

EXECUTIVE SUMMARY

The analysis in this *Global Financial Stability Report* (GFSR) shows that, despite recent favorable developments in financial markets, risks to financial stability have increased since the April 2012 GFSR, as confidence in the global financial system has become very fragile. Although significant new efforts by European policymakers have allayed investors' biggest fears, the euro area crisis remains the principal source of concern. Tail-risk perceptions surrounding currency redenomination have fueled a retrenchment of private financial exposures to the euro area periphery. The resulting capital flight and market fragmentation undermine the very foundations of the union: integrated markets and an effective common monetary policy.

The European Central Bank's (ECB's) exceptional liquidity operations around the beginning of 2012 eased the pressure on banks to shed assets, but that pressure rose again, accompanied by increasing market fragmentation. Subsequently, the statement by the president of the ECB in July, and measures proposed by the ECB in September to increase liquidity support and safeguard an appropriate monetary policy transmission, have been essential in addressing investors' biggest fears and prompted another market recovery. This GFSR updates work presented in the April 2012 report to assess the impact of bank deleveraging under three scenarios—*baseline*, *weak*, and *complete* policies. We find that delays in resolving the crisis have increased the expected amount of asset shrinkage at banks. The largest burden of projected credit supply contractions falls on the euro area periphery, where the combined forces of bank deleveraging and sovereign stress are generating very strong headwinds for the corporate sector.

Where the April 2012 GFSR found the need for euro area policymakers to build on improvements and avoid fresh setbacks, this GFSR finds that more speed is needed now. As detailed in Chapter 1, a leap to the *complete policies* scenario is neces-

sary to restore confidence, reverse capital flight, and reintegrate the euro zone. Key elements at the national level include implementation of well-timed and growth-friendly fiscal consolidation, structural reforms to reduce external imbalances and promote growth, and completion of the banking sector cleanup, including further steps to recapitalize or restructure viable banks where necessary and to resolve nonviable banks.

These national efforts need to be supported at the euro area level by sufficient funding to banks through the ECB's liquidity framework. More fundamentally, concrete progress toward establishing a banking union in the euro area will help to break the pernicious link between sovereigns and domestic banks and help improve supervision. Over the longer term, a successful banking union will require sufficient resource pooling to provide a credible fiscal backstop to both the bank resolution authority and a joint deposit insurance fund.

The unfolding euro area crisis has generated safe-haven flows to other jurisdictions, notably the United States and Japan. Although these flows have pushed government funding costs to historic lows, both countries continue to face significant fiscal challenges, as assessed in Chapter 2. In the United States, the looming fiscal cliff, the debt ceiling deadline, and the related uncertainty are the main immediate risks. Unsustainable debt dynamics remain the central medium-term concern. Japan faces high deficits and record debt levels, and interdependence between banks and the sovereign is growing. In both countries, necessary steps toward medium-term fiscal adjustment need to be laid out without further delay. The key lesson of the past few years is that imbalances need to be addressed well before markets start flagging credit concerns.

Emerging market economies have adeptly navigated through global shocks so far, but need to guard against potential further shockwaves while managing a slowdown in growth that could raise domestic

financial stability risks. Local bond markets have continued to attract inflows even as the euro area crisis intensified. Overall, many countries in central and eastern Europe are the most vulnerable because of their direct exposures to the euro area and certain similarities they bear to countries in the euro area periphery. Asia and Latin America generally appear more resilient, but several key regional economies are prone to the risks associated with being in the late phase of a credit cycle that has featured an extended period of rising property prices and debt. Meanwhile, the scope to provide fresh policy stimulus is somewhat constrained in several economies, which underscores the need to deftly manage country-specific challenges.

The crisis has spurred a host of regulatory reforms to make the financial system safer. Chapter 3 contains an interim report on whether these reforms are moving the financial sector in the right direction against a benchmark set of desirable features—financial institutions and markets that are more transparent, less complex, and less leveraged. The analysis suggests that, although there has been some progress over the past five years, financial systems have not come much closer to those desirable features. They are still overly complex, with strong domestic interbank linkages, and concentrated, with the too-important-to-fail issues unresolved. While there has not yet been any serious setback to financial globalization, in the absence of appropriate policies economies are still susceptible to harmful cross-border spillovers. Progress has been limited partly because many regulatory reforms are still in the early stages of implementation and partly because crisis intervention measures are still in use by a number of economies, delaying the “rebooting” of the financial system onto a safer path. Although the reforms currently under way are likely to produce a safer banking system over time, the chapter points to some areas that still require attention: (1) a global discussion of the pros and cons of direct restrictions on business activities to address

the too-important-to-fail issue, (2) more attention to segments of the nonbank system that may be posing systemic risks, and (3) further progress on recovery and resolution plans for large institutions, especially those that operate across borders.

Chapter 4 tackles the fundamental question of whether certain aspects of financial structure enhance economic outcomes. Are the forces currently changing financial structures, including regulatory reforms, likely to result in structures that will support higher, less volatile growth and a more stable financial system? The chapter finds that some structural features are indeed associated with better outcomes and others with less growth and more volatility. In particular, financial buffers (both for capital and liquidity) tend to be associated with better economic performance, whereas some types of nontraditional bank intermediation are linked to less favorable results. The analysis also indicates that certain positive characteristics may sometimes turn negative. For instance, some measures of cross-border connections are beneficial most of the time, but if not managed properly they can act as conduits to transmit destabilizing shocks during a crisis. Overall, the analysis needs to be interpreted carefully, since it is constrained by important gaps in data and a relatively short sample period that included the global financial crisis. As a result, the policy conclusions can only be viewed as tentative. Nonetheless, two of those that emerge are that (1) financial buffers made up of high-quality capital and truly liquid assets generally help economic performance; and (2) banks’ global interconnectivity needs to be managed well so as to reap the benefits of cross-border activities, while limiting adverse spillovers during a crisis.

Both Chapters 3 and 4 also stress that the success of steps aimed at producing a safer financial system hinges on effective implementation and strong supervision. Without those elements, regulatory reform may fail to secure greater financial stability.