International Monetary Fund

Global Financial Stability Report

April 2011

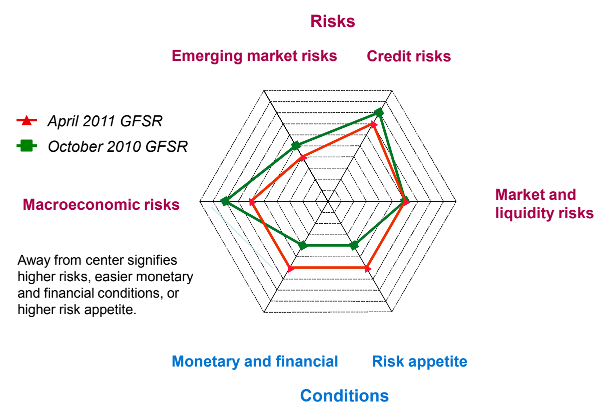
Press Points for Chapter 1: *Durable Financial Stability: Getting There From Here*

What are the Key Stability Risks and Challenges?

- ***Financial stability risks have eased with the improving economic outlook and continuing accommodative liquidity and macroeconomic policies.***
- ***But sovereign and banking system risks still remain high and are lagging the overall economic recovery. Structural weaknesses and vulnerabilities in the euro area pose downside risks.***
- ***Advanced economies need to shift to more structural policies to address (i) banks with thin capital buffers and weak asset quality; (ii) sovereigns facing debt affordability challenges; and (iii) households with large debt burdens and negative equity.***
- ***Emerging markets need to guard against overheating and a build-up of financial imbalances from the combined effects of rising capital flows, strong credit growth, and increasing corporate leverage.***

Risks to global financial stability have declined since the October 2010 Global Financial Stability Report, helped in part by improving macroeconomic conditions (Figure 1). However, many advanced economies are living dangerously with the legacy of high debt burdens weighing on economic activity and balance sheets, keeping risks to financial stability elevated. Capital flows into rapidly growing emerging markets could strain their absorptive capacity, raising concerns about the gradual build-up of macro-financial risks.

Figure 1. Global Financial Stability Map



Nearly four years since the start of the global financial crisis, confidence in the banking system has yet to be fully restored. Progress in strengthening capital positions and reducing leverage has been uneven (Figure 2). A comprehensive set of policies—including increased transparency, capital-raising, restructuring, and resolution—is needed to solve remaining vulnerabilities. The forthcoming European stress tests are an important opportunity to assess the health of the EU banking system. But the tests need to be credible, stringent, and part of a broader crisis management strategy that includes backstops against capital shortfalls. Figure 3 shows that over 30 percent of banks (almost 20 percent of assets) have a core tier 1 ratio below 8 percent. This weak tail of banks is creating excess capacity and raising funding costs for other banks as well.

Figure 2. Banking System Capital and Reliance on Wholesale Funding

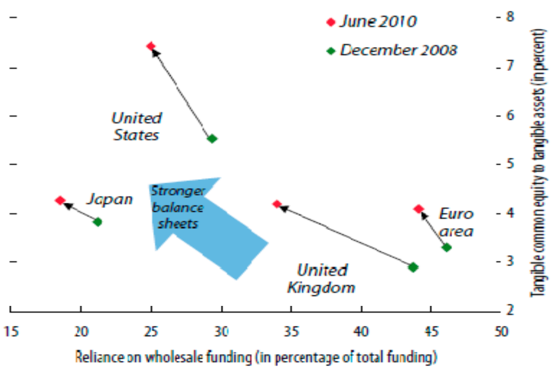
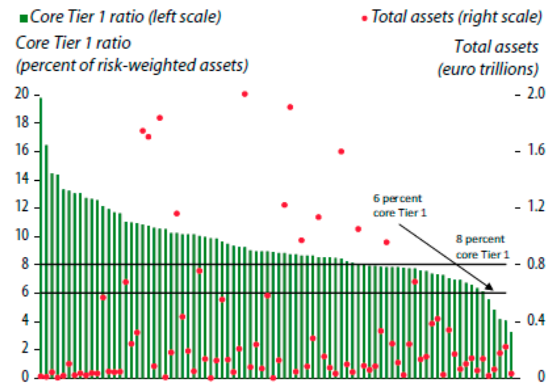
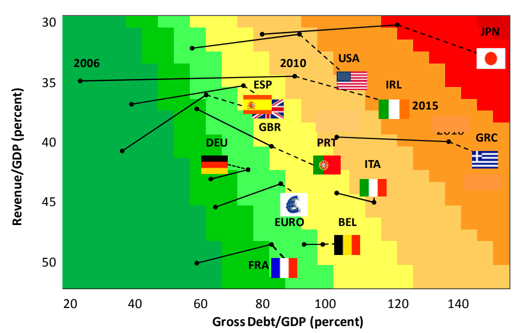


Figure 3. Core Tier 1 Ratios of EU Banks, 2010



Sovereign balance sheets remain under strain in several advanced economies. Certain countries in the euro area are especially at risk, as market concerns about the sustainability of public debt—which has increased sharply as a legacy of the crisis—have prompted a sharp increase in funding costs that damages bank balance sheets and creates an adverse feedback loop to the real economy. Sovereign funding challenges could extend beyond the euro area, as both the United States and Japan are sensitive to higher funding burdens if interest rates increase substantially from current levels (Figure 4). Strategies to contain financial stability risks must combine medium-term deficit reduction with adequate multilateral backstops for crisis countries.

Figure 4. Funding Cost Thresholds, Debt, Revenue

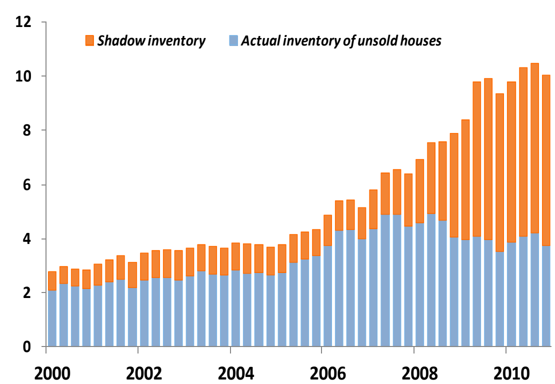


To keep the government interest bill below 20% of total revenue for a given combination of revenue and debt, the average interest rate must not exceed:

>15% | 12-15% | 10-12% | 8-10% | 6.5-8% | 5-6.5% | 4-5% | 3-4%

Household leverage ratios in the United States are elevated and pose downside risks to housing markets. The overhang of household debt risks further weakening banks' balance sheets, credit availability, and housing prices. The U.S. shadow housing inventory stands at approximately 6.3 million, or 16 months of additional housing supply (Figure 5). Household debt levels would need to decline by some $2-5 trillion to return to more normal levels. More structural policies may be needed to deal with the shadow inventory and reduce the overall debt burden. Indeed, our stress tests suggest that banks are strong enough to absorb sizeable principal writedowns. Meanwhile,

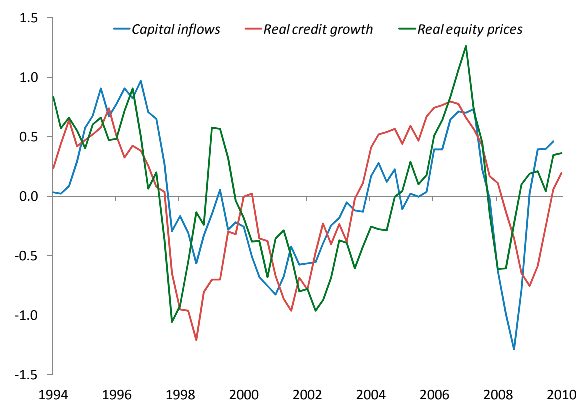
Figure 5. U.S. Inventory of Houses Potentially for Sale (millions of loans)



although corporate balance sheets have generally improved, the ingredients are in place for increased risk-taking among larger corporates.

Emerging markets need to guard against overheating and a buildup of financial imbalances, as rebounding capital inflows combine with strong credit growth and rising inflation (Figure 6). Corporate leverage is also rising and weaker firms are increasingly accessing capital markets, making corporate balance sheets more vulnerable to external shocks. Indeed, in a stylized stress test involving a 300 bps increase in funding costs and a decline in corporate earnings by 25 percent, emerging market corporates would experience a similar level of stress as in some past crises of sudden stops in capital inflows. Macro-prudential and, in some cases, capital control measures can play a supportive role in managing capital flows and their effects, but in the context of strong domestic momentum, policies need to rely more on macroeconomic measures to avoid overheating, accumulating financial risks, and undermining policy credibility.

Figure 6. Capital Inflows, Real Credit, and Real Equity Prices (Standard deviations from historical averages)



In sum, policymakers face four key challenges:

- ***Addressing legacy problems*** highlighted by the crisis, including high debt burdens and weakened balance sheets in many advanced economies;
- ***Navigating to a more robust financial system*** that is less reliant on public support and subject to greater market discipline;
- ***Guarding against overheating*** and the further buildup of financial imbalances, especially in emerging markets; and
- ***Preventing a recurrence of financial crises***, through a financial system grounded in better supervision, regulation, and macro-prudential oversight.