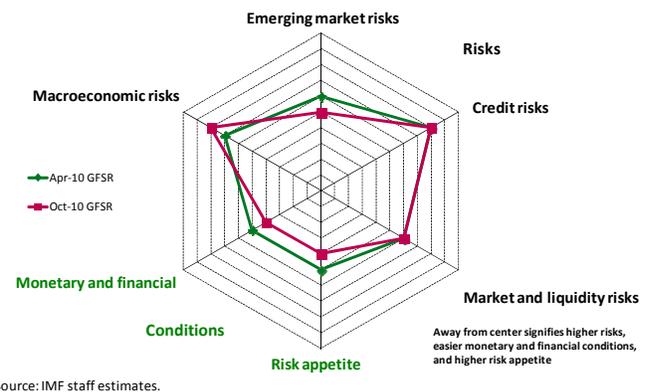
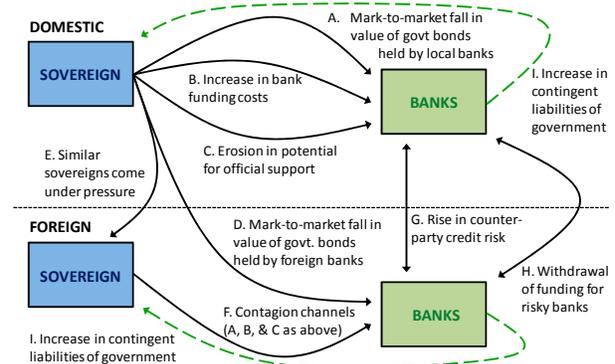


Press Points for Chapter 1: *Economic Uncertainty, Sovereign Risk, and Financial Fragilities****The financial sector remains the Achilles' heel of the economic recovery***

- ***Our baseline scenario is for a gradual improvement in financial stability as the ongoing economic recovery continues but substantial downside risks remain.***
- ***Without further bolstering of balance sheets, banking systems remain susceptible to funding shocks that could intensify deleveraging pressures and place a further drag on public finances and the recovery.***
- ***Sovereign risks remain elevated as markets continue to focus on high public debt burdens, unfavorable growth dynamics, and linkages to the banking system.***
- ***Policy actions need to be intensified to contain risks in advanced and emerging economies, tackle the legacy challenges of the crisis for the banking system, and put in place a new regulatory and institutional landscape to ensure financial stability.***

***Overall progress toward global financial stability has suffered a setback since the April 2010 GFSR as illustrated in our assessment of risks and conditions*** (Figure 1). The turmoil in sovereign debt markets in Europe highlighted increased vulnerabilities of bank and sovereign balance sheets and has served as a stark reminder of the close linkages between the two, as well as the potential for cross-border spillovers (Figure 2). Implicit and explicit guarantees for the banking system have heightened concerns about risk transfer between banks and the sovereign.

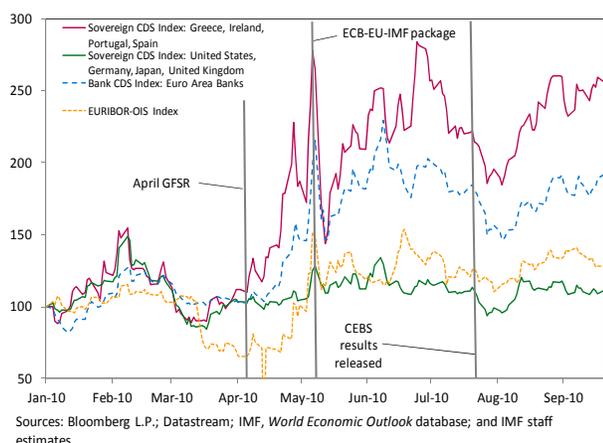
***Coordinated support programs and the announcement of fiscal reforms in countries facing the greatest funding difficulties have helped contain the turmoil.*** The forceful response by European policymakers helped to stabilize funding markets and reduce tail risks. Nevertheless, sovereign risks remain elevated as markets continue to focus on high public debt burdens, unfavorable growth dynamics, and increased rollover risks and linkages to the banking system (Figure 3). Governments' efforts to credibly address fiscal sustainability concerns are made more

Figure 1. *Global Financial Stability Map*Figure 2. *Spillovers from the Sovereign to Banks and Banks to Sovereigns*

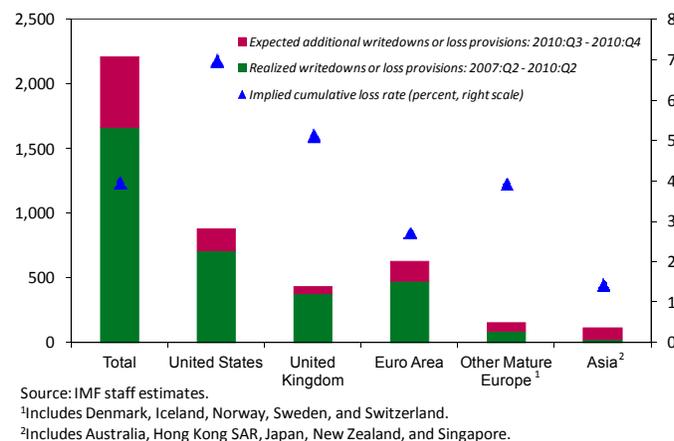
difficult by significant uncertainty about growth prospects. Medium-term debt sustainability concerns can lead to funding difficulties in the short term in the case of large public debt rollovers and difficult market conditions.

**The banking system continues to build on the ongoing economic recovery.** Our estimate of total crisis-related bank writedowns and loan provisions between 2007 and 2010 has now fallen from \$2.3 trillion in the April 2010 *GFSR* to \$2.2 trillion (Figure 4). In addition, banks have made further progress in realizing those writedowns, with more than three quarters already reported. The average Tier 1 capital ratio in the global banking system rose to over 10 percent at end-2009. In our baseline scenario, a gradual further strengthening of balance sheets is expected, with the further recovery of the economy.

**Figure 3. Mature Market Credit Default Swap Spreads**  
(1/1/2010=100)

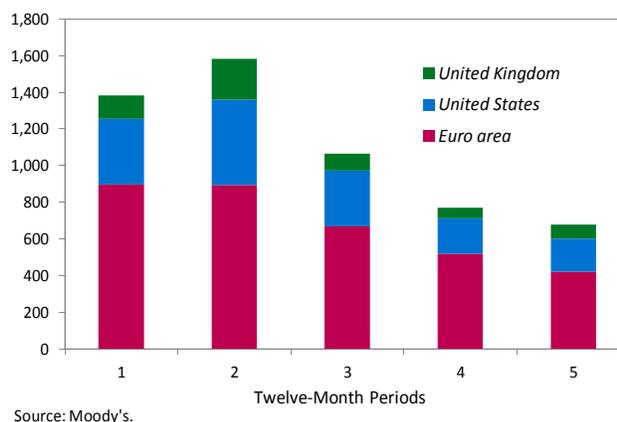


**Figure 4. Bank Writedowns or Loss Provisions by Region**  
(In billions of U.S. dollars)



**Yet structural weaknesses in bank balance sheets remain, leaving them vulnerable to a confidence shock.** These include a high degree of reliance on wholesale funding, little progress on lengthening the maturity of funding, and continued usage by some banks of central bank liquidity support (Figure 5). To reduce the vulnerability to potential future shocks, and to break the sensitivity and interconnectedness between sovereign and bank balance sheets, additional recapitalization and higher quality capital are still required in a number of countries. If left unaddressed, these weaknesses could intensify deleveraging pressures and place a further drag on the economic recovery.

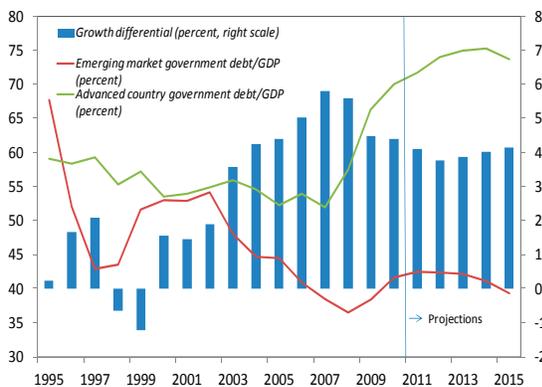
**Figure 5. Bank Debt Maturity Profile**  
(In billions of U.S. dollars, 12-month period from July 1, 2010)



Source: Moody's.

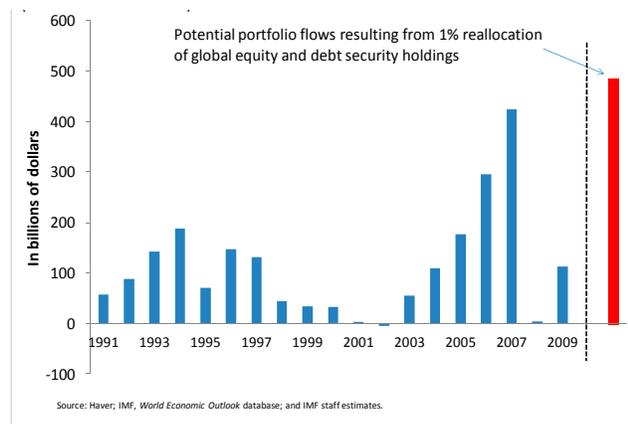
*The crisis in advanced countries has shifted perceptions of risk-reward in favor of emerging markets assets, and has contributed to a reallocation of investment portfolios towards these assets.* Emerging markets have become relatively more attractive compared with advanced economies because of their better fiscal fundamentals, stronger growth outlooks and higher yields (Figure 6). There is a scope for additional sizable asset reallocation to emerging markets, which could be overwhelming in some cases. The reallocation of a small proportion of financial assets of advanced countries could have very large effects on emerging market countries. A one percentage point shift of global equity and debt securities held by the world's largest real money investors would result in additional portfolio flows of \$485 billion (Figure 7).

**Figure 6. Government Debt and Growth Differential (In percent)**



Sources: IMF, *World Economic Outlook* database (gross government debt, median of individual country ratios); and IMF staff estimates.

**Figure 7. Portfolio Flows to Emerging Markets and Developing Countries (In billions of U.S. dollars)**



Source: Haver; IMF, *World Economic Outlook* database; and IMF staff estimates.

*The intertwining of sovereign and banking risk, means that policymakers need to act on several fronts to ensure a sound global financial system and to safeguard the recovery:*

- ***Sovereign balance sheets need to be strengthened.*** Such plans will, of course, need to take into account country-specific circumstances, and be accompanied where necessary by growth enhancing structural reforms.
- ***Legacy problems in the banking system need to be addressed and capital buffers strengthened.*** In some countries, both inside and outside of Europe, weaker nonviable financial institutions still need to be fully resolved and forced to withdraw from unprofitable activities in order to achieve a reduction in excess capacity.
- ***Exits from extraordinary policy support need to be carefully considered.*** Central banks and governments should remain open to providing financial support, if and when needed, and make their exit strategies contingent on adequate progress on the economic and financial stability front.
- ***Further regulatory reform and clarity on measures is needed to prevent future crises.*** We welcome the Basel Committee's announcements, which entail substantial progress towards more robust bank capital and liquidity standards. But more needs to be done. It is essential to establish a broad reform agenda for the financial sector, that goes beyond the

banking industry, and that addresses systemic risks generated by individual firms and collective behavior.

- ***Many emerging market policy makers need to focus on coping with the potential side effects of the relatively favorable outlook for their countries.*** Policy measures should also focus on the continued development of local capital markets and the reinforcement of regulation and supervisory frameworks to enhance the absorptive capacity of local financial systems to safely and efficiently intermediate structurally higher capital flows.