



## EXECUTIVE SUMMARY

**I**nternational financial markets experienced a pullback in prices and an increase in volatility during May–June 2006. Industrial country markets subsequently recovered.

In emerging markets (EMs), the correction followed advances that had lifted benchmark indicators to record highs. Viewed in this context, the recent market turbulence was modest in scale.

This modest rise in financial market volatility reflected greater investor uncertainty about risks to the economic outlook and the likely policy response. That investors would harbor doubts about market prospects is not surprising. After all, the combination during the past few years of strong global growth with relatively low core inflation, despite surging energy and commodity prices, and limited exchange rate volatility, despite record current payments imbalances, has no clear precedent.

According to the global forecast presented in the September 2006 *World Economic Outlook*, the most likely outcome will be a continuation of solid growth and contained inflation. The normalization of monetary policy in the key market economies is expected to proceed along the lines already reflected in market pricing. More broadly, favorable global financial market conditions appear to be consistent with the *World Economic Outlook's* baseline scenario.

### Assessing the Risks to the Baseline Scenario

The September 2006 *World Economic Outlook* also points to the most prominent risks to the baseline forecast. These include an intensification of inflation pressures (perhaps reflecting a new energy price surge), which would elicit more monetary policy tightening than is anticipated currently. They also include a more

pronounced economic slowdown in the United States (perhaps accompanied by a rapid weakening of the U.S. housing market), which could slow global growth.

If any of these—or other—risks materialize, financial market conditions could deteriorate. As has been noted widely, the unexpected resilience of global growth over the past few years—at least relative to the then-prevailing market consensus—has been associated with a decline in both risk premiums and market volatility. In these circumstances, it is reasonable to wonder whether financial markets might react to less favorable developments in a way that would amplify—rather than dampen—the emerging risks. In particular, concerns have been raised about the potential for illiquidity to emerge in response to unexpected stress in markets for new and complex financial instruments, such as structured credit products. Furthermore, some emerging market economies with large current account deficits are reliant on portfolio capital inflows from international investors; these could diminish sharply in a more volatile market environment.

Faced with these uncertainties, it is especially important that policymakers undertake the required policy adjustments to bolster prospects for a sustained global expansion. As well, supervisory and regulatory authorities need to continue to strengthen financial market infrastructure to underpin the resilience of the financial system.

### Financing of Global Imbalances

The variety of instruments available—together with the depth and liquidity of U.S. financial markets—has attracted capital inflows from both foreign official and private entities. Annex 1.4 shows that the structural strength of U.S. financial markets has no doubt

enhanced the scale and sustainability of the U.S. current account deficit. The continuing confidence of international investors in U.S. markets supports the prospects of orderly adjustments in current imbalances. However, structural improvements in financial markets elsewhere could influence the future relative terms for cross-border capital flows, by boosting these markets' attractiveness to investors relative to U.S. markets. In addition, as international reserve holdings continue to set record highs, it is possible that portfolio choices of reserve managers could shift away (at least in relative terms) from traditional high-liquidity, low-risk instruments.

In this respect, the future demand for U.S. assets is also likely to be affected by the broad trend toward liberalization and diversification of capital outflows in Asia, a region whose authorities hold more than half the world's net international reserves (see Annex 1.5). It will depend increasingly on the portfolio allocation choices of oil-producing nations, which have amassed substantial reserves in the last two years or so. Accordingly, while relative price adjustments between asset classes are likely to be smooth, there may be some shift in demand away from the highly liquid, short-duration, fixed-income assets typically held in official reserves portfolios. Over the longer run, when portfolios adjust fully and have exploited diversification and growth opportunities, net foreign asset positions will likely stabilize, and global imbalances will decline to more sustainable levels.

Still, during this transition, there remains a risk that a dollar decline could become disorderly. Data on foreign holdings of U.S. securities show that foreign investors' exposures to losses from a dollar decline are potentially large and, importantly, continue to increase. Although the baseline market view is that dollar adjustment will remain orderly, the risks of a disorderly adjustment would be reduced by appropriate policy actions by the authorities in countries that are the main counterparts to global current account imbalances.

## Growth in Emerging Market Household Credit

Household credit is growing rapidly, albeit from a low base, across many EM countries. Chapter II—which assesses recent trends in household credit—argues that greater access to credit helps smooth household consumption, improves investment opportunities, eases constraints on small and family-owned businesses, and diversifies assets held by household and financial institutions. However, a rapid increase in household credit, without adequate risk management and prudential infrastructure, can weaken household balance sheets, contribute to asset price bubbles and deterioration of external current account, and create vulnerabilities for financial systems in some EM countries.

In most EM countries, retail credit expanding from relatively low levels—compared with more developed countries—is desirable and does not pose a direct threat to financial stability. However, household credit has grown in EM countries during a period of low mature market interest rates and falling EM interest rates; thus household balance sheets may come under pressure as these conditions reverse. Under more adverse circumstances, the weaknesses in household balance sheets could increase stress on the financial sector, weaken property prices, and slow down consumption spending. There are also important localized concerns. For example, in some emerging European economies, credit-driven consumption has led to a deterioration of external balances, with household borrowers exposed to potentially large interest and exchange rate risks and declining house prices.

EM policymakers can take several steps to prevent or mitigate risks associated with a buildup in household credit. These include adopting prudent macroeconomic management that can help lower the risk of large shocks to household incomes, exchange rates, or interest rates; introducing sound prudential norms for household credit and encouraging good origination standards and information sharing

by banks; and developing the necessary legal and regulatory framework and infrastructure. While EM countries have made improvements in recent years, substantial progress remains to

be made in all three areas. These measures will allow EMs to reap the substantial benefits of developing this market, while avoiding boom-bust cycles during the formative years.