EXECUTIVE SUMMARY

Risks to global financial stability have eased as the economic recovery has gained steam, but concerns about advanced country sovereign risks could undermine stability gains and prolong the collapse of credit. Without more fully restoring the health of financial and household balance sheets, a worsening of public debt sustainability could be transmitted back to banking systems or across borders. Hence, policies are needed to (1) reduce sovereign vulnerabilities, including through communicating credible medium-term fiscal consolidation plans; (2) ensure that the ongoing deleveraging process unfolds smoothly; and (3) decisively move forward to complete the regulatory agenda so as to move to a safer, more resilient, and dynamic global financial system. For emerging market countries, where the surge in capital inflows has led to fears of inflation and asset price bubbles, a pragmatic approach using a combination of macroeconomic and prudential financial policies is advisable.

With the global economy improving (see the April 2010 *World Economic Outlook*), risks to financial stability have subsided. Nonetheless, the deterioration of fiscal balances and the rapid accumulation of public debt have altered the global risk profile. Vulnerabilities now increasingly emanate from concerns over the sustainability of governments' balance sheets. In some cases, the longer-run solvency concerns could translate into short-term strains in funding markets as investors require higher yields to compensate for potential future risks. Such strains can intensify the short-term funding challenges facing advanced country banks and may have negative implications for a recovery of private credit. These interactions are covered in Chapter 1 of this report.

Banking system health is generally improving alongside the economic recovery, continued deleveraging, and normalizing markets. Our estimates of bank writedowns since the start of the crisis through 2010 have been reduced to $2.3 trillion from $2.8 trillion in the October 2009 *Global Financial Stability Report*. As a result, bank capital needs have declined substantially, although segments of banking systems in some countries remain capital deficient, mainly as a result of losses related to commercial real estate. Even though capital needs have fallen, banks still face considerable challenges: a large amount of short-term funding will need to be refinanced this year and next; more and higher-quality capital will likely be needed to satisfy investors in anticipation of upcoming more stringent regulation; and not all losses have been written down to date. In addition to these challenges, new regulations will also require banks to rethink their business strategies. All of these factors are likely to put downward pressure on profitability.

In such an environment, the recovery of private sector credit is likely to be subdued as credit demand is weak and supply is constrained. Households and corporates need to reduce their debt levels and restore their balance sheets. Even with low demand, the ballooning sovereign financing needs may bump up against limited credit supply, which could contribute to upward pressure on interest rates (see Section D of Chapter 1) and increase funding pressures for banks. Small and medium-sized enterprises are feeling the brunt of the reduction in credit. Thus, policy measures to address supply constraints may still be needed in some economies.

In contrast, some emerging market economies have experienced a resurgence of capital flows. Strong recoveries, expectations of appreciating currencies, as well as ample liquidity and low interest rates in the major advanced countries form the backdrop for portfolio capital inflows to Asia (excluding Japan) and Latin America (see Section E of Chapter 1, and Chapter 4). While the resumption of capital flows is welcome, in some cases this has led to concerns about the potential for inflationary pressures and asset price bubbles, which could compromise monetary and financial stability. However, with the exception of some local property markets, there is only limited evidence of this actually happening so far.

Nonetheless, current conditions warrant close scrutiny and early policy action so as not to compromise financial stability. Chapter 4 notes that there are strong links between global liquidity expansion and asset prices in "liquidity-receiving" economies. The work shows that capital inflows in the receiving economies are less problematic if exchange rates are flexible and capital outflows are liberalized. Moreover, policymakers in these economies are encouraged to use a wide range of policy options in response to the surge in flows—namely macroeconomic policies and prudential regulations. If these policy measures are insufficient and the capital flows are likely to be temporary, judicious use of capital controls could be considered.

Main Policy Messages

To address sovereign risks, credible medium-term fiscal consolidation plans that command public support are needed. This is the most daunting challenge facing governments in the near term. Consolidation plans should be made transparent, and contingency measures should be in place if the degradation of public finances is greater than expected. Better fiscal frameworks and growth-enhancing structural reforms will help ground public confidence that the fiscal consolidation process is consistent with long-term growth.

In the near term, the banking systems in a number of countries still require attention so as to reestablish a healthy core set of viable banks that can get private credit flowing again. Policies need to focus on the "right sizing" of a vital and sound financial system. While deleveraging has occurred mostly on the asset side of banks' balance sheets, funding and liability-side pressures are coming to the fore. Further efforts to address a number of weak banks are still necessary to ensure a smooth exit from the extraordinary central bank support of funding and liquidity. The key will be for policymakers to ensure fair competition consistent with a well-functioning and safe banking system. While certain central banks and governments may need to continue to provide some support, others should stand ready to reinstate it, if needed, to avert a return of funding market disruptions.

Looking further ahead, the regulatory reforms need to move forward expeditiously after being adequately calibrated, and be introduced in a manner that accounts for the current economic and financial conditions. It is already clear that the reforms to make the financial system safer will entail more and better quality capital and improvements in liquidity management and buffers. These microprudential measures will help remove excess capacity and restrict a build-up in leverage. While the direction of the reforms is clear, the magnitude is not. Furthermore, questions remain about how policymakers will deal with the capacity of too-important-to-fail institutions to harm the financial system and to generate costs for the public sector and its taxpayers. In particular, there will be a need for some combination of ex ante preventive measures as well as improved ex post resolution mechanisms. Resolving the present regulatory uncertainty will help financial institutions better plan and adapt their business strategies.

In moving forward with regulatory reforms to address systemic risks, care will be needed to ensure that the combination of measures strikes the right balance between the safety of the financial system and its innovativeness and efficiency. One way that is being considered to improve the safety of the system is to assign capital charges on the basis of an institution's contribution to systemic risk. While not necessarily endorsing its use, Chapter 2 presents a methodology to construct such a capital surcharge based on financial institutions' interconnectedness—essentially charging systemically important institutions for the externality they impose on the system as a whole—that is, the impact their failure would have on others. The methodology relies on techniques already employed by supervisors and the private sector to manage risk. Other regulatory measures, of course, are also possible, such as those discussed in Section F of Chapter 1, and merit further analysis.

As important as the types of regulations to put into place is the question of who should do it. Chapter 2 also asks whether some recent reform proposals that add the task of monitoring the build-up of systemic risks to the role of regulators would help to mitigate such risks. The chapter finds that a unified regulator—one that oversees liquidity and solvency issues—removes some of the conflicting incentives that result from the separation of these powers, but nonetheless if it is mandated to oversee systemic risks it would still be softer on systemically important institutions than on those that are not. This arises because the failure of one of these institutions would cause disproportionate damage to the financial system and regulators would be loathe to see serial failures. To truly address systemic risks, regulators need additional tools explicitly tied to their mandate to monitor systemic risks—altering the structure of regulatory bodies is not enough. Such tools could include systemic-risk-based capital surcharges, levies on institutions in ways directly related to their contribution to systemic risk, or perhaps even limiting the size of certain business activities.

Another approach to improving financial stability is to beef up the infrastructure underling financial markets to make them more resilient to the distress of individual financial institutions. One of the major initiatives is to move over-the-counter (OTC) derivatives contracts to central counterparties (CCPs) for clearing. Chapter 3 examines how such a move could lower systemic counterparty credit risks, but notes that once contracts are placed in a CCP it is essential that the risk management standards are high and back-up plans to prevent a failure of the CCP itself are well designed. In the global context, strict regulatory oversight, including a set of international guidelines, is warranted. Such a set of guidelines is currently being crafted jointly by the International Organization of Securities Commissions and the Committee on Payments and Settlement Systems.

The chapter also notes that while moving OTC derivative contracts to a CCP will likely lower systemic risks by reducing the counterparty risks associated with trading these contracts, such a move will bring with it transition costs due to the need to post large amounts of additional collateral at the CCP. This calls for a gradual transition. Given these costs, however, the incentive to voluntarily move contracts to the safer environment may be low and it may need more regulatory encouragement. One way, for example, would be to raise capital charges or attach a levy on derivative exposures that represent a dealer's payments to their other counterparties in case of their own failure—that is, their contribution to systemic risk in the OTC market.

In sum, the future financial regulatory reform agenda is still a work in progress, but will need to move forward with at least the main ingredients soon. The window of opportunity for dealing with too-important-to-fail institutions may be closing and should not be squandered, all the more so because some of these institutions have become bigger and more dominant than before the crisis erupted. Policymakers need to give serious thought about what makes these institutions systemically important and how their risks to the financial system can be mitigated.