EXECUTIVE SUMMARY

Recent important policy steps have brought some much-needed relief to euro area financial markets. As discussed in Chapters 1 and 2, sovereign spreads have declined, bank funding markets have partly reopened, and equity prices have recovered. Nevertheless, pressures on European banks remain, including from sovereign risks, weak euro area growth, high rollover requirements, and the need to strengthen capital cushions to regain investor trust. Together, these pressures have induced a broader drive to reduce balance sheet size. Analysis in this *Global Financial Stability Report* suggests that large EU-based banks could shrink their combined balance sheet by as much as $2.6 trillion (€2.0 trillion) through end-2013, or almost 7 percent of total assets. Although subject to considerable uncertainty, our estimate is that about one-fourth of this deleveraging could occur through a reduction in lending, with the remainder coming largely from sales of securities and noncore assets. Under the baseline, the impact on euro area credit supply is estimated at about 1.7 percent of present credit outstanding. Some balance sheet reduction by individual banks is necessary because high leverage is no longer supported by either markets or regulators and some activities are no longer viable. But the potential consequences of a synchronized and large-scale deleveraging warrant supervisory efforts to avoid serious damage to asset prices, credit supply, and economic activity in Europe and beyond.

Against this backdrop, European policymakers need to build on recent improvements to implement the agreed reforms swiftly. Avoiding fresh setbacks will be critical, especially on the difficult path ahead, which is fraught with political and implementation risk. The recent decision to combine the European Stability Mechanism with the European Financial Stability Facility is welcome and, along with other recent European efforts, will strengthen the European crisis mechanism and support the IMF's efforts to bolster the global firewall. But to achieve lasting stability and move to a path that inspires confidence, these crisis management policies need to be anchored with a road map of further financial and fiscal integration of the Economic and Monetary Union.

Most emerging markets have policy room to buffer moderate deleveraging forces emanating from the European Union, but their resilience could be tested in a downside scenario, notably in emerging Europe. Elsewhere, the United States and Japan have yet to forge a political consensus for medium-term deficit reduction, perpetuating latent risks to financial stability. Meanwhile, the global financial regulatory framework is being strengthened, but key agreements still need to be concluded, while the transition to this new setting could add to cyclical challenges facing financial institutions.

The financial crisis and concerns about sovereign debt sustainability in some countries have reminded investors that no asset can be viewed as truly risk free. Chapter 3 examines the various roles of safe assets and the effects of different regulatory, policy, and market distortions, and it discusses future pressure points that may arise. It finds that the combination of heightened uncertainty, regulatory reforms, and crisis-related responses from central banks will drive up demand. On the supply side, the number of sovereigns whose debt is considered safe is declining—taking potentially $9 trillion in safe assets out of the market by 2016 (roughly 16 percent of the projected total). These developments will put upward pricing pressures on the remaining assets considered safe. Regulations should be designed flexibly and should be gradually phased in, according to an internationally agreed schedule, to avoid a choppy or uneven path of adjustment to a new price for safe assets.

Chapter 4 highlights the potentially very large financial implications of longevity risk—that is, the risk that people may live longer than expected. The chapter defines the risk, shows its magnitude—amounting to between 25 percent and 50 percent

of 2010 GDP, on average—and provides estimates of its effects on fiscal balance sheets and businesses. More attention to longevity risk is warranted now, given the potential size of these effects on already weakened public and private balance sheets, and because the effective mitigation measures take years to bear fruit. Governments need to acknowledge their exposure to longevity risk; put in place methods for better risk sharing between governments, private sector pension sponsors, and individuals; and promote the growth of markets for the transfer of longevity risk.