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IMF Warning on Global Financial Stability

This edition of *Commentary* is devoted to presenting a summary of the highlights of the International Monetary Fund's September 2011 Global Financial Stability Report. This 54-page report contains several warnings about the future prospects for preserving Global Financial Stability and the need to implement policies to counteract the significant challenges and risks that the IMF perceives as a threat to the financial system.

According to the IMF, overall macroeconomic risks have increased, reflecting a significant rise in sovereign debt vulnerabilities in advanced economies. Weaker growth prospects and higher downside risks have contributed to concerns about debt sustainability, especially in the euro area periphery. Elsewhere, political risks to achieving medium-term fiscal adjustment have risen in a few advanced economies, notably the US and Japan. Many sovereigns are vulnerable across multiple dimensions, raising market concerns about debt sustainability. Market and liquidity risks have risen, partly as a result of increased macroeconomic and sovereign risks. Higher volatility and rising yields on government bonds issued by countries on the periphery of the euro area are resulting in a loss of investor confidence, weakening the investor base, and further driving up funding costs. Public debt has become more difficult to finance, while higher sovereign risk premiums are disrupting bank funding markets. Credit risks have risen as sovereign strains have spilled over to the banking system in the euro area. The impact of the rise in sovereign credit risk on the financial system has negative implications for funding markets and for the flow of credit to the real economy. Low interest rates, although necessary under current conditions, can carry longer-term financial stability risks. The search for yield is pushing some market segments to become vulnerable and overleveraged, contributing to future risks. Emerging market risks have increased; rapid domestic credit growth, balance sheet releveraging, and rising asset prices may ultimately lead to deteriorating bank asset quality in emerging markets. Emerging markets remain vulnerable to external shocks; reduced capital flows coupled with a rise in funding costs and a fall in global growth could strain capitalization in emerging market banks.

The IMF report stresses that deep-seated challenges to the global financial system remain, and rapid progress is needed to increase financial system robustness. The economic and financial context for fiscal adjustment and reducing bank risks is daunting. Most advanced economies are facing a combination of relatively low inflation and subdued real growth; this situation has negative implications for significantly improving the debt-to-GDP ratio in these economies. Also, in many countries, the peak in sovereign debt burdens coincides with that of private debt burdens; the consequence is likely to be a prolonged period of economy-wide deleveraging. Bank balance sheets are more extended and remain highly leveraged and vulnerable to both economic and funding shocks. Cross-border dimensions increase the vulnerability of global financial stability to shocks, making the system more fragile and subject to contagion risks. Most crucially, the policy tools available in most advanced economies are geared to combating temporary liquidity shocks rather than tackling concerns about solvency. Achieving and maintaining financial stability requires addressing these underlying vulnerabilities, mitigating the risks of contagion and spillovers, raising the capital buffers in banks, and completing the financial reform agenda.

The set of policy choices that are both economically viable and politically feasible is shrinking as the crisis shifts into a new, more political phase. Negative surprises and the intensification of risks have raised the urgency of prompt policy action to strengthen the global financial system. The need for a more robust financial framework is heightened by the limited room to deploy further fiscal and monetary policy stimulus. In the advanced economies of the United States, Europe and Japan, the priorities are to repair public balance sheets and to address the overstretched condition of private balance sheets in European banks and US households. Global financial regulatory reforms need to be concluded as soon as possible and implemented internationally. Emerging market policymakers face a contrasting challenge of limiting the buildup of financial imbalances, often in the midst of expansionary conditions, while continuing to build a robust financial framework.

The weakening outlook for growth, coupled with heavy debt burdens on both private and sovereign balance sheets, presents heightened risks to global financial stability. With the crisis now entering its fifth year, and with sovereign and central bank balance sheets already heavily extended, the range of policy options has become much more limited. Fiscal space is limited in many advanced economies, and immediate fiscal consolidation is needed in economies under market pressure. On the monetary front, policy rates across the advanced economies are at or near zero, thus providing scope for balance sheet repair for banks and households. The important conclusion from the IMF report is that policymakers need to reinforce credibility and build defenses against potential systemic shocks.

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