Global financial market conditions have worsened since the publication of our last *Global Financial Stability Report* as the fallout from the subprime mortgage crisis widens. Coordinated central bank operations, together with rate cuts, have helped ease liquidity tensions in the interbank market; however, strains persist and term premiums are likely to remain elevated for some time (Figure 1a and b). This is because term premiums reflect wider problems in the financial system such as valuation of complex products, credit deterioration, counterparty mistrust, and balance sheet pressures. Credit and market risks have continued to rise, and the global macroeconomic outlook looks less favorable. The WEO update now projects a deceleration of global growth. Emerging markets have remained resilient so far, as underlying growth and better policy environments have supported the continuation of strong capital inflows, though recent falls in equity prices suggest that some emerging markets may not be able to avoid spillovers.

What began as a test of the structured credit markets and the associated funding needs has reached a new phase—a phase where credit concerns now extend beyond the subprime sector. One way this is becoming evident is through the pressure on some financial institutions’ balance sheets following the fallout of the earlier distress. Pressures on capital combined with additional losses as delinquencies on U.S. subprime borrowing reach record levels, raises the costs and reduces the capacity of financial institutions to use their balance sheets to provide credit (Figure 2). This could be exacerbated by deteriorating economic conditions. Evidence from lending surveys already shows some tightening of lending standards (Figure 3a and b). Although the focal point is still the United States, European banks have also felt the effects. While other regions’ financial institutions appear to have less exposure, subprime related writedowns are still possible.

A possibly deeper economic downturn in the United States or elsewhere could also serve to widen the crisis beyond the subprime sector, as credit deteriorates more broadly. Already, delinquency rates in 2007 vintages of U.S. prime mortgages (those to the most credit worthy borrowers) are rising faster than in previous years, albeit from low levels, and other forms of consumer credit show signs of deterioration (Figure 4). In Western Europe, signs of a future slowdown in credit growth are just now emerging and there is some potential for worsening credit quality as lending has been very robust in some countries and several countries face housing markets considered overvalued.

In both the United States and Europe, lending in some segments of the corporate sector also expanded rapidly in the first half of 2007 with the rise in leveraged buyouts. Weaker quality corporates have already seen a substantial rise in the cost of credit and anticipated corporate
default rates have risen by about five-fold. Additionally, slowing economies will be likely to exacerbate the tighter credit environment further as unemployment picks up and job growth slows.

Emerging markets have been resilient so far, but face challenges ahead. Emerging market equities have outperformed mature equity markets, but prices in some markets have declined steeply since the start of the year on expectations that the U.S. economy may slow more rapidly (Figure 5). Signs of spillover are most evident in the sharp fall in private emerging market bond issuance, particularly in some emerging European economies whose banks have relied heavily on external financing to support rapid domestic credit growth (Figure 6). So far, foreign bank financing of credit in Eastern Europe has held up well, but this financing could be curtailed if the global situation deteriorates and there are tighter global funding conditions. While there are some exceptions, most emerging markets have been able to continue to attract portfolio flows and financial markets have been far less affected during this turmoil than in previous episodes.

Policies are needed to address both near-term stresses and longer-term financial stability. There are a number of initiatives being developed by the private sector and in various public sector international fora (for instance, the Financial Stability Forum, various standard setters, national authorities, and so on) to draw lessons from this episode. Importantly, the episode is not yet over and today’s lessons cannot therefore be considered final. Nonetheless, the Fund, in conjunction with these groups, is also developing some policy recommendations.

Looking first to the short term, the purpose is to rebuild counterparty confidence and the financial soundness of institutions and thus to ease ongoing liquidity tensions, allowing interbank markets to function normally again and intermediation to continue. One positive development has been that systemically important institutions that have experienced weaker balance sheets are raising capital (some of which has come from sovereign wealth funds) and cutting dividends. Supervisors and auditors have a key role to play to promote early, consistent, and clear disclosure of exposures and values of subprime and related securities, both on and off the balance sheet. Explaining methodologies and valuation assumptions are equally important. On all of these issues, it is important to maintain a delicate balance so that actions do not exacerbate the cycle.

Central banks will need to continue to help manage the changing liquidity requirements in the money markets as long as needed to assure their smooth functioning to minimize the knock-on effects to the real economy. In this role, it will be very important that central banks maintain flexibility in adapting to the needs of the market—initiating and utilizing joint initiatives, such as the Term Auction Facility, announced by the Federal Reserve, the European Central Bank and the Swiss National Bank last December.
This period of instability, characterized by a mature market banking system liquidity disruption, raises issues for the private sector, central banks, and other financial supervisors and regulators in the longer run. Credit rating agencies, for instance, can improve their methodologies, provide differentiated ratings (as suggested in the April 2006 GFSR) and give more information about the sensitivity of their ratings to the underlying assumptions. The line between regulated and unregulated institutions is always a complex issue, but it has become evident that unregulated (or lightly regulated) financial institutions that originate mortgages and consumer credit products similar to those originated by regulated financial institutions should be subject to similar disclosures and consumer protection requirements.

Central banks could usefully review the effectiveness of their tools to reduce market stress—and whether they work globally. A convergence of practices in the tools for managing liquidity across central banks could help alleviate the difficult faced by central banks in communicating their actions and financial stability concerns. National and cross-border financial stability arrangements for information sharing and coordinated actions among the agencies responsible for supervisory oversight, the provision of liquidity, and bank resolution could be strengthened.