

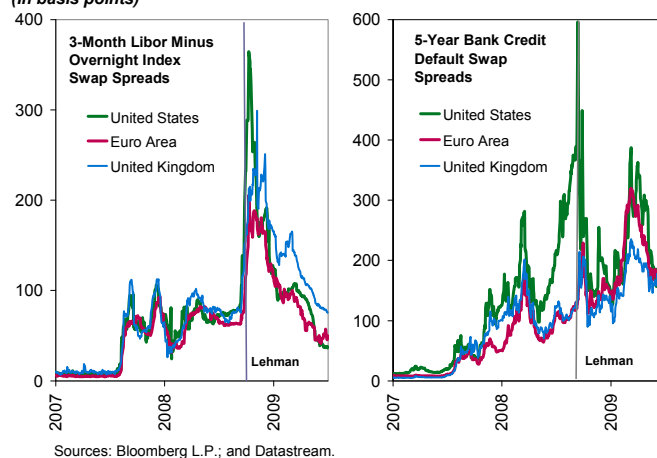
Policies Have Reduced Systemic Risks But Vulnerabilities Remain

Financial conditions have improved, as unprecedented policy intervention has reduced the risk of systemic collapse and expectations of economic recovery have risen. Nonetheless, vulnerabilities remain and complacency must be avoided. The financial sector continues to be dependent on significant public support, resulting in an unparalleled transfer of risk from the private to the public sector. At the same time, however, work will need to begin on exit strategies from the various financial, monetary, and fiscal support policies in order to address market uncertainty. Medium-term policies need to ensure that steps taken to normalize policies and markets are consistent with establishing a lasting framework of sound financial regulation, sustainable fiscal balances, and the maintenance of price stability.

The risks to the global financial system have moderated from the extreme levels identified in the April 2009 *Global Financial Stability Report* (GFSR). Unprecedented policy actions undertaken by central banks and governments worldwide have succeeded in stabilizing the financial condition of banks, reducing funding pressures and counterparty risk concerns, and supporting aggregate demand. These interventions have reduced the tail risk of another systemic failure similar to the collapse of Lehman Brothers. Bank debt and interbank markets have resumed functioning, albeit with massive public sector support. Concerns regarding liquidity and counterparty risks in the banking sector have declined, as evidenced by the narrowing of LIBOR-overnight index and credit default swap spreads (Figure 1).

However, overall financial conditions remain tight. Growth in bank credit to the private sector continues to slow in mature economies,

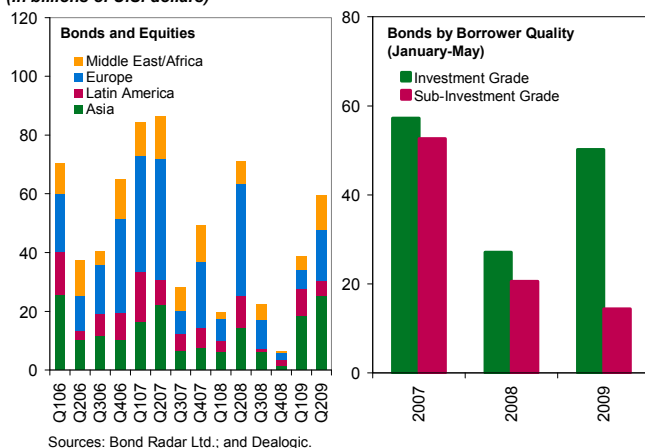
Figure 1. Bank Systemic Risk Indicators
(In basis points)



securitization markets outside those supported by the public sector remain impaired, and lower-quality borrowers have little access to capital market funding. Furthermore, the public sector interventions that have underpinned the reduction in private sector risks have resulted in a concomitant increase in public sector risks and a mounting burden on fiscal sustainability.

Severe recession risks have eased in response to concerted fiscal and monetary policy stimulus measures (as discussed in the July 2009 *World Economic Outlook Update*). This has helped spur some return of risk appetite and a decline in volatilities, with investors moving into risk assets from safe havens. Although perceived credit risk has diminished, as evidenced by narrower spreads and lower projected default rates, it remains high. Risks in emerging markets have also lessened, reflecting the recovery of commodity prices and the resumption of portfolio inflows and rising asset prices (Figure 2). These improvements have not been evenly distributed, and cross-border banking flows to emerging markets remain weak. Risks in emerging Europe have also been reduced, but strains remain and vulnerabilities flagged in the April 2009 *GFSR* persist.

Figure 2. Emerging Market External Securities Issuance
(In billions of U.S. dollars)



The April 2009 *GFSR* highlighted three main areas of risk: (i) that weaknesses in advanced-economy banking sectors could act as a greater drag on credit growth and economic recovery; (ii) that emerging markets remain vulnerable to a slowing or cessation of capital inflows; and (iii) that yields on sovereign debt may rise significantly and private borrowers may be

crowded out if the burden on public sector balance sheets is not managed in a credible way. While progress has been made in these areas, concerns remain.

Bank balance sheets need to be restored to health

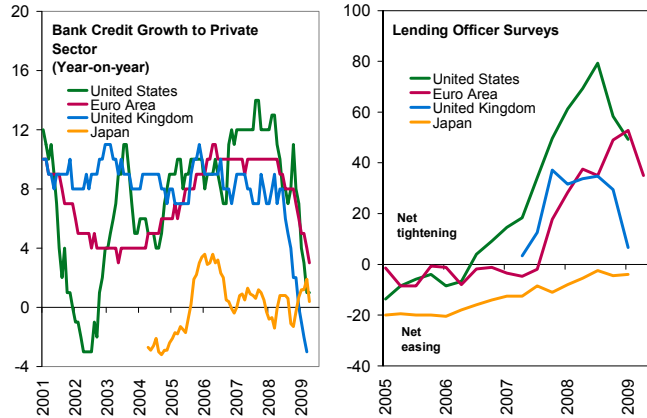
The risk of a widespread banking crisis has eased and prospective writedowns on securities are likely to be somewhat lower, as a result of the recovery in mark-to-market valuations, but bank capitalization still remains a concern as further writedowns on loans are expected. Confidence in the U.S. banking system has been bolstered by better-than-expected earnings results, a successful stress-testing exercise, the commitment by the U.S. government to stand behind the 19 largest banks, and a series of bank capital-raising. However, loss ratios are expected to continue to rise for loans. In Europe, universal banks have also benefited from better earnings and capital increases, but loss rates are expected to rise. The Committee of European Banking Supervisors is conducting a coordinated stress test exercise on a system-wide basis which should help to reestablish market confidence in the banking system. But, on both sides of the Atlantic, it is proving difficult to effectively implement measures that fully address the problem of impaired assets on banks' balance sheets, leaving banks vulnerable to a further deterioration in the quality of these assets if the global downturn is deeper, and more prolonged, than projected.

Corporate bond markets have reopened, but bank credit growth is still slowing

Corporate bond markets are functioning more normally, a critical development for countries, notably the United States, that rely more

heavily on nonbank market financing. Corporate credit and asset-backed spreads have tightened significantly and issuance has risen, as firms seek alternatives to scarce bank credit. High-yield issuance has also increased recently, but is still restricted to higher quality credit, and spreads remain historically wide. However, bank lending remains restricted, despite unconventional policies aimed at reviving credit to end users. Overall bank credit growth continues to diminish, as deleveraging pressures persist (Figure 3). Securitization markets continue to be impaired, except for those directly supported by government programs or central bank facilities (Figure 4).

Figure 3. Credit and Lending Conditions
(In percent)

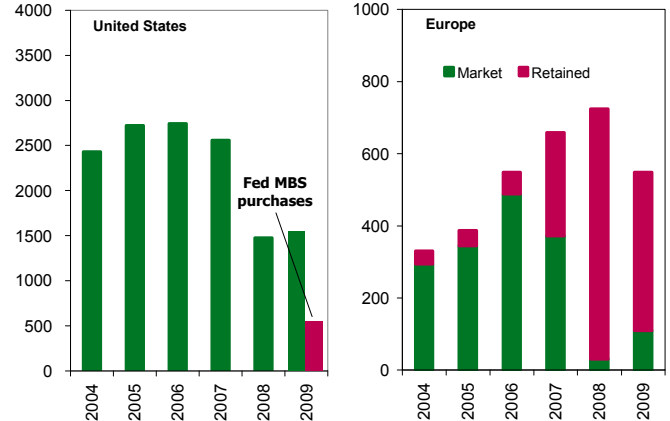


Sources: Bank for International Settlements; and central banks. Lending surveys represent weighted average of conditions for households and corporates.

Emerging market sentiment has strengthened, but markets remain vulnerable to capital outflows

Emerging market assets have benefited from the recovery of commodity prices and improved growth prospects, especially in Asia. The return of risk appetite has also led to a resumption of portfolio inflows from investors. Emerging market equities have rebounded 30 to 60 percent since end-February, matching or outpacing mature market equities. EMBI

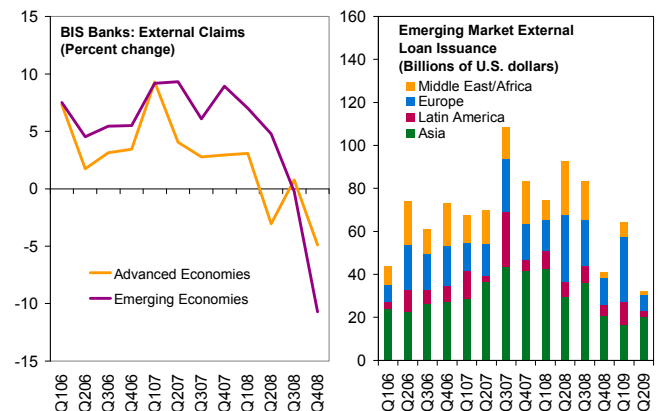
Figure 4. Securitization Issuance
(In billions of U.S. dollars)



Sources: Citigroup; European Securitization Forum; and SIFMA. Issuance data annualized for 2009 and include mortgage-related and asset-backed securities. Purchasing data through end-June.

Global sovereign spreads have more than halved since their peak in October. Despite these positive developments, the overall outlook for emerging markets remains vulnerable to lower than expected global growth and to constrained international bank lending. As highlighted in the April 2009 GFSR, banks are contracting their cross-border positions at a faster rate than their domestic balance sheets, although there is evidence that parent banks have maintained funding levels to their emerging market subsidiaries (Figure 5).

Figure 5. Cross-Border Bank Lending



Sources: Bank for International Settlements; and Dealogic.

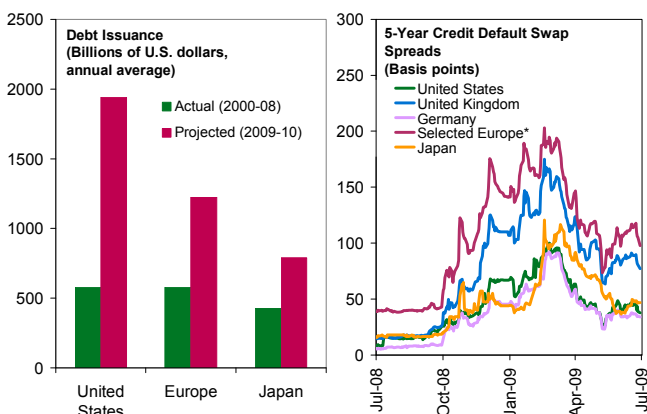
Consequently, cross-border deleveraging is leading to an unwinding of the rapid financial globalization that occurred over the past 10

years. This trend will likely continue, placing additional pressure on those banking systems that are heavily reliant on cross-border funding. Emerging Europe and the Commonwealth of Independent States are particularly vulnerable to contractions in cross-border funding and have not benefited as much from the market rebound seen elsewhere.

Concerns mounting regarding sovereign debt markets

Globally, sovereign yield curves have steepened considerably, as conventional monetary policy easing has anchored short-term rates, while the longer end of the curve has risen sharply, reflecting in part improved recovery prospects and reduced risks of deflation. Nevertheless, concerns about the ability of markets to absorb the supply of new government bonds may also be contributing to the rise in yields (Figure 6). With public debt levels expected to rise significantly in many mature market economies, increased focus on fiscal sustainability may have been reflected in sovereign credit default swap spreads remaining well above their pre-crisis levels.

Figure 6. Sovereign Debt



Sources: Bloomberg L.P.; and IMF, *World Economic Outlook*.
* Greece, Ireland, Italy, Portugal, and Spain.

The risks ahead

The April 2009 GFSR raised immediate policy challenges regarding the intensifying threats to systemic stability and a worsening credit crunch, emphasizing the need for a range of financial policies to mitigate downside risks. Since then, ongoing unprecedented policy actions have reduced the likelihood of major failures, an important step toward restoring confidence.

Complacency must be avoided. There is a risk that the recent improvements in the financial sphere could lead to complacency. Continued policy efforts are needed to stave off the chance that some of the recent gains could yet be reversed. Although the financial system has stepped back from a period of extreme uncertainty, there remains a high level of uncertainty consistent with significant dysfunction in some financial markets. Confidence is still fragile, and tail risks could reemerge. The improvement in financial markets is in large part due to far-reaching public sector support. Thus, the lasting regeneration of the wide range of markets necessary for efficient financial intermediation is far from assured.

More work is needed to fix banks and markets. Concerning banks, this implies in some cases implementing measures already taken, and, in others, adopting new measures. In spite of recent capital raisings by banks, there is a need to ensure adequate capital levels going forward as default rates increase, and to promote restructuring where needed. Moreover, actions continue to be needed to help banks deal effectively with troubled assets. Only then will they be in a position to support the real economy going forward. Parallel to this,

finding ways to reopen the securitization market by placing it on a sounder footing will be of particular importance, as it serves as a significant conduit of credit provision.

Deleveraging and tail risks. If the remaining problems with mature economy banks are not effectively addressed, then the deleveraging process required to restore their health will be more severe than otherwise necessary, acting as a greater drag on the economic recovery. Indeed, fixing the banks remains a prerequisite for a sustained recovery. Because much of the improvement in financial conditions is due to the robust rally in risk assets since March, there is a risk of a significant market setback if financial markets get too much ahead of the pace of economic recovery. Indeed, tail risks could reemerge if a major correction in asset prices were again to undermine confidence in financial institutions.

Further measures are still needed to restore confidence in the banking sector and to facilitate lending. Many countries have taken an active role in assessing their banking systems by performing stress tests, which, if accompanied by credible measures to address any shortfalls in capital, can be an effective tool in rebuilding bank balance sheet strength. The U.S. experience and recent European initiatives to organize coordinated stress tests are a welcome step forward. More generally, viable banks with capital shortfalls should be required to submit action plans to raise their capital ratios. If carrying out such plans over the near-term is not feasible, banks viewed as viable should receive temporary capital injections from the government with appropriate conditions. In some cases, such capital injections may need to be followed by restructuring, including the possible sale or

liquidation of parts of the bank. Banks deemed to be nonviable should be resolved as promptly as practicable. Determined and suitably transparent implementation of such policies would be helpful in restoring confidence in the banking sector.

Sovereign debt markets may be at risk of destabilization if the burden of public debt financing is viewed as unsustainable. Emerging markets remain vulnerable to spillovers from mature economies that may result in a more general slowing or cessation of capital inflows. Corporate borrowers in emerging markets are particularly susceptible because of their high rollover requirements and limited access to alternative sources of finance. As well, localized problems in some individual emerging markets could have wider repercussions if not addressed effectively.

Globally consistent exit strategies. Even though the time has not yet come to start withdrawing all the various forms of official support that have been extended in response to the crisis, it is important that carefully considered and coordinated exit strategies are put in place. Communication of such strategies can be of great value in reducing market uncertainty. The broad objectives that should guide the formulation of exit policies are price stability, a sound financial system based on market principles, and fiscal sustainability. Within countries, exits should be coordinated across monetary, financial, and fiscal policies. Central banks should have a range of effective instruments at their disposal for withdrawing liquidity in a timely fashion in order to avoid market disruption. Cleansing central bank balance sheets of quasi-fiscal interventions through transfers to fiscal authorities may also be needed to ensure central bank financial

independence. As confidence resumes, policy options for the withdrawal of extraordinary public support include natural run-off as the market rebounds and the orderly withdrawal of liquidity and funding measures. A crucial consideration throughout the exit is maintaining consistency of policies across countries to minimize the opportunities for regulatory arbitrage and adverse financial flows. There will likely be political pressures both to delay and accelerate the exit from various crisis policies, which will have to be resisted for the above reasons.

At this critical stage in emerging from the crisis, policymakers need to safeguard the gains made thus far. The unprecedented scope of the

crisis itself and the measures taken to contain it, will require a comparable policy response. Throughout this process, timing and modality will be crucial. Reliance on market mechanisms wherever possible will best ensure an outcome consistent with the exit objectives of price stability, a sound financial system, and fiscal sustainability.