Financial markets worldwide reflect ongoing deleveraging pressures amidst a deepening economic downturn. In spite of extensive policies, the global financial system remains under intense stress. Moreover, worsening economic conditions are producing new, large writedowns for financial institutions. In response, balance sheets are being cut back through asset sales and the retiring of maturing credits. These actions have increased downward pressure on asset prices and reduced credit availability. Restoring financial sector functionality and confidence are necessary elements of economic recovery. However, more aggressive actions by both policymakers and market participants are needed to ensure that the necessary deleveraging process is less disorderly. A broad three-pronged approach—including liquidity provision, capital injections, and disposal of problem assets—should be implemented fully and quickly so as to encourage balance sheet cleansing. At the same time, international cooperation will be required to ensure the policy coherence and consistency needed to re-establish financial stability.

Risks to financial stability have intensified since October 2008. Macroeconomic risks have risen as global growth has fallen precipitously alongside a sharp slowdown of global trade. Credit risks have also risen as a deterioration of economic and financial conditions have resulted in rising loan losses. At the same time, the flight from risky assets and illiquid market conditions has increased funding costs, even as risk-free rates have declined with monetary easing. Emerging market countries are also feeling the effects of the advanced economies’ financial and economic difficulties, and there is the potential that the abrupt pullback from emerging market assets by investors and heightened financing costs will erase some of the economic gains these countries have made in recent years.

With the help of extensive government support, market functioning toward the end of 2008 improved in a number of asset classes. However, the negative interaction between the economy and the financial sector has intensified as the credit crunch bites harder and extends globally, with confidence among financial counterparties remaining strained. Indeed, the recent shock to bank earnings and other bad economic news has put further downward pressure on bank equity prices, and the width of credit default swap spreads points to still-elevated systemic risks (Figures 1.1 and 1.2). Notwithstanding public injections of capital, many banks around the world may have an insufficient capital cushion to weather a deep global economic downturn.
The difficulty of keeping up with the increasing size and breadth of writedowns borne by financial institutions, along with continued high funding pressures, have hampered the ability of policymakers to address the crisis. Credit intermediation and confidence are severely impaired, which will weigh heavily on recovery prospects and the ability of institutions to attract needed capital from private investors. Absent further firm action from policymakers, this situation threatens to worsen, given that banks, both advanced country and emerging market corporations, and to a lesser extent, sovereign entities, face risks that they will not be able to roll over large amounts of existing debt in coming years.

Beyond the banking system, systemic concerns are rising for insurance companies and pension funds. Insurance companies have significant exposure to assets whose quality is deteriorating sharply. Pension funds have also been hit severely on the asset side.

**Writedowns Mounting**

Until now banks have managed to obtain sufficient capital to offset existing writedowns, but that is mainly due to the massive public sector injections of capital in the fourth quarter (Figure 2). The worsening credit conditions affecting a broader range of markets have raised our estimate of the potential deterioration in U.S.-originated credit assets held by banks and others from $1.4 trillion in the October 2008 GFSR to $2.2 trillion. Much of this deterioration has occurred in the mark-to-market portion of our estimates (mostly securities), especially in corporate and commercial real estate securities, but degradation is also occurring in the loan books of banks, reflecting the weakening outlook for the economy.

Going forward, banks will need even more capital as expected losses continue to mount. On a global basis, estimates are quite difficult to construct, but for European and U.S. banks, (including their exposure to assets domiciled not only in the United States, but also in
Europe and emerging markets), our rough estimates for expected writedowns during 2009 and 2010, partly offset by the anticipated revenues over the same period, would result in a net capital shortfall in the order of magnitude of at least half a trillion dollars. This implies that for U.S. and European banks taken together such an amount in new capital is necessary just to prevent their capital position from deteriorating further. Moreover, forceful measures to clean up banks’ balance sheets of troubled assets will be required to raise the level of confidence in the banking system.

Hedge funds and mutual funds have also been hit hard, experiencing losses of assets under management as investors shift to safer asset classes. The combination of asset price declines and redemptions suggest the hedge fund balance sheets shrunk by about half in the last quarter of 2008, a particular concern for those markets in which hedge funds provided a significant proportion of market trading liquidity.

**Financing Gaps Widening**

Despite capital injections and guarantees, funding markets are opening only slowly for banks. Securitized forms of wholesale borrowing are limited: current securitizations are almost all retained on the balance sheet of the originators to use as collateral at central banks, while banks are unable to issue cost-effective unsecured debt unless it is government guaranteed. With the various government guarantee programs, banks have begun to raise substantial amounts of term funding to stabilize their balance sheets.

Central bank liquidity injections and rate cuts are pushing down interbank rates, and further gradual declines in term premiums are anticipated (Figure 3). However, despite most banks needing longer-term liquidity, much of the liquidity supplied by central banks is being recycled in the overnight market, or ends up back at the central banks, raising rollover risks even further (Figure 4). This pattern reflects continuing worries about potential liquidity shocks and counterparty concerns, as well as uncertainty surrounding the amounts needed to fund future assets.

Looking forward, emerging market countries, particularly corporate borrowers, remain vulnerable to continued deleveraging and credit retrenchment. Syndicated lending to emerging markets dropped sharply in the fourth quarter, as the contagion spread, with emerging Europe suffering a particularly sharp decline. Emerging bond markets virtually shut
down for a period of time in the fourth quarter, though there has been some resumption of issuance by higher-quality sovereigns in January (Figure 5). As corporates tap banks for short-term loans, the maturity structure for corporate debt also shortens, further raising rollover risks. Capital markets remain reluctant to lend pending large external rollover needs and corporates face the additional challenge of falling revenues as the global economy slows, raising the risk of corporate defaults.

Figure 5. Emerging Markets Bond Financing ($ bns)

Credit Provision Impaired

With interbank markets still dysfunctional and liquidity being hoarded by banks, governments need to step in to support financial intermediation in some cases. Where they have done so, intermediation channels have continued to function to some extent. This is evident in bank debt issuance, where nearly all recently-issued bank debt now carries a government guarantee. In the United States, the Fed’s commercial paper program has successfully reinvigorated this market and its purchase program of mortgage-backed securities has also encouraged lower rates and larger issuance of the equivalent securities. By contrast, the functioning of those markets that have not received official support have shown little improvement—in the United States, asset-backed securities on autos and credit card receivables have improved only marginally and the commercial real estate sector has deteriorated.

Domestic private sector credit growth is falling across a large number of countries, while public sector credit growth is expanding (Figure 6). So far, this has been mostly driven by banks’ tighter credit standards, but will increasingly be related to falling demand for credit. This trend is also evident in cross-border bank lending, which does not bode well for emerging market countries reliant on external funds for their own domestic credit expansions or for trade finance. In fact, trade finance appears to have dropped sharply and at least part of the fall appears to be attributable to banks’ reluctance to lend as they attempt to delever their balance sheets. In turn, several banking systems in Western Europe remain highly exposed to a deterioration in asset quality in emerging Europe (Figure 7). While recognizing the benefits of diversification, there is a risk that the crisis may propagate further as shocks are transmitted between mature and emerging market banking systems.

Figure 6. Credit Growth in Private and Public Sectors (qoq changes, s.a., Billions of local currency)

Figure 7. Exposure of Western European Banking Systems to Asset Quality Deterioration in Emerging Europe
Decisive and Prompt Policies Needed

Turning to policy recommendations in the financial sphere, the October 2008 GFSR highlighted a three-pronged approach to resolving the crisis: the provision of ample liquidity and term-funding support from central banks; bank recapitalization; and measures to address problem assets. The report noted that to be effective financial policies need to be comprehensive and internationally coordinated to limit unintended cross-border effects.

So far, the policy measures to cap potential bank losses and inject capital have not yet stemmed concerns about the health of the financial system. The process thus far still appears piecemeal—providing capital as the direct need arises; supporting some types of assets and specific categories of lending; and providing various guarantees. While these measures have stabilized some financial institutions, they come with the risk that they will distort credit allocation decisions, crowd out markets that do not receive special treatment, disfavor more efficient financial institutions that do not require public support, and potentially increase the ultimate cost to taxpayers. Indeed, there are already concerns about the fiscal implications of the government guarantees and recapitalizations, which are reflected in higher credit default swap spreads and credit ratings uncertainty regarding some sovereign entities.

The speed and size of the impact of the adverse feedback loop between the economy and the financial system has overwhelmed policy responses so far. Decisive and urgent action is now needed to stem the downward spiral of accumulating losses. The costs are likely to be higher than the amounts currently allocated—though much depends on the speed with which confidence is restored. In particular, a comprehensive and coordinated approach needs to be framed in a strategy that incorporates the following elements:

- **Move expeditiously toward recapitalization and measures to deal with distressed assets.** An assessment of banks’ business plans—and deciding which financial institutions will need public monies based on their viability—should be done proactively by supervisors, since history suggests that the longer one waits, the higher the fiscal costs. Banks with heavy distressed asset burdens, but solvent and viable, would be restructured and recapitalized, and those that are not viable could be taken over by the public sector and either restructured and resold, or wound down in an orderly fashion.

Generally, increasingly stringent conditions would be applied as banks receive larger amounts of public funds. The restructuring process might involve the use of a publicly-owned “bad bank” to remove distressed assets from the balance sheets of institutions.

- **Immediate, short-run policies and actions taken need to be consistent with the long-
run vision for the structure of a viable financial system. Without this end-point, the credibility of the policies will come under question. In addition, it will be important to recognize that the adjustment will need to continue for some time and that the viable financial sector of the future will be less leveraged and therefore smaller relative to the rest of the economy. That said, reaching higher bank capital ratios needs to be done in a gradual manner in order to avoid any additional adverse feedback effects and to encourage lending to healthy borrowers. Experiences of previous crises show that credit growth will be slow to return and does not normalize until banks’ balance sheets are cleansed.

- **Rules governing the process toward a more stable financial system need to be clear and consistent.** To restore confidence, transparency and clarity are essential in both the private sector and public policy actions. Authorities should maintain transparency of policies, the use of public support, and any decisions taken as regards individual financial institutions. This applies in particular to the identification and valuation of assets, especially those of which the banks are to be relieved, to the conditions applied to their recapitalization, and to the level of capital buffers that the authorities consider adequate.

- **International cooperation on a common framework for financial policies should receive high priority.** The application of substantially different conditions when supporting financial institutions should be avoided in order to prevent unintended consequences that may arise from competitive distortions and regulatory arbitrage. International coordination is also needed to avoid excessive “national bias,” whereby domestic institutions are favored or local credit provision is encouraged, to the detriment of other countries. A more consistent insolvency framework for financial institutions would also help.

No one model of restructuring will be appropriate for every country or every bank, but even if the models differ, international coordination remains essential. Where solutions need to be customized this should be done within a common strategy and framework that ensures clarity and a level playing field.

The commitment displayed through the wide-ranging policies and measures in addressing the crisis is welcomed. In the medium-term, the initiatives already underway to improve the regulatory and supervisory frameworks will be crucial to build a resilient and innovative financial system.