

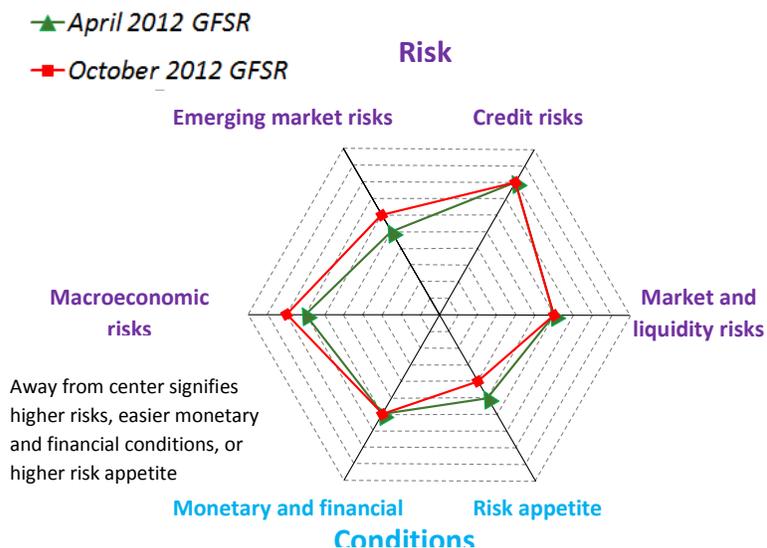
Restoring Confidence and Containing Global Spillovers: Press Points for Chapters 1-2**What are the Key Stability Risks and Challenges?**

- *Confidence is fragile despite significant policy steps by policymakers and recent market improvements.*
- *The euro area crisis remains the principal risk: recent improvements need to be built upon by further policy action, as the forces of financial and economic fragmentation within the euro area have widened the divide between the core and the periphery.*
- *Safe haven flows have reduced sovereign funding costs in the United States and Japan, but policymakers need to address significant fiscal and financial challenges ahead of market pressures.*
- *Emerging market economies need to keep their “guard up” against global risks, but diminished policy space could pose challenges and domestic vulnerabilities need to be addressed.*

Since the April 2012 GFSR, risks have increased, notwithstanding recent improvements in financial markets (Figure 1).

Confidence in the global financial system has become fragile, as incremental policy making has yet to fully resolve near and medium term vulnerabilities. Recent steps—particularly taken by euro area policy makers—are encouraging and have been essential in addressing investors’ biggest fears, but more complete policies will be needed to stabilize the system. The combination of the weakened outlook for growth and volatile and wide peripheral spreads, has led to an increase in macroeconomic risks. Emerging market risks have also risen. Credit risks remain at elevated levels, especially in the euro area periphery.

Figure 1. Global Financial Stability Map

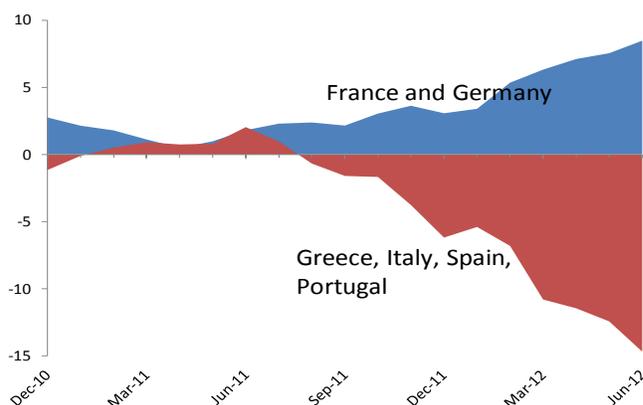


Euro area financial and economic fragmentation has intensified, as the crisis has moved from a sudden stop into a capital-flight phase . . . Cross-border private capital is being repatriated from the periphery to the core at a pace typically associated with currency crises or sudden stops (Figure 2), while large public sector flows, principally across central bank balance sheets, is replacing private capital (Figure 3). Concerns over a possible euro area breakup have led to extreme fragmentation between financial markets in the core and the periphery, as banks, corporates, and even some households try to limit uncovered exposures to the most vulnerable

countries in the euro area periphery. The resulting forces of fragmentation undermine the very foundations of the union: integrated markets and an effective common monetary policy.

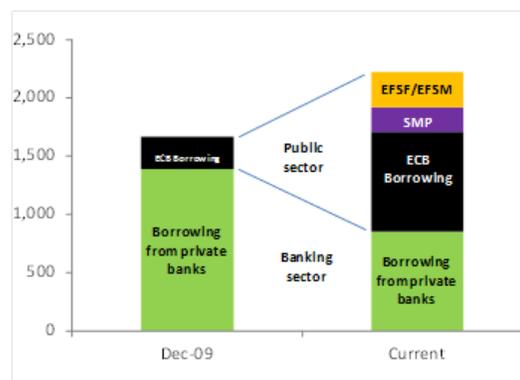
... increasing deleveraging pressures and raising the risk of a vicious cycle of credit crunch and economic recession. This report updates analysis presented in the April 2012 GFSR on the impact of deleveraging pressures under three policy scenarios — *baseline policies*, *weak policies*, and *complete policies*. Owing to mounting pressures on periphery banks since the April report, the degree of deleveraging stress under all three scenarios is now higher, rising to \$2.8 trillion under the *baseline* and as high as \$4.5 trillion under the *weak policies* scenario (Figure 4). The largest burden of projected credit supply contraction falls on the euro area periphery, with downside risks to growth (Figure 5).

Figure 2. Portfolio and Other Investment Capital Flows, Excluding Central Banks (Cumulative from December 2009, in percent of GDP 2010)



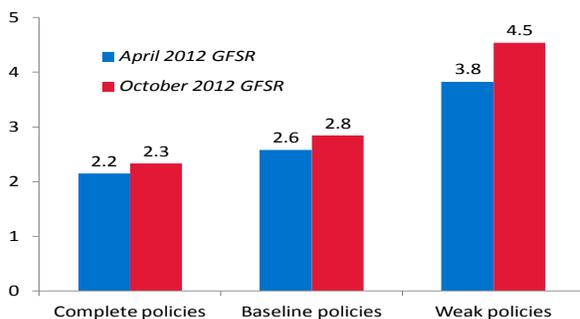
Sources: Haver Analytics; and IMF staff estimates.

Figure 3. Euro Area Exposures to Greece, Ireland, Italy, Portugal, and Spain (In billions of euros)



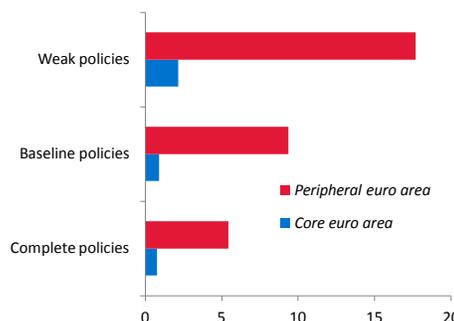
Sources: Bank for International Settlements; Bloomberg L.P.; European Financial Stability Fund; Haver Analytics; national central banks; and IMF staff estimates.

Figure 4. Total Deleveraging by EU Sample Banks (In trillions of U.S. dollars)



Source: IMF staff estimates.

Figure 5. Reduction in Supply of Credit by Scenario (Cumulative for end Q3 2011-Q4 2013, in percent of total credit) Impact EU Bank Deleveraging on GDP (2013, percentage point deviation from WEO baseline)

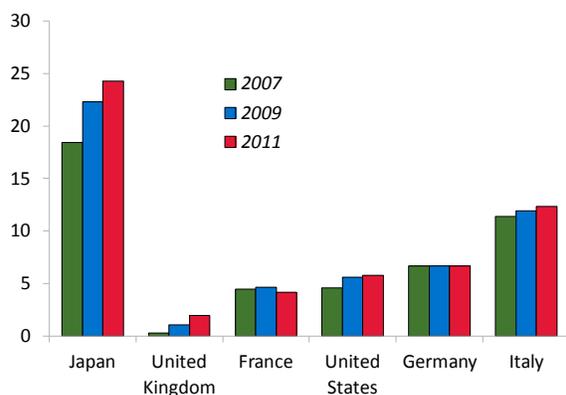


Sources: IMF staff estimates.

Imbalances in the United States and Japan are amenable to medium-term adjustment, but a blueprint for policy actions needs to be developed right away.

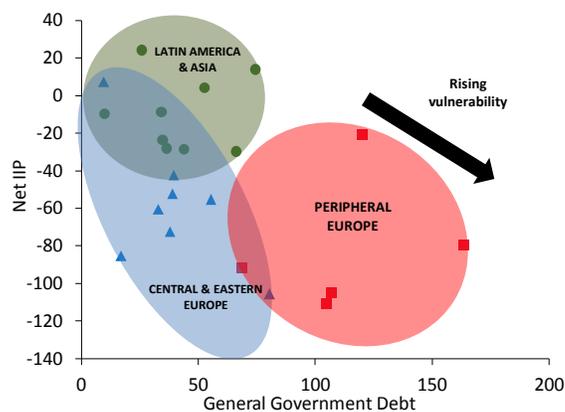
- **Stability or Complacency?** In the United States, unsustainable public debt dynamics remain a medium-term concern, but the looming fiscal cliff, debt ceiling deadline, and related uncertainty also pose near-term risks. Safe haven flows, central bank purchases, and balance sheet de-risking have contributed to an unprecedented compression of credit risk premiums and yields. Low rates and suppressed risk premiums could lull markets and policymakers into complacency, leading to a buildup of stability risks.

Figure 6. Bank Holdings of Government Debt in Major Advanced Economies (Percent of bank assets)



Sources: IMF.

Figure 7. Net International Investment Position versus Gross External Debt, 2011



Sources: Haver Analytics; and IMF staff estimates.

- **How Safe a Safe Haven?** In Japan, the key risks include high budget deficits and record debt levels, combined with a rising concentration of government bond risk in the domestic banking system. With banks holding a large amount of sovereign bonds, the government may find it hard to act as a financial sector backstop (Figure 6).

Are emerging markets safe? Emerging markets need to guard against potential further shockwaves, including from the euro area, while managing a slowdown in growth that could expose home-grown financial stability risks. So far, inflows into local bond markets have continued even when sovereign fears in the euro area have escalated. However, markets could come under strain if a bout of acute global stress precipitated large-scale capital outflows. Overall, vulnerabilities are most pronounced in many central and eastern European economies because of their high direct exposures to the euro area and some similarities with the euro area periphery (Figure 7). Asia and Latin America generally appear more resilient, but several key economies in those regions are prone to late-cycle credit risks. Meanwhile, the scope to provide fresh policy stimulus is somewhat constrained in several economies. Policymakers therefore need to deftly navigate country-specific challenges to safeguard financial stability.

Key policy challenges:

- **Reversing financial fragmentation within the euro area is the key policy challenge.**
 - **Implementation of announced policies is needed.** Incremental and reactive policymaking will not restore confidence. Additional policy measures need to be taken swiftly to achieve the ‘complete policies’ scenario. Otherwise, confidence will remain weak, resulting in higher levels of deleveraging, a greater reduction in credit supply, and a steeper drop in output.
 - **Further actions are needed at both the national and euro area levels:** (1) make sovereigns safer through well-timed fiscal consolidation; (2) make banks safer, through recapitalization, restructuring, and, when needed, resolution; (3) make adequate use of existing mechanisms, including the European Stability Mechanism and the ECB’s OMT, to fully stabilize the euro area; and (4) establish a single supervisor and provide a clear roadmap for subsequent steps towards a complete banking and fiscal union.
- **In the United States and Japan, policymakers need to avoid the pitfalls of complacency and tackle the challenges ahead to preserve growth and financial resiliency.** The key lesson of the past few years is that imbalances need to be addressed well before markets start signaling credit concerns. Both the United States and Japan need to put forth without delay fiscal consolidation strategies that address important fiscal risks. In the United States, additional measures may be needed to unclog the transmission mechanism and accelerate household balance sheet repair. In Japan, measures to induce banks to take greater account of the risks inherent in large JGB holdings may be necessary.
- **In emerging markets, policymakers need to remain vigilant and use policy space wisely.** They should maintain adequate buffers, including foreign reserves and sufficient exchange rate flexibility, preserve and, if needed, use wisely their available monetary and fiscal policy space; strengthen prudential vigilance in their financial systems; and continue developing domestic capital markets.