EXECUTIVE SUMMARY

Systemic risks have been substantially reduced following unprecedented policy actions and nascent signs of improvement in the real economy. There is growing confidence that the global economy has turned the corner, underpinning the improvements in financial markets. Nonetheless, the risk of a reintensification of the adverse feedback loop between the real and financial sectors remains significant as long as banks remain under strain and households and financial institutions need to reduce leverage. Although indicators of sovereign risk are lower than six months ago, the transfer of financial risks to fiscal authorities, combined with the financing burden of fiscal stimulus, has raised concerns over crowding out the private sector and the sustainability of public sector finances. These vulnerabilities underscore the need to strengthen financial intermediation, restore health to the financial system, and eventually reduce the private risks now borne by sovereign balance sheets. Great care in disengaging from public support will be necessary to avoid either sparking a secondary crisis through premature withdrawal or endangering monetary and fiscal credibility through a belated exit. Complacency now becomes a risk—banking system problems could go unresolved and much-needed regulatory reforms may be delayed or diluted. Policymakers should promptly provide a plan for the future regulatory framework that mitigates the buildup of systemic risks, grounds expectations, and underpins confidence, thereby contributing to sustained economic growth.

Prospects for the Road Ahead

The immediate outlook for the financial system has improved markedly since the April 2009 *Global Financial Stability Report* (GFSR) and extreme tail risks have abated. Financial markets have rebounded, emerging market risks have eased, banks have raised capital, and wholesale funding markets have reopened. Even so, credit channels are still impaired and the economic recovery is likely to be slow. Chapter 1 first chronicles the path toward reestablishing sound credit intermediation and the near-term risks that could interrupt its restoration, including the rising burden of sovereign financing. The chapter then examines how near-term policies should be managed to provide a secure backdrop for economic recovery and a withdrawal of extraordinary public support to the financial system. Some medium-term policy options are also discussed that aim to reshape the financial landscape.

Extreme systemic risks have abated, but complacency about banking system repair is still a concern.

A key question addressed is whether the financial system can provide sufficient credit to sustain an economic recovery. Recently, bank balance sheets have benefited from capital-raising efforts and positive earnings. Nonetheless, there are still serious concerns that credit deterioration will continue to put pressure on banks' balance sheets. Our analysis suggests that U.S. banks are more than halfway through the loss cycle to 2010, whereas in Europe loss recognition is less advanced, reflecting differences in the economic cycle.

While stronger bank earnings are supporting capital levels, they are not expected to fully offset writedowns over the next 18 months. Moreover, steady-state earnings are likely to be lower in the post-crisis environment. Stronger action to address impaired assets will help bolster bank earning capability and support lending.

The tightening of bank regulation under way is expected to reduce net revenues and require more costly self-insurance through higher levels of capital and liquidity.

Crisis risks in emerging markets have subsided, but vulnerabilities remain.

Tail risks in emerging markets have declined as a result of strong policy measures—including increased IMF resources. Financial stresses have eased substantially in emerging Europe, but vulnerabilities remain high. Western European banks appear able to absorb deteriorating credit conditions in emerging Europe, but may lack sufficient capital to support a recovery in the region. Asia and Latin America have benefited most from the stabilization of core markets and a recovery in portfolio inflows. Although international flows into emerging market debt have recovered, they have been skewed toward higher quality borrowers, leaving many corporates facing substantial rollover risks, particularly in emerging Europe. Financial policies should continue to foster an orderly adjustment of bank, corporate, and household balance sheets. Extending agreements to maintain or even increase sustainable cross-border bank funding channels would also help.

Impaired credit channels may face difficulty meeting even tepid private sector demand.

With ongoing bank deleveraging pressure and dislocations in securitization markets, our scenarios envisage the supply of bank credit falling for the remainder of 2009 and into 2010 both in the United States and Europe. When set against projected demand for credit by the public and private sectors, it appears that ex ante supply may fall short of even anemic private sector demand. As a result, pressure on funding rates could increase and the flow of credit to support recovery could be curtailed. The results highlight which areas are likely to suffer the tightest credit conditions and where prolonged policy interventions are needed to ensure an adequate flow of credit, particularly with the authorities' objective of keeping interest rates low.

The transfer of private risks to sovereign balance sheets needs careful management.

The transfer of risk to public balance sheets as a result of financial system rescues and fiscal stimulus packages has raised concerns that record sovereign issuance could push up interest rates and hurt the nascent recovery. In this context, credit capacity could struggle to meet even tepid private sector demand, while deteriorating public finances may compromise sovereign creditworthiness. Countries should mitigate this risk by designing and articulating medium-term fiscal consolidation plans that take into account their financial sector stabilization policies and contingent liabilities.

Financial institutions need further restructuring to ensure their ability to lend and support economic recovery.

Credit capacity constraints suggest little room for complacency in cleansing bank balance sheets of impaired and illiquid assets and resuscitating securitization. Deeper financial reform and the resolution of weak banks will be needed before authorities in many jurisdictions can fully exit from liquidity and funding provision. This calls for renewed efforts to increase bank capital and cleanse troubled assets from bank balance sheets. Official stress tests are important instruments through which the condition of banks can be diagnosed in order to design appropriate strategies for recapitalization of viable banks and for careful resolution of nonviable banks. However, the public release of bank-by-bank outcomes should be considered only if effective remedies to address any capital shortfalls can also be presented. Nondisclosure should not imply the absence of such remedies, if needed.

Incentives are critical to repair and restart securitization.

Given the importance of repairing credit intermediation, Chapter 2 examines the role of private securitization and assesses proposals to restart the market. A combination of new regulation and better private sector practice will be needed to align incentives of those institutions taking part in securitization and avoid it contributing to systemic instability once more.

In redesigning regulation and market practices, the benefits of transferring credit risk outside the banking system and the ability of lenders to diversify funding sources need to be retained.

The chapter suggests that a robust private securitization market requires policy action in several areas, including credit rating agency oversight, accounting practices, capital charges, and retention policies. This action needs to be coordinated across regulators within a country and internationally. The chapter illustrates the potential dangers of uncoordinated responses by examining the impact of retention policies and capital requirements imposed on originators and shows that these could, in some cases, fail to encourage screening and monitoring or, in other cases, make securitization prohibitively expensive. Undertaking careful impact studies before introducing new regulations should ensure that their interaction and potential for damaging unintended consequences is recognized in advance.

The chapter also examines the benefits and costs of issuing covered bonds, in which the loan cash flows are pooled but kept on the balance sheet of the issuing entity. This method has the advantage that the issuer has an incentive to screen and monitor the loans, but because they remain on the issuer's balance sheet, capital must still be held against them, reducing the benefits of securitization. Nonetheless, the advantages of capital-market-type financing—selling the bonds to investors—allows more intermediation to occur. On balance, the chapter concludes that this model, too, should be encouraged with appropriate legislation and regulation.

Policies Needed to Underpin Financial System Recovery and Reform

The policy response to dislocations in funding and credit markets has been unprecedented and, though definitive conclusions are difficult to make on the longer-term benefits, the initial evidence is generally positive. Chapter 3 takes an early look at the very short-term impact and more medium-term effects of conventional and unconventional policy responses, including whether they stabilized financial markets at the time of their announcement.

Some unconventional policies have provided support better than others.

The chapter looks at the impact of intervention announcements made by 13 advanced economies. Those aimed at supporting liquidity were most effective prior to the Lehman Brothers event, but were less so once it was evident that the financial crisis had become one of solvency rather than liquidity risk in a number of countries. Correspondingly, announcements of capital injections were most effective in reducing the default risk of banks in the post-Lehman period, as was the announcement of the potential use of asset purchases. Another important result is that interventions aimed at domestic institutions or markets had important spillover effects to other countries, with magnitudes sometimes larger than in the home country. This underlines the critical importance of coordinating policy responses.

Although it is too soon to gauge with confidence the longer-term effects of these policy actions, initial evidence suggests that some facilities have been effective in supporting funding and issuance activity. Examples include the bank liability guarantees introduced in several countries, the U.S. Term Asset-Backed Securities Loan Facility with its impact on secondary market spreads and issuance of consumer asset-backed securities, and the European Central Bank's decision to purchase covered bonds outright, which helped to lower spreads and reenergize issuance.

It is too early to withdraw official support policies, but a strategy for disengagement is needed.

While the time is not ripe for a full-fledged disengagement from all the unconventional policies undertaken—indeed in some countries additional public resources may still be needed—it is time for policymakers to consider and articulate how and in what sequence policies may be unwound. Timing is complicated by the fact that some policies may be effective even if their usage is limited, as they may be bolstering confidence or acting as a backstop to a class of institutions or investors.

Chapter 3 outlines some considerations regarding the modalities and timing of unwinding unconventional policies. In general, if a facility can be phased out by raising its costs or gradually decreasing its availability, one can attempt to wean the private sector from support in a gradual manner. Expensive policies or those where costs are not commensurate with the benefits should be considered first for withdrawal, as should policies that significantly distort financial markets. Importantly, given the global nature of the crisis and the types of unconventional policies used, attention must be paid to the cross-border impact of unwinding, and coordination may be helpful, notably with regard to the withdrawal of guarantees for bank debt across countries where potential arbitrage opportunities can arise. Clarity of communication over withdrawal strategy is critical. In this context, the use of signposts—described in terms of indicators of market conditions rather than firm deadlines—may be more helpful for influencing market expectations. Given that this is uncharted territory for policymakers, some experimentation may be appropriate to test market conditions. If warranted, reinstatement of some facilities should not be viewed as a setback.

A clear vision of future financial system regulation is needed to provide clarity and boost confidence.

In addition to a well-defined strategy for unwinding unconventional policies, confidence in the financial system will be bolstered by clarity over future regulatory reforms needed to address systemic risks. The recent easing of tail risks should not prompt authorities to relax their efforts to map out the path to a more robust financial system. A holistic, understandable approach needs to be formulated so that the private sector can plan appropriately.

The priority should be to reform the regulatory environment so that the probability of a recurrence of a systemic crisis is significantly reduced. This includes not only defining the extent to which capital, provisions, and liquidity buffers are to rise, but also how market discipline is to be reestablished following extensive public sector support of systemic institutions in many countries. There are already proposals that will go some way toward removing procyclicality in the financial system and increasing buffers against losses and liquidity dislocations. But hard work lies ahead in devising capital penalties, insurance premiums, supervisory and resolution regimes, and competition policies to ensure that no institution is believed to be "too big to fail." Early guidance at defining criteria for identifying systemically important institutions and markets—such as that being formulated by the International Monetary Fund, Financial Stability Board, and Bank for International Settlements for the G-20—should assist in this quest. Once identified, some form of surcharge or disincentive for marginal contributions to systemic risk will need to be formulated and applied.

A macroprudential approach to global policymaking is needed to restore market discipline and ensure that the benefits of financial integration are preserved.

The further challenge is to place these reforms in the context of an integrated macroprudential policy framework in which both domestic and cross-border institutions can operate securely. There is now recognition that a combination of microprudential and macroeconomic policies operated procyclically and led to a buildup of leverage and systemic risk. Policymakers will need to address ways in which their own actions exacerbate systemic risks, regardless of whether they oversee monetary, fiscal, or financial policy.

Cooperation and consistency in the policy field must extend across borders. Cross-border relationships between institutions and markets have made it impossible for policymakers to act unilaterally without consequences for others. Following the crisis, however, there is a danger that some countries will want to ring-fence their institutions and withdraw from global markets to protect their domestic economies from external shocks. What is needed instead is a way to benefit from increasing financial integration, while ensuring that potential negative spillovers are contained and clarity exists about the roles of home and host authorities. As policymakers move forward on this difficult task, the IMF can play a catalytic role through its surveillance activities and work on global macrofinancial linkages.