to an unexpected acceleration of inflation, the potential impact would be less benign than in the baseline scenario. This would be especially true if the markets were to perceive monetary policy as having fallen behind the curve and needing to catch up. Since the correlation is high between U.S. treasury yields and bond yields in Europe and emerging markets, the spillover effect of such a spike in U.S. yields may be widely felt—whether or not other regions are cyclically ready to absorb higher market interest rates. In the future, and driven by increasingly global asset allocation processes, these linkages will become even stronger as the world moves further toward a common pool of global savings.

Global current account imbalances pose a continued risk, even though it is difficult to forecast how or when the financing of the current account deficits or the adjustment of the imbalances could become disorderly. Data through June show that foreign portfolio flows into the United States remain strong. The sustainability of capital flows to the United States, however, remains a matter of concern. A sharp and disorderly decline of the dollar would, among other things, cause significant losses to many international institutions holding dollar assets or generating dollar income. But in the absence of a compelling alternative to liquid dollar assets within a high-growth area, it is not easy to see why investors would trigger a wholesale shift away from dollar assets without undermining the rationale of their investment decisions.

Overall, global geopolitical risks continue to be elevated and could quickly heighten risk aversion among international investors to the detriment of asset markets—especially those of weak credit quality or limited liquidity. Oil prices, in particular, could spike further, contributing to inflation concerns and potentially hurting financial markets and the economic recovery.

Policy Conclusions for the Short and Medium Term

Now that the Fed and other central banks have successfully managed the first phase of the transition to higher interest rates, the task ahead is to guide market expectations in executing the planned adjustment program. Recent growth and inflation data have brought market participants over to the Fed's vision of a "measured" pace of monetary stimulus removal. The current benign conjunctural situation should be used by the authorities of all countries to address weak spots in their financial systems. In particular, in countries where insufficient profitability has long plagued the banks, a conducive environment should be created to facilitate the consolidation process so as to allow the emergence of a profitable and vibrant banking sector. This would help support the financial system to cope with the next downturn. The benign economic and financial conditions also make the task of policy coordination to reduce global imbalances all the more important and timely. According to the *World Economic Outlook*, these measures encompass policies, including structural policies, to improve the growth performance of Europe and Japan, while achieving fiscal consolidation in the United States over the medium term.

For emerging market countries, the continuation of benign external financing conditions provides an excellent window of opportunity for maintaining strong economic policies and reform efforts to enhance their growth potential and the resiliency of their financial systems. Again, this will enable them to better deal with future shocks.

Beside the conjunctural issues, Chapter II also reviews several structural issues, either mentioned in earlier GFSRs or just emerging, that could have an impact on financial markets. Of particular interest are the sections on the recent developments of hedge funds (page 45) and the growing involvement of

financial market participants in energy trading markets (page 58).

Issues for the Long Term: Reforms of the Pension Industry

Chapter III looks at the potential systemic implications of the growth and changes of pension funds within the global financial system. This chapter is the second installment in a series looking at the management of risk in various nonbanking sectors and its impact on financial stability.

Many countries face the challenge of improving the adequacy of pension provisions to cope with rising dependency ratios (i.e., the ratio of retirees to working people). For company-sponsored pension funds, the quick succession from overfunding during the equity market boom years of the late 1990s to underfunding since has given rise to various reform efforts. Among other things, these efforts include improvements to the valuation and disclosure of the assets and liabilities of pension funds.

Another set of measures deals with risk management at pension funds and risk sharing between corporate sponsors and employees. In terms of risk management, the focus among industry members and regulators is shifting from asset portfolio management—frequently benchmarked to the major market indices—to a greater emphasis on asset-liability management, particularly the duration matching of assets to long-term pension liabilities. A growing debate has ensued on the role of governments in providing long-term and inflation-indexed bonds.² The focus on asset-liability management has also given rise to a lively debate within the industry concerning the appropriateness of equities or fixed-income instruments in matching pension assets to liabilities. The outcome of such debate could have a considerable effect on

the equity and fixed-income asset classes, as a result of a potential rebalancing of pension assets. In addition, international diversification of pension assets, including to emerging markets, will continue to progress, driven mainly by the uneven demographic developments in different countries, as well as diversification benefits. Given the already dominant size of pension funds in mature markets, even small changes in asset allocations of these funds will have a large impact on relatively illiquid markets, such as emerging markets.

More emphasis on risk management is likely to underpin the shift from defined benefit corporate pension plans to defined contribution plans, or to one of the hybrid plans. This shift has transferred the taking of investment risk from the corporate sponsors to the employees. Potentially, it could give rise to a public policy issue of the role of government if retirees incur losses in their defined contribution plans due to poor investment management or market declines. This issue is becoming quite relevant, since the contribution to retirement income from state pensions is projected to decline in many countries, while individuals' retirement savings are increasingly viewed as insufficient. As mentioned above, the transfer of financial risk outside the financial sector has supported the stability of financial intermediaries. However, once the household sector (and policymakers) fully understand the scope of risk they have incurred and what that could mean for their retirement income, there may be policy implications. The next GFSR will study mutual funds as another important nonbanking financial sector, and the implications that such a trend could have on the financial system more broadly, including new forms of moral hazard ("markets too important to fall" mentioned in the April 2004 GFSR).

Overall, the growing size of pension assets and the focus on asset-liability management

²In an interesting development, Brazil announced plans to issue new 40-year inflation-index-linked bonds in response to demands from local pension funds.

should strengthen the role of pension funds as stable, long-term institutional investors. This would tend to support financial stability as long as there is an adequate supply of financial assets to meet their demands. However, changes in asset allocation of pension funds would have a large impact on different asset classes and financial markets, especially smaller ones. Understanding these changes in asset allocation, and the subsequent capital flows, thus lies at the heart of multilateral surveillance of financial markets.

Policy Issues for the Pension Sector

Important policy issues are highlighted by the analysis of pension funds and of the changes required to cope with the challenge of an aging workforce. These policy issues are relevant to mature market countries, but could also be applicable to some emerging market countries.

- The aging of the workforce in many countries has intensified the need to promote sufficient and stable retirement savings. First and foremost is the need to better communicate the pension challenges and policy priorities, particularly in countries where the public sector has traditionally provided the bulk of pension benefits. Policymakers should try to establish a broad legal environment (and a tax environment in some cases) conducive to savings growth.
- Within a multi-pillar approach to pension provisions, policymakers should try to work toward a relatively balanced contribution from each pillar. As demographic and cost pressures have increased on Pillar 1 (state pension), the contribution of state plans to pensioners' retirement income is projected to decline in most countries. Therefore, measures to encourage larger contributions from Pillar 2 (occupational pension schemes) and Pillar 3 (individual savings schemes) are increasingly important.
- Measures to strengthen risk management by pension funds. Regulations and tax rules

should be designed to foster a closer alignment of pension assets to liability structures. Policymakers should facilitate the development of certain markets and instruments, including long-term, fixed-income and index-linked products. Such securities are necessary to allow pension funds to better match assets and liabilities, as well as to facilitate the supply and pricing of annuity and long-term savings products by market participants, such as insurance companies.

- Risk-based approaches to supervision and to guarantee fund premiums should be enhanced to reflect the riskiness of asset allocations. This would allow for a fairer distribution of the cost of guarantee funds, reduce moral hazard, and encourage risk management.
- As pension funds need to diversify internationally, including to emerging markets, policymakers should aim to remove the frictions that continue to limit international capital mobility. On the other hand, emerging market countries need to strengthen their capacity to absorb such potential capital flows.

Capital Flows Between Emerging and Mature Markets

Conventional wisdom suggests that capital normally flows from mature market countries, enjoying higher capital-labor ratios, to capital-scarce emerging market countries. Indeed this has been the case, except for selected episodes, such as the current period since 2000 when emerging market countries, as a group, have become net exporters of capital (as defined in footnote 1 in Chapter IV, page 121).

As analyzed in Chapter IV, the current episode of net capital outflows follows a series of financial crises in emerging market countries and changes in global imbalances. There are three main themes driving the changes in international capital flows, associated with

the net outflow from the emerging market countries.

In the aftermath of crises in the late 1990s and early 2000s, emerging market countries have undergone an adjustment process. Crisis countries had to reduce domestic absorption and increased exports to generate a trade surplus. Many emerging market countries, not just those in crisis, have also reduced their external indebtedness. International banks adjusted their portfolios by reducing exposures to emerging markets. During the adjustment period, countries had to restructure and strengthen their financial and corporate sectors, so as to restore normal financial intermediation and growth.

Second is the unprecedented accumulation of reserves by many central banks, both to maintain a competitive exchange rate and to have insurance against future crises. Various studies point out that a high ratio of reserves relative to external debt, particularly short-term debt, reduces the probability of debt crises. However, the desirable level of reserves varies from country to country, depending on exchange rate policy as well as institutional strengths, including the development of local capital markets, which can facilitate corporate restructuring.

Last but not least is the role of global factors, especially the growing global current account imbalances. Changes in global merger and acquisition activities also affect capital flows. Global risk aversion affects all assets with similar risk characteristics, regardless of their geographical locations. Conversely, abundant global liquidity prompts the search for yield for all emerging markets as an important segment of high-yield assets.

During the period under study, the 2000–01 subperiod was characterized by the adjustment effort, a reduction in private nonresident capital flow into the emerging markets due—among other things—to risk aversion, and a large outflow from emerging market residents. In the subsequent subperiod since 2001, reserves accumulation by central banks

has been impressive, being greater than the rising current account surplus and a rebound in private capital inflows.

Going forward, as emerging market countries recover their economic growth, domestic demand could revive and lead to normal trade developments. Reserves accumulation by many emerging market countries may slow. Beyond a certain level, the opportunity cost and policy complications of acquiring additional reserves may become more evident. Finally, the increase in gross issuance of bonds, equities, and loans by emerging market countries—at an annualized rate of \$264 billion year-to-date, compared to \$198 billion in 2003—as well as foreign direct investment flows suggest that international investors' appetite for emerging market assets has returned. Indeed, as highlighted in Chapter III, pension funds in mature market countries have a long-term need to diversify a small portion of their assets to emerging market countries. Consequently, the net capital exporting position of emerging market countries could prove to be a temporary development.

To the extent that emerging market countries need to attract stable capital inflows to develop their economies, policy measures can be taken to help change the phenomenon that emerging market countries have become net exporters of capital. Three sets of policy issues correspond to the three factors accounting for the net capital outflow from emerging market countries.

- As emerging markets are becoming more mainstream assets in global portfolios, they have to compete for risk capital vis-à-vis other asset classes in increasingly globalized capital markets. Emerging market countries have to establish a track record of consistently strong economic policies and reforms to enhance their risk-adjusted return prospects to international investors in order to attract stable inflows.
- Policies to self-insure against sudden stops in capital inflows. Implementing a strong economic policy is a necessary condition for

financial stability, but it may not be sufficient in times of global financial turmoil. Accumulating large amounts of reserves can lower the risk of debt crises, but it may become costly, including in terms of posing complications to macroeconomic stability. Implementing financial sector reforms, including the development of local securities markets, can help emerging market countries reduce their reliance on volatile

external financing and lower the cost of self-insurance.

- Policies designed to improve the mechanisms for post-crisis balance sheet adjustments. Of particular importance is the need to improve markets for distressed debt to facilitate the transfer of corporate ownership and control, and to produce a better allocation of resources to help revive growth.