IMF Survey MAGAZINE

Policymakers Face Triad of Challenges to Ensure Financial Stability

- Financial stability not assured; 3 percent of global output at stake
- Risks in emerging markets remain elevated, with implications for the rest of the world
- Goal is successful normalization of monetary and financial conditions

While financial stability has improved in advanced economies, risks remain elevated and continue to rotate toward emerging markets, which now play a greater role in the world economy, according to the International Monetary Fund's latest *Global Financial Stability Report*.

The Federal Reserve is poised to raise interest rates in the United States, and European Central Bank policies have bolstered confidence in the euro area, where credit conditions are improving. Although many emerging market economies have enhanced their policy frameworks and built up greater resilience to external shocks, several face domestic imbalances, slower growth, and lower commodity prices. A build up of credit in emerging market economies since the global financial crisis has made them vulnerable to the expected increase in interest rates in advanced economies and potential economic downturns, which may create additional pressure on banks, the IMF said.

"Vulnerabilities in emerging markets are important, given their significance to the global economy, as are the role of global markets in transmitting shocks to other emerging markets and to advanced economies," said José Viñals, Financial Counsellor and head of the IMF's Monetary and Capital Markets Department. "The recent financial market turmoil is a demonstration of this materialization of risks."

To secure global financial stability, the IMF said policymakers must address a triad of policy challenges.

A triad of challenges

- **Emerging market vulnerabilities**. Corporate and bank balance sheets are currently stretched in emerging markets, with an estimated total of up to $3.3 trillion in over borrowing. This has resulted in sharply higher debt in the private sector, particularly among commodity producers, accompanied by rising foreign currency exposures.

- **Crisis legacies in advanced economies.** In the euro area, tackling the large amount of nonperforming loans and completing the banking union remain critical to consolidate financial stability and to reduce headwinds to growth. In the United States, embarking on the much-telegraphed, although unprecedented, process of increasing interest rates for the first time in nine years is going to be an important transition for global markets.

- **Global financial markets under strain.** As seen in recent episodes of market turmoil, weak market liquidity amplifies shocks and acts as a source of volatility and contagion. Low interest rates for a long period of time and quantitative easing have compressed risk premia across a range of asset markets. Underlying market fragilities, such as low market liquidity, may cause disruption in markets if risks are repriced, creating a risk of firesales, redemptions, and more volatility in global markets. Leverage in investment funds also has the potential to amplify shocks—the *Global Financial Stability Report* points to $1.5 trillion in embedded leverage in investment funds through derivatives exposures.

These diverse challenges call for an urgent policy upgrade to achieve an upside scenario—that is a successful normalization of financial conditions and monetary policies, as part of a sustained economic recovery. By contrast, policy missteps or adverse shocks could result in a downside scenario—of prolonged global market turmoil that would ultimately stall the recovery.

“The difference between these two scenarios is quite stark,” said Viñals. “It amounts to nearly three percent of global output by 2017.”

Calling for a collective effort

Achieving the upside scenario calls for policymakers in advanced economies and emerging markets to confront the triad of challenges and upgrade policies in order to enhance confidence and build resilience, according to the IMF.

First, monetary policies in key advanced economies must remain accommodative. Both the euro area and Japan will need to continue to counter downward price pressures. Amid more uncertainty in the global economy, the United States should wait to raise policy rates until there are further signs of inflation rising steadily, with continued strength in the labor market. The pace of subsequent policy rate increases should be gradual and well communicated.

Euro area policymakers cannot rely on the European Central Bank alone; they must strive to complete the banking union to move financial stability onto firmer ground. Further strengthening of euro area banks by comprehensively tackling nonperforming loans and the corporate debt overhang will enhance the effectiveness of monetary policy, bolster market confidence, and improve the outlook. Resolving nonperforming loans in euro area banks could deliver 600 billion euro in new lending capacity, or nearly three percent of loans.

Second, building resilience and maintaining confidence in emerging markets will be crucial. The potential for higher interest rates in advanced economies and weaker growth in emerging markets warrants prudential attention to ensure the resilience of both corporates and banks. Maintaining sovereign investment-grade status is a priority. Managing any outbreak of financial contagion will require nimble and judicious use of available policy buffers.

As for the most important emerging market economy, China, its rebalancing and deleveraging will require great care. The Chinese authorities face unprecedented but manageable policy challenges in making the transition to a new growth model and a more market-based financial system. Commitment to reform will be key to policy credibility and effectiveness. Deleveraging the corporate sector and enhancing market discipline will inevitably entail some corporate defaults, exits of nonviable firms, as well as write-offs on nonperforming loans, thus requiring a further strengthening of banks. Yet, moving decisively will ultimately prove less costly than trying to grow out of the problem.

In addition, policymakers need to safeguard against market illiquidity. They should enhance oversight of liquidity in the asset-management industry to avoid the risk of fire sales, and agree on globally consistent standards for reporting derivatives leverage in investment funds, allowing regulators and investors to better understand and evaluate these risks.

A collective effort to deliver a policy upgrade is needed urgently to face up to rising challenges in an uncertain world. This will help ensure financial stability and balanced, sustainable growth. Three percent of global output is at stake.