EXECUTIVE SUMMARY

The global financial system is undergoing a series of transitions along the path toward greater financial stability. The United States may soon move to less accommodative monetary policies and higher long-term interest rates as its recovery gains ground. After a prolonged period of strong portfolio inflows, emerging markets are facing a transition to more volatile external conditions and higher risk premiums. Some need to address financial and macroeconomic vulnerabilities and bolster resilience, as they shift to a regime in which financial sector growth is more balanced and sustainable. Japan is moving toward the new "Abenomics" policy regime marked by more vigorous monetary easing, coupled with fiscal and structural reforms. The euro area is moving toward a more robust and safer financial sector, including a stronger monetary union with a common framework for risk mitigation, while strengthening financial systems and reducing excessive debt levels. Finally, the global banking system is phasing in stronger regulatory standards. Chapter 1 examines the challenges and risks of each of these transitions.

The primary challenge resulting from these changes relates to managing the side effects and eventual withdrawal of accommodative monetary policy in the United States. Such a transition, including the benefits of a strong U.S. economy, should help limit financial stability risks associated with an extended period of low interest rates. Yet managing a smooth transition could prove challenging, as investors adjust portfolios for a new regime with higher interest rates and greater volatility. The analysis in Chapter 1 highlights the risk that long-term interest rates could rise more sharply than currently anticipated. Structural reductions in market liquidity and leveraged positions in short-term funding markets and the shadow banking system (for instance, in the mortgage real estate investment trust sector) could amplify these rate increases and spill over to global markets.

Financial stability challenges are also prevalent in many emerging market economies. Bond markets are now more sensitive to changes in accommodative monetary policies in advanced economies because foreign investors have crowded into local markets and may withdraw. Emerging market fundamentals have weakened in recent years, after a protracted interval of credit expansion and rising corporate leverage. Managing the risks of the transition to a more balanced and sustainable financial sector, while maintaining robust growth and financial stability, will be a key undertaking confronting policymakers.

As central banks elsewhere consider strategies for eventual exit from unconventional monetary policies, Japan is scaling up monetary stimulus under the Abenomics framework, aiming to pull the economy out of its deflationary rut. Successful implementation of a complete policy package that features fiscal and structural reforms would reinforce domestic financial stability, while likely boosting capital outflows. But substantial risks to financial stability could accompany the program if planned fiscal and structural reforms are not fully implemented. Failure to enact these reforms could lead to a return of deflation and increased bank holdings of government debt, further increasing the already-high sovereign-bank nexus. In a more disorderly scenario, with higher inflation and elevated risk premiums, the risks to both domestic and global financial stability could be greater still, including rapid rises in bond yields and volatility, and sharp increases in outflows.

In the euro area, reforms implemented at the national level and important steps taken toward improving the architecture of the monetary union have helped reduce funding pressures on banks and sovereigns. However, in the stressed economies of Italy, Portugal, and Spain, heavy corporate sector debt loads and financial fragmentation remain challenging. Even if financial fragmentation is reversed over the medium term, this report estimates that a persistent debt overhang would remain, amounting to almost one-fifth of the combined corporate debt of Italy, Portugal, and Spain. Assuming no further improvement in economic and financial conditions which would correspond to a more adverse outcome than the cyclical improvement built into the October 2013 *World Economic Outlook* baseline scenario, some banks in these economies might need to further increase provisioning to address

the potential deterioration in asset quality of corporate loan books. This could absorb a large portion of future bank profits. Recent efforts to assess asset quality and boost provisions and capital have helped to increase the loss-absorption capacity of banks, but further efforts to cleanse bank balance sheets and to move to full banking union are vital. These steps should be complemented by a comprehensive assessment and strategy to address the debt overhang in nonfinancial companies.

A number of policy actions can help promote an orderly move toward greater financial stability:

- Stronger growth in the United States is setting the stage for monetary normalization. Achieving a smooth transition requires policies that manage the effects of increased volatility and portfolio adjustments, while addressing structural liquidity weaknesses and systemic vulnerabilities. A clear and well-timed communication strategy by central bank officials is critical. Compared with previous tightening cycles, the authorities have a bigger toolkit at their disposal. Yet in the event of adverse shocks, contingency backstops may be needed to address the risk of fire sales in some market segments and to manage orderly unwinding or liquidation. Increased oversight would help reduce related risks of excessive leverage in the shadow banking system and, in particular, in the larger mortgage real estate investment trusts.
- For emerging market economies, the principal transmission channel of external pressures is more likely to be via liquidity strains in bond and foreign exchange markets, rather than through bank funding channels. In addition, the response of foreign investors to changing expectations for U.S. monetary policy will continue to affect local markets. In the event of significant capital outflows, some countries may need to focus on ensuring orderly market functioning, using their policy buffers wisely. Keeping emerging market economies resilient requires increased focus on domestic vulnerabilities as relative growth prospects moderate, U.S. nominal rates rise, and capital flows recede. Policymakers should carefully monitor and contain the rapid growth of corporate leverage. Local bank regulators need to guard against foreign currency funding mismatches affecting bank balance sheets, including through foreign currency borrowing by companies. In addition, establishing sufficient buffers and addressing macroeconomic imbalances will likely prove to be worthwhile steps for cushioning against increased volatility and risk premiums.
- Containing the risks to China's financial system is as important as it is challenging. Broad credit growth needs to be reined in to contain financial stability risks and promote the rebalancing of China's economy away from credit-fueled capital and property investment. It is important that prudential oversight of shadow banking activity be tightened, that incentives for regulatory arbitrage be removed through continued financial liberalization (for example, of deposit rates), and that the widespread belief in implicit guarantees and bailouts of risky corporate loans and saving products be counteracted. Unless credit losses are taken by lenders and savers, the state faces large and unpredictable fiscal costs.
- Japan's bold policies need to be completed, with the authorities following through on fiscal and structural policy commitments, to avoid downside risks. These policies are needed to contain a potential sharp rise in government bond risk premiums if sovereign debt dynamics do not improve. To help mitigate stability risks, market structures also need to be made more resilient (such as through the modification of circuit breakers in derivatives markets) and the risk profile of regional banks addressed.
- In the euro area, further progress in reducing debt overhangs and bolstering bank balance sheets needs to go hand in hand with a strengthened euro area financial architecture and the completion of the banking union agenda. Investors' faith in euro area bank balance sheets needs to be fully restored and credit flows to viable enterprises strengthened: a first step, as planned, is to conduct a thorough, realistic, and transparent balance sheet assessment. Credible capital backstops to meet any identified shortfalls need to be put in place and communicated in advance of the publication of results from the exercise. The corporate debt overhang should be addressed using a more comprehensive approach, including corporate debt cleanups, improvements to corporate bankruptcy frameworks, and active facilitation of nonbank sources of credit. Further monetary support by the European Central Bank and credit support to viable firms by the European Investment Bank are crucial to providing time for the repair of private balance sheets.
- Global bank capitalization remains diverse, because institutions are at different stages of balance sheet repair and operate in different economic and regulatory environments. The key tasks are to improve

the credibility, transparency, and strength of balance sheets, while avoiding undue pressures on banks from uncoordinated national regulatory initiatives and uncertainty. Further efforts are needed to assess the way in which market developments and regulatory initiatives affecting dealer-bank business models may influence the cost and provision of market liquidity. At a minimum, increased surveillance of and vigilance over the effects of trading liquidity pressures will be needed as financial markets move to a regime with higher interest rates and volatility.

If these policy challenges are properly managed, and if reforms are implemented as promised, the transition toward greater financial stability should prove smooth and provide a more robust platform for financial sector activity and economic growth. But a failure to implement the reforms necessary to address the many policy challenges highlighted above could trigger profound spillovers across regions and potentially derail the smooth transition to greater stability.

Chapter 2 looks at efforts by policymakers to revive weak credit growth, which has been seen by many as a primary reason behind the slow economic recovery. The chapter catalogues the policies implemented by various countries and offers a framework for assessing their effectiveness. It argues that policies are most effective if they target the constraints that underlie the weakness in credit. Using several analytical tools, the chapter finds that the constraints in credit markets differ by country and evolve over time, requiring a careful country-by-country assessment. Better data on new lending would also help identify constraints. In many cases, demand- and supply-oriented policies are complementary, but their relative magnitude and sequencing can be important. Moreover, policymakers should be cognizant of the fiscal costs and implications for financial stability of credit-supporting policies. The main risks center on increased credit risk, including a relaxation of underwriting standards and the risk of "evergreening" existing loans. Mitigation of these risks may not be necessary or appropriate while the economic recovery is still weak because it could run counter to the objectives of the credit policies (which are often designed to increase risk taking); still, policymakers will need to continually weigh the near-term benefits against the longer-run costs of policies aimed at boosting credit.

Chapter 3 explores how bank funding structures affect financial stability and whether regulatory reform initiatives are likely to make them more stable, diversified, and resilient. The chapter finds that healthy banks rely more on equity and less on debt—especially short-term wholesale funding that contributed to the global financial crisis—and use deposits as their primary funding source. Various reforms are rightly promoting many of these desirable attributes, but there could be potential trade-offs among them. On the one hand, there are pressures to use more secured funding—which increases asset encumbrance—as well as deposits, to reduce banks' vulnerability to turbulence in wholesale funding markets. On the other hand, bail-in power and depositor preference give better protection to taxpayers and depositors at the expense of unsecured wholesale debt holders. A numerical analysis illustrates the impact on the cost of unsecured debt as the proportion of newly protected creditors rises. Under current conditions and depositor protections (and especially for well-capitalized banks) the increase would be modest; however, if depositor protections were to be expanded substantially, the impact could be quite large. Careful implementation of the reforms can moderate tensions: Basel III and over-the-counter derivative reforms should be implemented as planned, but policymakers should monitor the increased demand for collateral and ensure that enough unencumbered assets are available to permit the meaningful bail-in of unsecured senior creditors.