ANNEX

SUMMING UP BY THE ACTING CHAIR

The following remarks by the Acting Chair were made at the conclusion of the Executive Board's discussion of the Global Financial Stability Report *on September 15, 2008.*

Executive Directors had a broad-ranging discussion of recent financial market developments, the prospects for global financial stability, and the linkages between financial markets and the macroeconomy. Since the issuance of the April 2008 *Global Financial Stability Report* (GFSR), the global financial system has come under increasing stress, which is unlikely to dissipate quickly. Directors welcomed the steps taken by governments in recent weeks to support the housing and mortgage finance markets and ensure systemic liquidity support. Private financial institutions, for their part, have taken notable remedial actions, by attempting to adjust their balance sheets and business models through revealing losses, raising capital, securing stable funding sources, and improving their risk management systems. Directors agreed that these efforts should assist eventual recovery in the financial system. However, they observed that near-term liquidity pressures, deleveraging, and banking consolidation still pose significant challenges, even while varying in their implications for banks across the advanced economies—in particular, between U.S. and euro area banks, and indeed, even within the European region. In any case, as the events of recent days demonstrate, the adjustment process has not yet run its full course, and financial institution failures and other market disturbances may still lie ahead.

Directors stressed that the preeminent policy challenge in the present context of uncertainty and turmoil is to mitigate the risks of an adverse feedback loop between the financial system and the economy in the near term, while establishing a clear road to lasting recovery for the financial system. Directors underscored the growing ramifications of the financial crisis for economic growth in the advanced economies and the greater risk of spillovers to emerging markets. The considerable uncertainty regarding the depth and breadth of the credit default cycle is likely to continue to curtail credit availability and place a further drag on economic recovery. Directors observed that financial market stresses—while emanating from and concentrated in advanced countries—have an evident potential to threaten emerging markets, where policy frameworks are being tested. In addition, more recent financial market developments suggest that national authorities will need to remain resolute in the face of pressures for further public resources to contain systemic risks and the economic fallout of threats to the solvency of some institutions. This will be challenging against the backdrop of the deterioration in the global economic outlook, with a deepening housing downturn, tighter credit conditions, and heightened inflation risks, which has—in turn—increased financial stresses. Against this background, Directors called for continued vigilance with respect to macrofinancial linkages, and welcomed the further work in the GFSR in this area.

Directors agreed with the staff's recommendation that national authorities will need to stand ready for further policy actions, as needed, in the event of a weaker-than-expected global economic recovery in 2009. Specifically, Directors were mindful that central banks and fiscal authorities will need to work together to address problems in the financial system as well as the prospects for slower growth and potentially higher inflation. At the same time, various authorities will need to make clear to the public their respective roles in the event of broader threats to financial institutions' solvency. Directors generally agreed that central banks should primarily deal with liquidity issues, and that the fiscal authorities should take the lead on major institutions' solvency issues. They pointed out that liquidity and solvency issues are increasingly difficult to separate, but that transparency and clear communication about how various problems are to be addressed will be critical to their successful resolution. Directors stressed that public support for troubled financial institutions in the advanced economies should take account of moral hazard concerns, as well as its medium-term implications for the public sector balance sheet, and be backed up where possible by concrete restructuring plans. They also called for close monitoring of the performance of financial institutions and for continued coordination among national supervisors.

Directors underlined the importance of continuing to build the infrastructure necessary to handle effectively the liquidation of financial institutions in difficulty. Several Directors recognized that new product growth, such as credit default swaps, could raise important issues about resolution, as the newest bankruptcy of Lehman Brothers Holdings demonstrates.

Directors discussed the recent conservatorship of the U.S. government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. They noted that the U.S. Treasury and the Federal Housing Finance Agency (FHFA) have acted promptly to avert fallout of potentially global systemic dimensions, and that the new plan should help support the U.S. housing and mortgage finance markets. Although a large tail risk event was avoided, Directors acknowledged that the broad stresses in the financial system will still be present for some time to come. Directors saw the recent intervention as an opportunity to develop and implement concrete plans for a broad restructuring of the GSEs that would aim at ensuring market discipline and facilitating competition, while minimizing fiscal costs and containing systemic risks.

Directors agreed that the deleveraging process raises several near-term issues. The private sector should take the lead on corrective actions—with regulators and supervisors providing guidance to regulated financial institutions to promote steady improvement. The environment for raising capital has become more difficult, and sustained efforts by private financial institutions will be required to raise capital and reduce assets. Directors acknowledged that reductions in assets would naturally limit credit extension. They also saw scope for reassessing funding models and mechanisms, and restructuring balance sheets and business models. Directors noted the updated estimate of potential future losses to financial institutions of their U.S.-based loans and securities, suggesting that the updated values could also be linked with information about progress on financial institutions' loss recognition and capital-raising activities.

Directors noted that emerging market countries have shown resilience to the global financial crisis thus far, reflecting policy improvements, strengthened reserves, and high growth in recent years, but are now experiencing the spillovers from the stresses in advanced economies. External corporate and bank borrowing is becoming more costly and less available, with falling domestic credit growth and slowing housing markets. Lower risk appetite of institutional investors has led to some easing in capital flows to emerging markets. Directors emphasized the considerable differences in the experience of emerging markets, and noted that the countries that are most vulnerable to spillovers are likely to be those with large current account deficits, recent rapid credit growth, and adverse terms of trade shocks.

Directors discussed various aspects of the financial crisis and its implications, as presented in Chapters 2, 3, and 4 of the GFSR. They welcomed the analysis in Chapter 2 of the stress in bank funding markets and its potential effect on monetary policy transmission. They observed that much of banks' funding liquidity difficulties, as proxied by the difference between the 3-month London Interbank Offer Rate (LIBOR) and the overnight index swap rate, have been related to distress risk—a combination of credit and liquidity risks experienced by financial institutions. In the cases of the sterling LIBOR and the Euribor, an additional factor influencing those spreads was the inability to obtain dollar funding. Directors agreed that central banks would need to provide liquidity support, attempt to lower distress risks, and address foreign exchange funding issues.

Directors welcomed the analysis in Chapter 2 of the interest rate transmission mechanism for monetary policy in the United States and in the euro area. The empirical results in the chapter suggest that the interest rate transmission channel became less predictable during the crisis—more so in the United States than in the euro area, and more so for the transmission between the effective policy rates and intermediate interest rates than for final consumer and business borrowing rates. Several Directors saw this experience as pointing to the importance of resolving the underlying counterparty credit risk issues.

Directors noted that the crisis has raised issues about how financial firms arrive at valuations of assets and liabilities, particularly in illiquid markets. This issue was examined in Chapter 3 by looking at the relationship between fair value accounting (FVA) and procyclicality. Directors noted that, under different circumstances, FVA could either add to or mitigate the procyclicality of banks' balance sheets. In some cases, the procyclical effects could be dampened by certain enhancements to FVA methodologies, but it was noted that there are also other ways of accomplishing this through higher capital buffers and provisions. On balance, Directors generally considered that FVA is still the way forward. They also noted that some alternative accounting methods may reduce transparency and blur the assessment of financial institutions' capital positions. Directors supported the staff recommendation that accounting, prudential, and risk management practices will need to work more coherently to safeguard financial stability in the future.

Directors welcomed the analysis in Chapter 4 on the impact of the advanced country subprime crisis on equity markets in emerging market countries. Directors noted that global, external factors (including global liquidity, market and credit risks) have been found to be important influences on the evolution of domestic equity prices, and that, over time, the integration of equity markets has made the transmission of shocks more likely to occur. Directors welcomed the staff's additional work to gauge the possible effect of equity price changes on real domestic private consumption and investment, which shows that, although there is a statistically significant consumer wealth effect from equities, it is relatively small compared with advanced economies, and subject to a time lag. Even though the real economic effects are likely limited, Directors believed it is still important for emerging market countries to move forward to strengthen the infrastructure underpinning their equity markets, and to make them transparent, well-functioning parts of their financial systems so as to limit potential negative effects on the real economy.

In conclusion, while global financial stability continues to be impaired and systemic risks are still elevated, most Directors viewed the ongoing adjustment process as one that could lead, ultimately, to a stronger, more robust global financial system. In particular, Directors noted that regulators and supervisors have a responsibility to ensure comprehensive financial industry oversight that addresses past problems of lax supervision and regulatory gaps. They noted that, while national authorities in individual countries move forward to stem the effects of the financial market crisis and its macroeconomic consequences, the IMF should, in coordination with national bodies and other international groups such as the Financial Stability Forum, sustain and intensify its efforts to assess developments and influence policy. They agreed that the IMF is uniquely placed for adding a multilateral perspective to policy responses to the crisis, including through the GFSR and the *World Economic Outlook*, and country Financial Sector Assessment Programs (FSAPs).

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Following the Executive Board meeting on the GFSR on September 15, the Executive Board was briefed informally on September 22 on the latest financial market developments and the exceptional policy responses contemplated by the United States and other governments. The following paragraphs provide an overview of this briefing.

Directors noted that acute strains in financial markets had been observed in mid-September and acknowledged that these threatened a severe disruption of the financial system as it became apparent that, without public intervention, market adjustment would be disorderly and more costly for the real economy. A host of authorities accordingly moved to provide a needed rapid and concerted response. Although the specifics of the measures are still being worked out, Directors emphasized that the recent events will likely have far-reaching consequences for the structure of the financial sector and for the macroprudential framework required to support financial stability. The staff observed that global financial strains will likely slow the growth recovery, as anticipated in the October 2008 *World Economic Outlook*. Moreover, the risk of a stronger adverse feedback loop between the financial system and the broader economy has been heightened and still represents the principal threat to the projected upturn. The effects of this distress are also spilling over to many other parts of the world, including emerging market countries.

Directors noted that addressing the attendant liquidity strains and resolving the troubled institutions on a case-by-case basis had failed to support market confidence, requiring the U.S. authorities to shift to a more comprehensive approach. Uncertainty about which institutions might be rescued and which would not intensified systemic concerns and obliged the Federal Reserve to extend a large collateralized emergency loan to insurance company AIG. It also required the commitment of a potentially large amount of public resources to facilitate the functioning of markets. Directors were broadly supportive of this strategy, and welcomed the U.S. authorities' intention to design the specifics of the proposal with due regard to minimizing the risk to the U.S. budget.