Executive Directors welcomed the improvement in financial stability on the heels of the global economic recovery. They agreed, however, that vulnerabilities requiring the continued attention of policymakers remain, especially in advanced economies. Emerging market economies, which are generally enjoying a stronger rebound, face different policy challenges.

Directors concurred that the key task for policymakers is the transition from measures that mainly responded to the symptoms of the crisis to structural reforms that address its underlying causes. They noted that many policy challenges highlighted in previous GFSRs have yet to be addressed. Directors agreed that paving the way for an unwinding of public support to financial institutions and the restoration of market discipline calls for stronger actions to strengthen the global financial system.

In particular, Directors underscored that funding of banks and sovereigns could prove difficult in some advanced economies, especially in some euro area countries. In the period ahead, these difficulties could be exacerbated by rising funding costs. Directors emphasized the linkage between public debt sustainability and bank balance sheets, and concurred that the risks of a funding disruption would be limited if banks strengthen their balance sheets, sovereigns improve their medium-term fiscal plans, and the private sector reins in its indebtedness.

Directors agreed that a combination of actions may be needed to restore to full health the financial systems, including recapitalization, restructuring, and, in some cases, closure of weak financial institutions. In this context, they noted that a high level of transparency in policy implementation, which for some Directors would include rigorous and realistic stress tests, could improve market sentiment.

Directors shared the view that, while the recent surge in capital inflows to emerging markets could support investment and growth, pressures are building in some countries, setting the stage for excessive leverage and asset price bubbles. Some Directors were of the view that the impact on capital flows to emerging markets of monetary policy in advanced economies deserved more analysis in the GFSR, suggesting that it was an important factor in explaining the rebound in flows. A few other Directors, however, considered that monetary policy settings in advanced economies play a more limited role in determining capital flows.

Directors agreed that overheating in emerging market economies complicates policy responses to safeguard financial stability. A combination of measures may be required, including a reorientation of the macroeconomic policy mix and macroprudential measures to limit the buildup of financial vulnerabilities. Some Directors noted that carefully deployed capital controls could help manage inflow surges, although a few other Directors were skeptical about their effectiveness except in special circumstances.

Overall, Directors agreed with the staff’s assessment of the near-term policy challenges. These include reducing the debt burdens and repairing the financial system in advanced economies; controlling the risks of overheating and asset bubbles in emerging market economies; and, in all countries, enhancing market discipline.

Directors welcomed the analysis in Chapter 2, which contributes to the development of techniques for measuring and mitigating systemic liquidity risk. They called for further work in this area as well as on the associated macroprudential policies. In this context, they agreed that Basel III regulations were a step in the right direction, but that more needs to be done since Basel III rules apply only to banks and only partially account for the interconnectedness of various institutions and
their common exposures to funding markets. Directors also supported the call for improving the information available to market participants to allow a fuller assessment of an institution’s liquidity risk management.

Directors supported the “back to basics” approach to housing finance outlined in Chapter 3, which recommends best practices in underwriting, supervision, and risk management; a more careful consideration of government participation in housing markets; and a better alignment of incentives in mortgage funding. More broadly, Directors cautioned that the sophistication of housing finance systems needs to be commensurate with a country’s legal and financial infrastructure, and that emerging market countries should first focus on developing sound regulation and adequate information provision as they develop housing finance. Lastly, Directors shared the staff assessment of the need to reform the U.S. housing finance system, where the recent crisis had its origin, and noted recent U.S. proposals in this area.