International Monetary Fund
Global Financial Stability Report
MARKET UPDATE
Monetary and Capital Markets Department
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Global Financial Stability Still at Risk

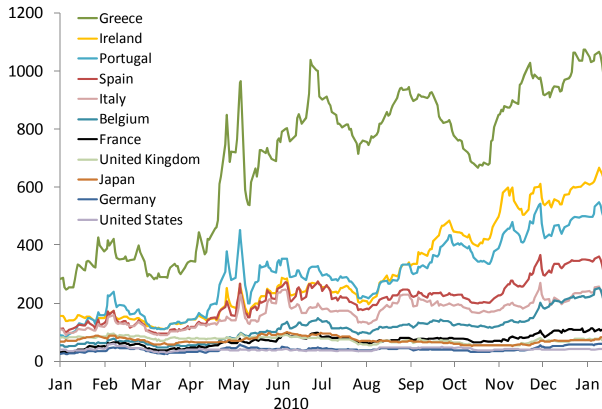
Nearly four years after the onset of the largest financial crisis since the Great Depression, global financial stability is still not assured and significant policy challenges remain to be addressed. Balance sheet restructuring is incomplete and proceeding slowly, and leverage is still high. The interaction between banking and sovereign credit risks in the euro area remains a critical factor, and policies are needed to tackle fiscal and banking sector vulnerabilities. At the global level, regulatory reforms are still required to put the financial sector on a sounder footing. At the same time, accommodative policies in advanced economies and relatively favorable fundamentals in some emerging market countries are spurring capital inflows. This means that policymakers in emerging market countries will need to watch diligently for signs of asset price bubbles and excessive credit.

Even though global economic growth has accelerated somewhat (see the *World Economic Outlook Update*), global financial stability has yet to be secured. The two-track global recovery—with advanced countries growing much more slowly than the rest of the world—continues to pose policy challenges. The slow growth prospects of advanced economies and the continued weakness in their fiscal balances have raised the market's sensitivity to debt sustainability risks. The evident links between weak balance sheets of government and banking sectors have led to renewed pressures in funding markets in the euro area and widening strains. At the same time, accommodative monetary policies in advanced countries and relatively favorable fundamentals in emerging market economies have spurred capital flows to such economies. This creates upward pressure on asset markets in receiving countries, while raising the latent risk that inflows could reverse and, as a result, poses considerable policy challenges on how best to absorb the flows.

Notwithstanding these factors, financial market performance has been favorable thus far in early 2011, reflecting the more positive economic climate, ample liquidity, and expanding risk appetite. Equity markets in advanced and emerging market countries have risen since the October 2010 *Global Financial Stability Report* (GFSR). Commodity prices have taken off—with oil, food, metals, and raw material prices all rising rapidly. However, such positive developments have been notably absent for many advanced country sovereigns and their banking systems (Figure 1). In fact, there are now several cases in which sovereign credit default swap (CDS) spreads exceed

those in large emerging market countries. Banks in those advanced economies also have elevated CDS spreads.

Figure 1. Sovereign Credit Default Swap Spreads
(In basis points)

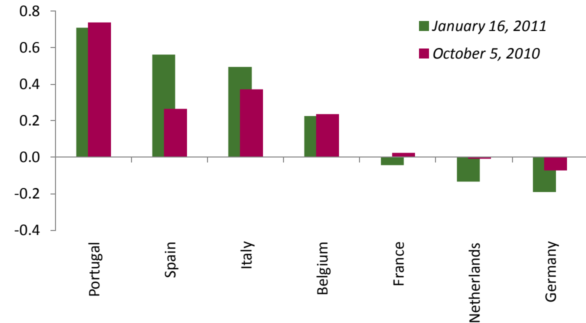


Source: Bloomberg L.P.

Interaction between Sovereign and Banking Sector Risks Has Intensified

Despite improvements in market conditions since the October 2010 GFSR, sovereign risks within the euro area have on balance intensified and spilled over to more countries. Government bond spreads in some cases reached highs that were significantly above the levels seen during the turmoil last May. Pressures on Ireland were particularly severe and led to an EU-ECB-IMF program. Correlations between the average sovereign yields of Greece and Ireland and the yields of Portugal have remained high, but correlations have increased sharply in recent months with the yields of Spain, and to a lesser extent, Italy, as the tensions spread (Figure 2).

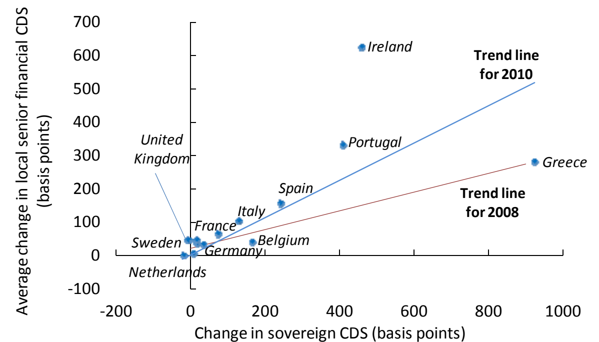
Figure 2. Ten-Year Government Bond Correlation with Average of Greece and Ireland
(3-month correlation coefficient)



Sources: Bloomberg L.P.; and IMF staff calculations.

While still contained to the euro area, the adverse interaction between the sovereign and banking risks in a number of countries has intensified, leading to disruptions in some funding markets. Figure 3 shows that CDS spreads written on financial institutions have increased the most in countries in which there has been the greatest sovereign stress—and this relationship is more positive now than in 2008.

Figure 3. Sovereign and Bank Credit Default Swap Spreads[1]



Sources: Bloomberg L.P.; and IMF staff estimates.
[1]January 2010 to December 2010. Data points not labeled are for Austria, Denmark, and Norway.

Smaller and more domestically-focused banks in some countries have found access to private wholesale funding sources curtailed. Many banks that have retained access have faced higher costs and are only able to borrow at very short maturities.

Several countries, as well as their main banks, face substantial financing needs in 2011 as bank and sovereign debt-to-GDP ratios have risen substantially in the last several years (see IMF Fiscal Monitor Update and Figure 4). The confluence of funding pressures and continued banking sector vulnerabilities leaves financial systems fragile and highly vulnerable to deterioration in market sentiment.

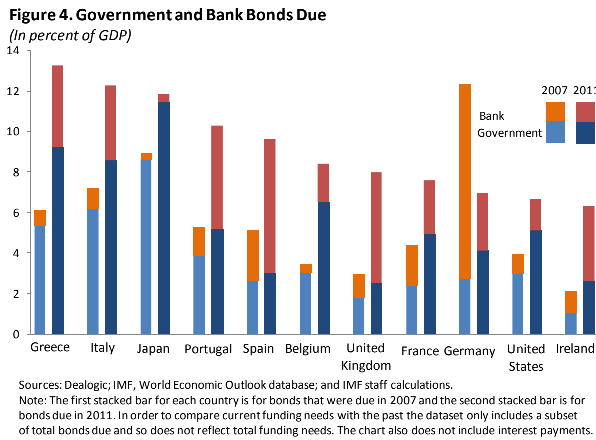


Figure 4. Government and Bank Bonds Due

Sources: Dealogic; IMF, World Economic Outlook database; and IMF staff calculations.
Note: The first stacked bar for each country is for bonds that were due in 2007 and the second stacked bar is for bonds due in 2011. In order to compare current funding needs with the past the dataset only includes a subset of total bonds due and so does not reflect total funding needs. The chart also does not include interest payments.

Little Progress on Deleveraging

The build-up of gross debt accumulated by the private sector in a number of advanced markets has in most cases been only partly reversed, if at all (Figure 5).

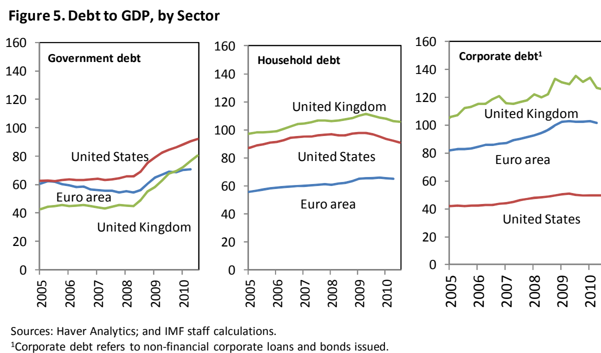


Figure 5. Debt to GDP, by Sector

Sources: Haver Analytics; and IMF staff calculations.
[1]Corporate debt refers to non-financial corporate loans and bonds issued.

Private sector debt-to-GDP ratios should fall gradually over time as economic activity picks up, but the high current debt levels and the usual tendency for loan losses to lag the recovery could still pose risks to the banking system.

Most countries' banking systems have reduced their vulnerabilities by increasing their Tier 1 capital ratios (Figure 6). However, improvements in the structure of funding have been more difficult to achieve. Moreover, some euro-area banking systems are particularly vulnerable to deterioration in the credit quality of their sovereign debt holdings. Even for countries that look better positioned along both these dimensions, there are still risks. In the United States, nonperforming loans related to commercial and residential real estate continue to pose downside risks to banks' balance sheets, and the government debt-to-GDP ratio remains high.

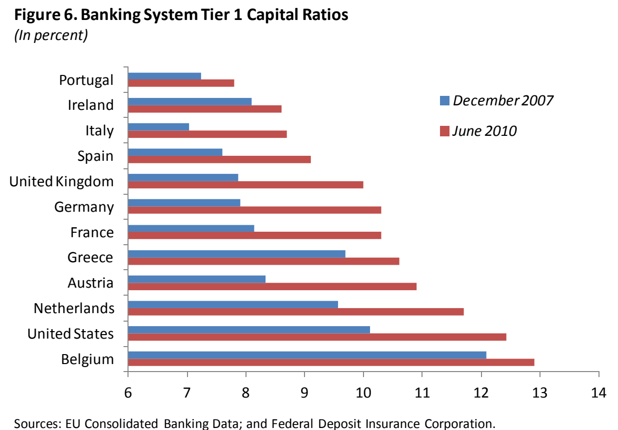


Figure 6. Banking System Tier 1 Capital Ratios

Sources: EU Consolidated Banking Data; and Federal Deposit Insurance Corporation.

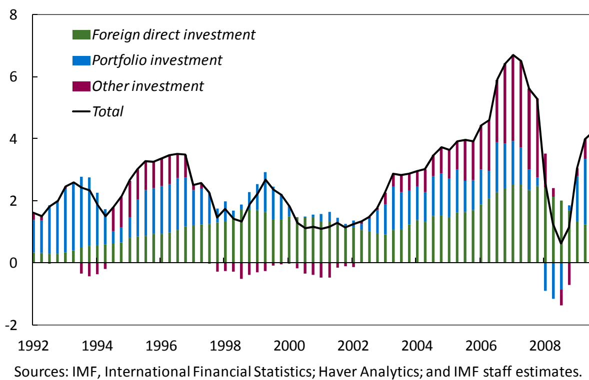
Still-high levels of private debt in some countries are likely to dampen both private sector demand for credit and banks' willingness to lend, weighing on the economic recovery. Although accommodative monetary policies are appropriate to help spur recovery, low interest rates and the use of quantitative easing can have adverse financial stability side effects, including by encouraging riskier

investments. Low rates also pose a challenge for fixed-income investors such as pension funds and insurance companies that rely on higher-yielding assets to match their long-term fixed liabilities.

Resurgent Capital Flows to Emerging Market Economies

Stronger economic fundamentals in some key emerging markets, along with low interest rates in advanced countries, have led to a rebound in capital flows, after the significant drop at the height of the financial crisis. Net inflows to emerging market countries now represent around 4 percent of GDP in aggregate (Figure 7). By comparison, inflows prior to the crisis were above 6 percent of GDP. Capital inflows have been accompanied by a large increase in equity and bond issuance, potentially limiting some of their effects on the price of these assets.

Figure 7. Capital Flows to Emerging Markets
(Net liabilities, percent of aggregate GDP, 4-quarter moving average)

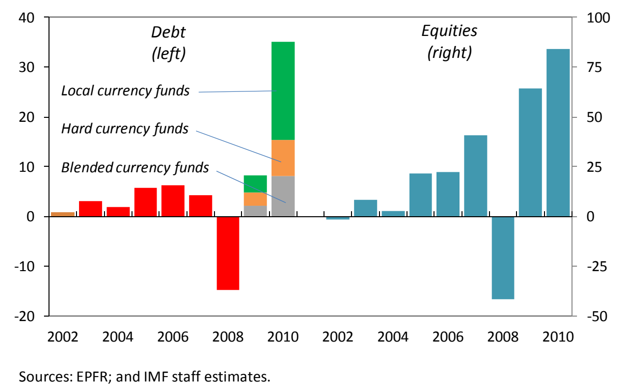


Sources: IMF, International Financial Statistics; Haver Analytics; and IMF staff estimates.

These capital flows may be partly driven by structural factors underlying changes in asset allocation decisions by institutional investors who are now looking at emerging market assets more favorably. However, these flows are also being driven by carry trades, in which investors hope to profit from interest rate differentials and expectations of exchange rate appreciation. Such expectations often accompany policies designed to temporarily limit exchange rate appreciation. Forward interest rates show that the current differential between emerging and advanced country policy rates is expected to rise, which will further increase the incentive for such carry trades. This suggests a vulnerability to reversals in response to, for instance, an unexpected rise in advanced country interest rates, a shift in growth prospects in emerging market countries, or a rise in risk aversion.

Capital inflows are normally beneficial for recipient countries, but sustained capital inflows can strain the absorptive capacity of local financial systems. Retail flows into debt and equity mutual funds have been strong, particularly for equity funds, and could give rise to the formation of asset price bubbles if local assets are in limited supply (Figure 8).

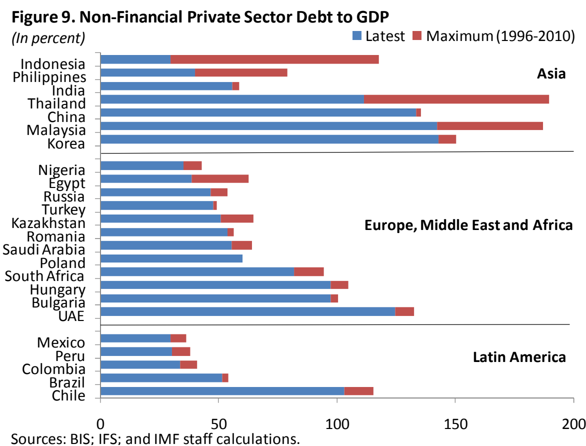
Figure 8. Annual Retail Flows to Emerging Market Debt and Equity Mutual Funds
(In billions of U.S. dollars)



Sources: EPFR; and IMF staff estimates.

Although most measures of equity valuations are within historical ranges, “hot spots” appear to be emerging in the equity markets in Colombia and Mexico and, to a lesser extent, in Hong Kong SAR, India, and Peru.

Inflows can also lead to a rapid increase in private sector indebtedness in recipient countries. As shown in Figure 9, in some economies in Asia and Latin America, nonfinancial private debt is approaching the maximum ratios reached between 1996 and 2010 (Brazil, Chile, China, India, and Korea, for example).[1] While in some countries the change may represent financial deepening and healthy market development, in other countries it could signal an increase in risk, and it is important that country authorities remain vigilant.



A further symptom of large capital inflows is that lower-rated entities gain greater market access to issue debt, lowering the average quality of assets held by investors. There has been an increase in the proportion of debt issued by lower-grade credits during the last two years.

Policy Priorities

Policy action is needed to ensure that the required restructuring and balance sheet repair take place—both for banks and sovereigns—and that regulatory reforms move forward.

The time purchased with the extraordinary support measures of the past few years is running out. Low policy interest rates that are close to the zero bound are likely to have a diminishing effect over time. Fiscal stimulus and further government support of the financial sector are also becoming increasingly unpalatable politically. It is clear that monetary and fiscal policy support can be helpful in the short term, but that such support is no substitute for structural solutions to longstanding problems. Such solutions need to address sovereign risk and financial fragilities in a holistic and comprehensive fashion.

Breaking the Adverse Sovereign-Financial Loop

The root of the problem in many of the countries hit by the crisis—the detrimental interaction between sovereign and financial sector risk—must be addressed. This applies in particular to the euro- area countries where, despite the set-up of area-wide instruments, markets remain concerned about the lack of a sufficiently comprehensive and consistent strategy to repair fiscal balance sheets and the financial system.

All countries with outsized debt levels—inside and outside the euro area—must make further medium-term, ambitious, and credible progress on fiscal consolidation strategies, together with better public debt management based on the

[1] Private sector debt includes domestic and cross-border bank credit, and domestic and international corporate debt.

Stockholm Principles.[2] In particular, in countries facing funding pressures, there is a continued need for the authorities to convince markets that they can, and will, reduce reliance on rollovers and lengthen the maturity structure of their debt. This process will inevitably involve other policies, in particular structural measures aimed at supporting potential growth. Solid movements in this direction have taken place in a number of euro- area countries, but sustained follow-through is still required. In the United States, the delay of a credible strategy for medium-term fiscal consolidation would eventually drive up U.S. interest rates, with knock-on effects for borrowing costs in other economies. The longer fiscal stabilization is stalled, the more likely there would be a sharper rise in Treasury yields, which could prove disruptive for global financial markets and the world economy. Another country with high debt levels, Japan, also needs to continue to work toward lowering those levels and ensuring fiscal sustainability in the face of an aging population.

At the same time, financial system repair must be undertaken—strengthening the banking sector through well-targeted remedial actions, removing the tail risks, and establishing a better regulatory system.

In the European Union, the steps listed below are needed to reduce uncertainty and help restore confidence in markets.

- Further rigorous and credible bank stress testing is required along with time-bound follow-up plans for recapitalization and restructuring of viable, undercapitalized institutions and closure of nonviable ones.

- The effective size of the European Financial Stability Facility should be increased and it should have a more flexible mandate. For countries where the banking system represents a large proportion of the economy, it is now even more essential to ensure access to sufficient funds, going beyond national backstops whenever necessary.

- Euro area-wide resolution mechanisms need to be deployed and strengthened as needed. The introduction of a pan-European bank resolution framework with an EU-wide fiscal backstop would help decouple sovereign and banking risks.

- The European Central Bank will need to continue to supply liquidity to banks that need it and keep its Securities Markets Program active, while also recognizing that this is a temporary set of measures and will not solve the underlying problems.

In the United States, efforts are needed to address the headwinds from the still-damaged real estate markets.

- It is important to find ways to mitigate the negative macro-financial linkages from the large “shadow inventory” of houses for sale (i.e., properties that are already in foreclosure or expected to default) that is likely to dampen house prices for some time to come and exacerbate negative home equity problems. Steps are also needed to revive securitization markets, while at the same time making sure that

[2] See www.imf.org/external/np/mcm/Stockholm/principles.htm for a complete set of the principles.

structured credit products are consistent with systemic stability.

- As emphasized in the conclusions of the recent Financial Sector Assessment Program, an overhaul is needed of the U.S. housing finance system, including the role of the mortgage-related, government-sponsored enterprises. These could be either privatized or converted to public utilities with an explicit (and explicitly funded) guarantee. The authorities should not delay efforts to create an action plan for the future.

In many advanced countries, bank balance sheet and operational restructuring is necessary to preserve the long-term viability of financial institutions and hence reduce the implicit pressure on the sovereign balance sheet in these countries. In some banking systems, the problems are less cyclical and more structural in nature—namely chronically low profitability and fading business lines. Where durable solutions are not possible, effective resolution tools are required that can, in an increasingly complex and interconnected global financial system, preserve financial stability, while ultimately allowing losses to be borne by creditors rather than taxpayers. Governments need to consider carefully how, through better capital structures and possibly through restrictions on the scope and riskiness of activities, large financial institutions can be less of a threat to overall systemic stability and to sovereign balance sheets.

Regulatory Reform Efforts Need to Continue

At the global level, regulatory reform efforts have been moving forward, but increasingly suffer from a combination of fatigue and the sheer complexity of the issues. Progress has been made on microprudential banking regulation aimed at ensuring the solidity of individual institutions, though important gaps remain. Macroprudential policymaking, which aims to preserve the stability of the financial system as a whole, is still in its infancy in most countries, and there are concerns that systemic vulnerabilities may build up again before solid progress is made to prevent such a build-up. Financial systems will need to adjust to the new reforms, including as the recovery takes hold and interest rates rise. This will be more challenging for those countries, such as Japan, that have had low interest rates and a build-up of debt over a long period of time.

New entities are being established to improve systemic oversight. They should waste no time in collecting and analyzing data and issuing policy advice, especially in light of the present low interest rate environment that could well be laying the ground for new financial vulnerabilities. The new European Systemic Risk Board has become operational this month, and markets will watch closely for strong risk warnings and recommendations. The new Financial Stability Oversight Council in the United States, which has already initiated regular meetings, needs to demonstrate that the financial stability arrangements and surrounding regulatory structure have been upgraded in light of the lessons from the crisis.

Guidelines to identify systemically-important financial institutions and measure their contribution to systemic risk are being worked out, though how to mitigate the risks they pose to the financial system is still an open question. Particularly, how to deal with systemically-important nonbanks and markets is a difficult and outstanding issue. Moreover, methods to improve the quality of supervision and produce

a fully functional cross-border resolution scheme are still on the "to do" list.

Coping with Capital Inflows

The need for macroprudential policymaking is also very relevant for emerging market economies facing absorptive constraints on capital inflows. These policies are complements, not substitutes, for traditional macroeconomic policies. So far, evidence of asset price bubbles and credit booms is still isolated to a few countries in a few sectors, but equity inflows and carry-trade activity are generally quite strong and these flows have to be watched carefully, particularly where leverage may be involved.

Policymakers will need to be attentive and act in a timely manner when pressures from inflows are building up, since policies take time to work. Those facing strong inflows and maintaining procyclical policies need to move to a neutral policy setting. Countries with undervalued exchange rates should allow this price mechanism to operate to help offset inflow pressures. However, if currency appreciation is not an option, other means such as monetary and/or fiscal policy should be deployed. Macroeconomic policy responses may, however, need to be complemented by strengthened macroprudential measures (e.g., stricter loan to value ratios, funding composition restrictions) and, in some cases, capital controls.

* * *

Overall, while progress has been made and most financial sectors are on the mend, risks to global financial stability remain. Problems in Greece, and now Ireland, have reignited questions about sovereign debt sustainability and banking sector health in a broader set of euro-area countries and possibly beyond. The current detrimental interaction between financial system stability and sovereign debt sustainability needs to be dealt with in a comprehensive fashion, so as to break the adverse feedback loop that could spread beyond the smaller euro-area countries. Pressing forward with the regulatory reform agenda—for both institutions and markets—continues to be crucial. Without further progress in this field, global financial stability and sustainable growth will remain elusive.