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Commentary

BUFFIN PARTNERS INC. ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

Global Financial Stability

In its latest report on Global Financial Stability, the International Monetary Fund (IMF) states that risks to the financial system have eased as the economic recovery process gains momentum. As fears of systemic crisis subside, global risk aversion has lessened. However, there are a number of risks that have the potential to undermine the improvement in global financial stability. In particular, sovereign debt risks are causing concerns that the goal of generating adequate credit in the system may experience prolonged difficulties. Any deterioration in the sustainability of public debt levels could adversely affect the banking system across national borders. As a result of this adverse scenario, the IMF is advocating interventionist policies so as to reduce sovereign vulnerabilities. The IMF is stressing the importance of medium-term fiscal consolidation plans, and the necessity of reducing financial leveraging. The IMF is also recommending a regulatory agenda to ensure a safer and more resilient global financial system.

The banking systems in some countries remain deficient in their capital structure. However, overall global bank capital needs have declined recently as the condition of the banking system has improved in general along with the global economic recovery. Nevertheless, banks still face considerable challenges since substantial short-term funding will need to be refinanced in the near future. It is also apparent that higher-quality capital will be needed in anticipation of a more stringent regulatory environment.

The recent turmoil in the euro zone has clearly demonstrated how weak financial fundamentals can result in short-term financing strains. The current focus of concern has shifted to economies with weaker fiscal outlooks and financial strains, as is most evident in Greece. Outsized deficits and an unsustainable debt trajectory are serious situations that create heavy reliance on external demand for government obligations. When accompanied by large concentrated debt rollover requirements, the timetable for addressing solvency challenges becomes considerably shorter.

Prospects for strong growth, appreciating currencies, and rising asset prices are influencing capital flows into Asia-Pacific (excluding Japan) and Latin American countries. The financial crisis has had the effect of altering opinions about risk and return in emerging markets compared to mature markets. Assessments of sovereign credit risks have moved in favor of emerging markets, primarily due to unfavorable debt dynamics in the major advanced economies and southern Europe. Low interest rates in major advanced economies are also a factor in the global direction of capital flows. If the current environment of low interest rates, abundant liquidity, and capital flows persists over a long period, the likely result will be the emergence of asset price bubbles. There is at present only limited evidence of excessive valuations in the near term. However, current conditions could give rise to circumstances for asset price bubbles to form in the medium term. The environment where bubbles would have an impact on the global financial system typically include substantial overvaluation in several classes of risk assets for a protracted period, supported by excessive leverage, mainly in the form of concentrated bank lending.

Credible plans for fiscal consolidation are needed to address sovereign risks. These plans must be transparent and command public support; this objective represents the greatest challenge facing governments in the near term. Better fiscal frameworks and growth-enhancing structural reforms will help support public confidence that the fiscal consolidation process is consistent with long-term growth. Fiscal reform and consolidation plans should be backed up by contingency measures in the event that the degradation of public finances is greater than expected.

In the near term, the banking systems in a number of countries still require attention so as to establish a healthy core set of viable banks that can succeed in getting private credit flowing again. Further efforts to address a number of weak banks are still necessary to ensure a smooth exit from the extraordinary central bank support of funding and liquidity. In moving forward with regulatory reforms to address systemic risks, care will be needed to ensure that the combination of regulatory reform measures strikes the right balance between the safety and the efficiency of the financial system. Some recent reform proposals add the task of monitoring the build-up of systemic risks to the role of regulators in order to mitigate such risks. A unified regulator that oversees liquidity and solvency issues would remove some of the conflicts that result from the separation of these powers. To address systemic risks, regulators need additional means that are tied explicitly to their mandate to monitor systemic risks. These include systemic-risk-based capital surcharges, or levies that are related to an institution's contribution to systemic risk. Addressing problems with too-big-to-fail institutions remains essential to achieving global financial stability. Policymakers need to evaluate why and how these institutions are systemically important and determine how the risks that they pose to the global financial system can be controlled.

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