International Monetary Fund

Global Financial Stability Report

April 2012

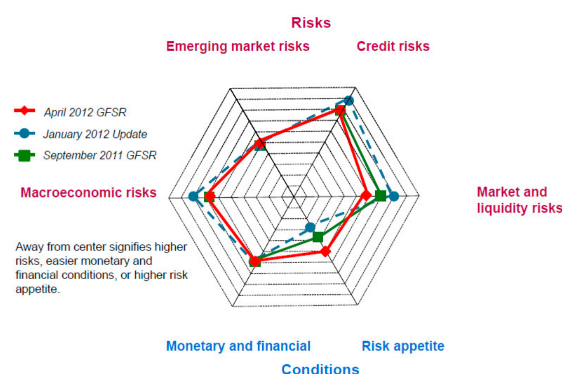
The Quest for Lasting Stability: Press Points for Chapters 1-2

What are the Key Stability Risks and Challenges?

- ***Policymakers need to build on recent stabilization gains by swiftly implementing a comprehensive set of policies to secure lasting financial stability.***
- ***Sovereign bond markets remain fragile, due to strained fiscal positions and a shrinking demand from traditional investors. Financing public debt could still prove challenging for some euro area countries.***
- ***Banks remain under pressure to raise capital or reduce assets by scaling back credit or cutting business lines. Some of these adjustments are healthy, but there is a risk that a synchronized, large-scale, and aggressive reduction in European bank assets might have serious repercussions for the economy.***
- ***Emerging markets have deftly navigated the financial shocks and economic spillovers from advanced economies so far, but are vulnerable to a sharp pullback of bank credit and cross-border lending, a sudden reversal in capital flows, and domestic weaknesses in some economies.***
- ***Policymakers need to coordinate a careful mix of financial, macroeconomic, and structural policies that ensure a smooth deleveraging process, support growth, and facilitate rebalancing. In the euro area, a clear path towards a more integrated economic and monetary union, built on solidarity and strengthened risk-sharing arrangements, is essential.***

Recent policy actions brought some much-needed relief, but the risks to global financial stability remain elevated (Figure 1). In late 2011, severe stress in the euro area's banking and government bond markets pushed financial stability risks to a new peak of intensity. Subsequent policy actions eased bank funding strains, reducing market and liquidity risks, and helped stabilize sovereign markets. Risk appetite was also boosted, but risks to global financial stability remain elevated. This report calls on policymakers to build on recent improvements in market conditions by swiftly implementing a comprehensive set of policies to achieve durable stability.

Figure 1. Global Financial Stability Map



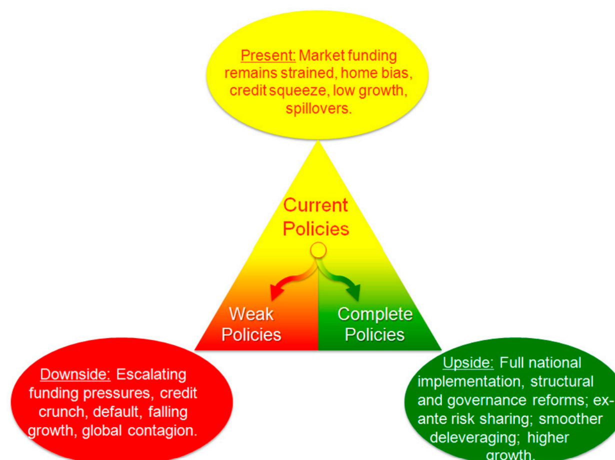
Source: IMF staff estimates.

Recent policy action has provided a much-needed reprieve, but euro area sovereign bond markets remain vulnerable, due to strained fiscal positions and shrinking demand from traditional investors. Financing public debt could still prove challenging for some euro area countries. A lasting recovery in market confidence will take time, during which domestic policy efforts may need to be bolstered by stronger external support. Countries currently facing market pressures need to sustain their resolve to rectify fiscal imbalances in a well-timed manner.

Fiscal challenges are by no means confined to the euro area. The United States and Japan have yet to forge the political consensus for medium-term deficit reduction needed to remove persistent latent risks to financial stability.

This report analyzes the risks to global financial stability by comparing three policy scenarios (Figure 2): (i) a baseline scenario of *current policies*, where systemic risks are averted but strains remain, as policymakers do not capitalize on recent progress to complete the reforms that are needed to secure lasting stability; (ii) an upside scenario of *complete policies*, where policymakers further strengthen crisis management, pursue bank restructuring, and commit to a road map for a more financially and fiscally integrated monetary union, including a prudent framework for ex-ante risk sharing; and (iii) an adverse scenario of *weak policies*, where current policies are either not implemented fully (or quickly enough) or are overwhelmed by external shocks, which results in conditions deteriorating to the point of reviving acute market tension.

Figure 2. Policy Action to Entrench Stability and Avoid Downside Risks



Source: IMF staff estimates.

Bank Deleveraging—Why, What, by How Much, and Where? Banks have been under pressure to deleverage since the outbreak of the subprime crisis. Pressures on European banks escalated at the end of 2011, as sovereign stress increased and many private funding channels closed. The ECB's provision of longer-term funding has substantially eased banks' funding strains, but they still need to raise capital or reduce assets by cutting business lines or scaling back credit. Some of these adjustments are healthy since high leverage is no longer supported—by either markets or regulators—and some activities are no longer viable. However, there is a risk that a synchronized, large-scale, and aggressive reduction in European bank assets might have serious negative repercussions for the economy and financial markets in the euro area and beyond.

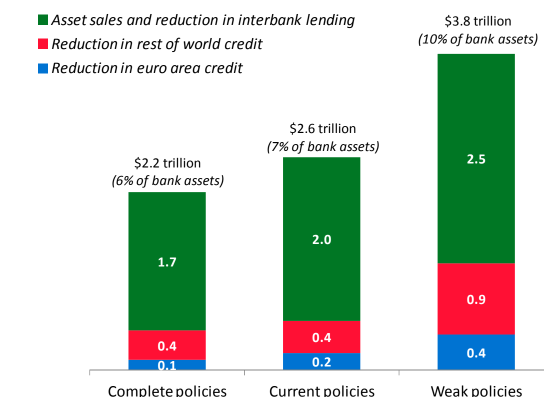
Under the *current policies* scenario, this GFSR estimates that large EU-based banks could shrink their combined balance sheet by some $2.6 trillion (€2.0 trillion) between end-September 2011 and end-December 2013, which represents almost 7 percent of bank assets (Figure 3). Most of this asset reduction is estimated to occur through sales of securities and noncore assets, but about a quarter could occur through a cutback in lending (Figure 4). Under the *current policies* scenario, the negative impact on euro area credit supply from EU bank deleveraging is estimated at around 1.7 percent of credit outstanding. But under the *weak policies* scenario, the decline of euro area credit could be as high as 4.4 percent over the two years, causing euro area real GDP to be 1.4 percent lower than the baseline at the end of 2013. The impact of bank deleveraging is global, although it will likely be strongest in the periphery of the euro area and in emerging Europe.

Figure 3. Impact of European Bank Deleveraging Under Three Policy Scenarios, Through End-2013

Scenario	Change in Bank Assets[1] (US$ trillions)	(percen	Change in Euro Area Supply of Bank Credit[2] (percent)	Change in Euro Area GDP[3] (percent)
Complete	–2.2	–6	–0.6	0.6
Current	–2.6	–7	–1.7	-
Weak policies	–3.8	–10	–4.4	–1.4

Source: IMF staff estimates.
[1]For a sample of 58 large EU banks.
[2]Domestic and direct cross-border credit relative to level in 2011 Q3.
[3]Change from level of GDP in 2011, relative to the current policies

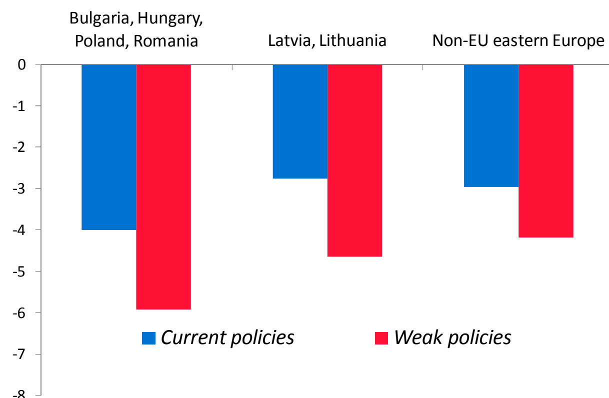
Figure 4. Contributions to Aggregate Reduction in Bank Assets
(In trillions of U.S. dollars)



Source: IMF staff estimates.
Note: For a sample of 58 large EU banks.

Most emerging markets have policy room to buffer moderate deleveraging forces emanating from Europe, but their resilience could be tested under a weak policies scenario. Stability should not be taken for granted. Among emerging markets, emerging Europe is most vulnerable, given the region's large economic exposure and strong banking links to the euro area, as well as its large gross external financing needs and more limited policy buffers (Figure 5). More broadly, a re-intensification of strains in the euro area could lead to a reversal of capital flows, amplifying the negative effects of bank deleveraging. Although many emerging markets have substantial buffers and adequate policy room, homegrown vulnerabilities in some economies could magnify the impact of external shocks.

Figure 5. Reduction in Supply of Credit by Sample Banks in Emerging Europe: Current and Weak Policies Scenario
(In percent of total domestic private credit)



Source: IMF staff estimates.
Note: For a sample of 58 large EU banks.

The Quest for Lasting Stability

- ***Euro area policy makers need to take further steps to entrench stability.*** The first step is the continued implementation of well-timed fiscal consolidation policies at the national level, supported by growth-enhancing policies, including sufficiently accommodative monetary policy, and structural reforms that raise potential growth. The second step is further progress on bank restructuring and resolution, which is essential to complement the bank capital and provisioning increases currently under way. The recently strengthened financing backstop will help bolster reform efforts. This "firewall" should also be able to take direct stakes in banks in order to help break the adverse feedback loop between sovereigns and banks. The third step is achieving longer-term reform objectives to underpin stability. These include developing—and committing to—a roadmap for a more financially and fiscally integrated monetary union. This

requires a more centralized euro area coordination of policies and a common framework for bank supervision and resolution as well as deposit insurance, and greater progress toward ex-ante sharing of fiscal risk.

- ***Macroprudential authorities need to ensure an orderly process of deleveraging.*** This requires close macroprudential oversight by European banking authorities of bank business plans. A key challenge will be to control spillovers from the euro area into emerging Europe and elsewhere.

- ***Both Japan and the United States need to put in place credible multi-year plans for deficit reduction,*** which protect short-term growth but reassure financial markets that debt will return to a sustainable trajectory over the medium term.

- ***Policymakers in emerging markets should stand ready to use their existing policy space to cushion negative external shocks.*** However, policy makers need to be cautious. For example, the scope for easing credit policy may be limited in some countries, due to sustained periods of above-trend credit expansion. At the same time, home grown vulnerabilities should be addressed to further increase resilience.

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- ***Long-lasting stability of the financial system will be supported by progress in implementing the G20 regulatory reform agenda.***