Press Points for Chapter 1: Navigating the Financial Challenges Ahead

Global Financial Stability Report (GFSR), October 2009

Key messages

- Global financial stability has improved, but risks remain elevated.
- Estimated global losses have improved to $3.4 trillion. However, further deterioration in banks’ loans is to come—over half of their writedowns are still to be recognized.
- Policymakers face considerable near-term challenges. These include ensuring sufficient credit growth to support economic recovery; devising appropriate exit strategies; and managing the risks arising from heavy public borrowing.

Global financial stability has improved following unprecedented policy actions and signs of economic recovery. Still, overall risks remain elevated and the risk of reversal remains significant (Figure 1). Our estimate of global losses arising from the crisis for 2007-10 now stands at roughly $3.4 trillion (around $600 billion lower than the last GFSR), largely due to rising securities values.

Financial institutions continue to face three main challenges—rebuilding capital, strengthening earnings, and weaning themselves off government funding support. Securities writedowns by financials have begun to taper, but credit deterioration will continue to lead to higher loan losses over the next few years. Bank writedowns on holdings of loans and securities realized between mid-2007 and mid-2009 have amounted to $1.3 trillion. We estimate that $1.5 trillion of actual and potential writedowns through end-2010 has yet to be recognized (Figure 2). While the capital positions and outlook for banks have improved significantly since the last GFSR, earnings are not expected to fully offset forthcoming writedowns. Banks have enough capital to survive, but they remain under deleveraging pressure. With steady-state earnings likely to be lower in the post-crisis environment, stronger action is needed to bolster bank capital and earnings capacity to support lending.
Private sector credit growth has continued to contract across the major economies as weak activity and household deleveraging restrain private sector credit demand and the financing capacity of both the bank and nonbank sectors remains limited (Figure 3). However, total borrowing needs are not decelerating as rapidly, due to burgeoning public sector deficits. The likely result is constrained credit availability. Continued support by central banks may be required to help alleviate this constraint.

Tail risks in emerging markets have declined as a result of strong policy measures. Asia and Latin America have benefited most from the stabilization of core markets and a recovery in portfolio inflows. However, refinancing and default risks in the corporate sector remain relatively high, with corporates facing a foreign-currency debt refinancing burden of $400 billion in the next two years. The situation is most acute in emerging Europe, where corporate revenues are declining sharply as a result of the recession and several large defaults have already occurred, but is also a concern for smaller, leveraged corporations in Asia and Latin America. Countries heavily dependent on external financing and cross-border funding are most vulnerable.

The transfer of risk from the private sector to public balance sheets raises concerns that longer-term interest rates may face upward pressure unless governments credibly commit to medium-term fiscal sustainability and anchor expectations. While net sovereign issuance is expected to decline in 2010–12 relative to the projections for 2009, it is likely to remain well above the 2002–07 average, as fiscal deficits remain high (Figure 4). Historical panel data analysis indicates that a persistent 1 percentage point increase in the fiscal deficit relative to GDP leads to a 10 to 60 basis point increase in long-term interest rates.

While systemic risks have declined, the policy challenges are significant. Policymakers need to (i) ensure sufficient credit growth to support the nascent economic recovery; (ii) devise appropriate exit strategies; (iii) manage risks associated with sovereign balance sheet pressures; and (iv) maintain a balance between regulation and market forces in reducing future systemic risks. Moving toward the medium-term, policymakers should seek to restore market discipline, address risks posed by systemic institutions, institute a macroprudential policy approach, and strengthen the oversight of cross-border financial institutions.