IMF Warns of Threats to Financial Stability

- Risks to global financial stability have risen in advanced economies, remain high in emerging markets
- Market turmoil reflected setbacks to growth, greater uncertainty, weaker confidence
- More balanced, potent policy mix can expand global output by an additional 2 percent

Over the last six months, global financial stability risks increased because of higher economic risks and uncertainty, falling commodity prices, and concerns about China's economy, according to the International Monetary Fund's latest *Global Financial Stability Report*.

Earlier in the year, financial markets reacted negatively to these developments. Global equities plummeted; volatility rose sharply; talk of recession in advanced economies increased; and bank equity prices came under renewed pressure. These developments reflected increased concerns about the ability of policies to offset the impact of higher economic and political risks.

The situation in markets appears significantly improved since February, according to the IMF, following some better news on the economic front, as well as intensified policy actions by the European Central Bank, and a more cautious stance toward raising rates by the U.S. Federal Reserve. China has also stepped up efforts to strengthen its policy framework to bolster growth and stabilize the exchange rate.

"A key question that this report addresses is whether the turmoil over the past months is now safely behind us, or is it a warning signal that more needs to be done?" said José Viñals, Financial Counsellor and head of the IMF's Monetary and Capital Markets Department. "I believe it is the latter: more needs to be done to secure global stability."

Policies to fix three global challenges

The IMF said policymakers need to deliver additional measures to create a more balanced and potent mix of policies to reduce risks and support growth. If not, market turmoil could recur and intensify, and could create a pernicious feedback loop of fragile confidence, weaker growth, tighter financial conditions, and rising debt burdens. This could tip the global economy into economic and financial stagnation. In such a scenario, the report estimates that world output could be almost 4 percent lower than the baseline over the next five years. This would be roughly equivalent to forgoing one year of global growth.

To avoid this downside scenario, policymakers must tackle a triad of pre-existing global challenges: namely crisis legacy issues still unaddressed in advanced economies, elevated vulnerabilities in emerging markets, and systemic market liquidity risks. By tackling these challenges, world output could be as much as 1.7 percent above the baseline by 2018.

First, policymakers in advanced economies need to tackle crisis legacies, particularly banks, as they play a key role in financing the economy. Banks in advanced economies are now safer, according to the IMF. However, they came under significant pressure from financial markets at the start of the year, as the economic outlook weakened and became more uncertain.

But banks also face important structural challenges in adapting to the new post-crisis realities that continue to depress their profitability. Many banks in advanced economies face significant business model challenges. The report estimates that these banks account for about 15 percent of bank assets in advanced economies. In the euro area, market pressures also highlight long-standing legacy issues. Banks urgently need to tackle elevated nonperforming loans using a comprehensive strategy. Over time, they will also need to address overcapacity in some banking sectors. Finally, Europe must also complete the banking union and establish a common deposit guarantee scheme.

Second, policymakers in emerging markets need to bolster their resilience to global headwinds. The sharp fall in commodity prices has exacerbated both corporate and sovereign vulnerabilities, keeping economic and financial risks elevated. After years of growing indebtedness, emerging economies face a difficult combination of slower growth, tighter credit conditions, and volatile capital flows. So far, many emerging market economies have shown remarkable resilience to this difficult environment, thanks to the judicious use of buffers accumulated during the boom years. But buffers are depleting, with some countries running out of room to maneuver, the IMF said.

As the health of the corporate sector deteriorates, especially in commodity exporting countries and commodity related sectors, refinancing pressures may become more acute. This can generate spillovers to the sovereign, as many weaker corporates are state owned. Bank buffers are generally adequate in many emerging markets but may be tested by increasing nonperforming loans. These interlinkages underscore the importance of close monitoring of corporate vulnerabilities, swift and transparent recognition and management of nonperforming assets, and strengthening the resilience of banks.

China can manage transition

Among emerging economies, the most important one is China. China continues to navigate a complex transition to a slower and more balanced pace of growth and a more market-based financial system. The Chinese authorities have advanced reforms but the transition remains inherently complex, according to the IMF.

The corporate-bank nexus is also critical. Despite progress on economic rebalancing, corporate health in China is declining due to slowing growth and lower profitability. This is reflected in the rising share of debt held by firms that do not earn enough to cover their interest payments. This measure, which the IMF labels “debt at risk,” has increased to 14 percent of the debt of listed Chinese companies, more than tripling since 2010.

Increased strains in Chinese firms are important to Chinese banks. The report estimates that bank loans to companies potentially at risk in China could translate into potential bank losses of approximately 7 percent of GDP.

“This may seem like a large number, but it is manageable given China’s bank and policy buffers and continued strong growth in the economy,” said Viñals. “Equally important, the Chinese authorities are aware of these vulnerabilities and are putting in place measures to deal with the over indebted corporates.”

The IMF said the magnitude of these vulnerabilities calls for an ambitious policy agenda: 1) addressing the corporate debt overhang, 2) strengthening banks, and 3) upgrading the supervisory framework to support an increasingly complex financial system.

Going Beyond Monetary Policy

Policymakers working collectively can strengthen growth and financial stability beyond the current baseline, according to the IMF. They need to deliver a more balanced and potent policy mix that goes beyond continued over reliance on monetary policy. Monetary policy remains crucial but cannot be the only game in town. Well-designed structural reforms and growth-friendly and supportive fiscal policies are essential. In addition, stronger financial policies that further enhance resilience must be put in place. At the global level, the financial regulatory reform agenda must also be completed and implemented—including for nonbanks. All of these actions will help bring balance to the policy mix, and together will make policies more potent and effective.