EXECUTIVE SUMMARY

Global financial stability has improved over the past six months, bolstered by better macroeconomic performance and continued accommodative macroeconomic policies (see the April 2011 *World Economic Outlook*), but fragilities remain. The two-speed recovery—modest in advanced economies and robust in emerging market economies—has posed different policy challenges for countries. In advanced economies hit hardest by the crisis, governments and households remain heavily indebted, to varying degrees, and the health of financial institutions has not recovered in tandem with the overall economy. Emerging market economies are facing new challenges associated with strong domestic demand, rapid credit growth, relatively accommodative macroeconomic policies, and large capital inflows. Geopolitical risks could also threaten the economic and financial outlook, with oil prices increasing sharply amid fears of supply disruptions in the Middle East and North Africa.

The main task facing policymakers in advanced economies is to shift the balance of policies away from reliance on macroeconomic and liquidity support to more structural policies—less "leaning" and more "cleaning" of the financial system. This will entail reducing leverage and restoring market discipline, while avoiding financial or economic disruption during the transition. Thus, ongoing policy efforts to withdraw (implicit) public guarantees and ensure bondholder liability for future losses must build on more rapid progress toward stronger bank balance sheets, ensuring medium-term fiscal sustainability and addressing excessive debt burdens in the private sector.

For policymakers in emerging market economies, the task is to limit overheating and a buildup of vulnerabilities—to avoid "cleaning" later. Emerging market economies have continued to benefit from strong growth relative to that in advanced economies, accompanied by increasing portfolio capital inflows. This is putting pressure on some financial markets, contributing to higher leverage, potential asset price bubbles, and inflationary pressures. Policymakers will have to pay increasing attention to containing the buildup of macrofinancial risks to avoid future problems that could inhibit their growth and damage financial stability. In a number of cases, this will entail a tighter macroeconomic policy stance, and, when needed, the use of macroprudential tools to ensure financial stability. Increasing the financial sector's capacity to absorb higher flows through efforts to broaden and deepen local capital markets will also help.

In the next few months, the most pressing challenge is the funding of banks and sovereigns, particularly in some vulnerable euro area countries. As detailed in Chapter 1 of this *Global Financial Stability Report*, policies aimed at fiscal consolidation and strengthening bank balance sheets in these countries should be supported by credible assurances that multilateral backstops are sufficiently flexible and endowed to facilitate an orderly deleveraging without triggering further fiscal or bank funding strains. In other countries, funding is less problematic, but still a concern. Under a baseline scenario, higher funding costs and a rising government debt stock will cause government interest payments to increase in most advanced economies (see also the April 2011 *Fiscal Monitor*). If deficit reduction continues as projected, the interest costs should generally remain manageable, although much greater progress on medium-term fiscal consolidation strategies will be needed in both the United States and Japan to avoid downside risks to financial stability and to preserve confidence. In Japan, the immediate fiscal priority is to support reconstruction following the earthquake, returning in due course to progress toward medium-term consolidation goals.

Overall, despite the transfer of risks from the private to the public sector during the crisis, confidence in the banking systems of many advanced economies has not been restored and continues to interact adversely with the sovereign risks in the euro area. Analysis presented in this report suggests that in order to restore market confidence and reduce excessive reliance on central bank funding, considerable further strengthening of euro area bank balance sheets will be needed. This will require higher capital levels, if a detrimental

process of deleveraging is to be avoided, and a set of mostly smaller banks will have to be restructured and, where necessary, resolved. In the United States, a lackluster housing market, legacy mortgage problems, and a backlog of foreclosures continue to put pressure on the banking system, limiting credit creation and a return to a fully functioning mortgage market. Larger bank capital buffers and strengthened balance sheets will also be necessary as countries transition to a new and more demanding regulatory regime. Countries in which banking systems are still struggling should enhance transparency (including through more rigorous and realistic stress tests) and recapitalize, restructure, and (if necessary) close weak institutions. Without these longer-term financial sector reforms, short-term funding difficulties may escalate into another systemic liquidity event.

Measuring and mitigating systemic liquidity risks should be at the forefront of the agenda of policymakers. Those risks were a main feature of the latest crisis and have yet to be addressed. Chapter 2 takes a close look at this topic, examining the role that Basel III liquidity requirements will play when they are introduced. The analysis suggests that, while helping to raise liquidity buffers, Basel III will be unable to fully address the systemic nature of liquidity risk. The chapter provides some illustrative techniques for measuring systemic liquidity risk and firms' contribution to it, and suggests some accompanying macroprudential tools that could, after further refinement and testing, be used to mitigate such risks. For instance, one of the approaches provides a way to gauge, based on a firm's assets and liabilities and its interbank connections, the higher capital needed to ensure that its risk of insolvency does not cause a destabilizing liquidity run during stressful periods. Tools of this type would allow for more effective sharing of the private-public burden of systemic liquidity risk and help reduce central bank interventions during periods of stress.

A common feature of the crisis in many countries was excessive and misallocated credit growth, which helped fuel housing market booms. Chapter 3 examines the connections between the housing finance systems and financial stability, noting that the structure of some countries' housing finance systems led to a deeper housing bust and financial instability. The chapter suggests a set of best practices for housing finance. For the United States, where the housing market and its financing are still problematic, these best practices imply that there should be better-defined and more transparent government participation in the housing market, including a diminished role of the two large government-sponsored entities (Freddie Mac and Fannie Mae). These goals will need to be pursued incrementally, while taking into account the still-weak housing market and economic recovery. Economies seeking to create a strong housing finance system are advised to "go back to basics"—ensuring safe loan origination and encouraging simple and transparent mortgage contracts.