

## Financial Stability Set Back as Sovereign Risks Materialize

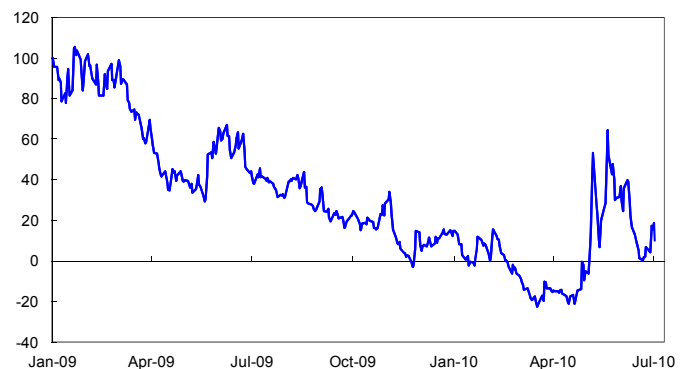
*Despite generally improved economic conditions and a long period of healing after the failure of Lehman Brothers, progress toward global financial stability has recently experienced a setback. Sovereign risks in parts of the euro area have materialized and spread to the financial sector there, threatening to spill over to other regions and re-establish an adverse feedback loop with the economy. Further decisive follow-up is needed to the significant national and supranational policy responses that have been taken in order to strengthen confidence in the financial system and ensure continuation of the economic recovery.*

Although the global economic recovery remains intact, progress toward financial stability experienced a setback in late April and early May. Spillovers between sovereigns and the banking system increased market and liquidity risks. Banks again have become less willing to lend to one another, except at the shortest maturities, especially to banks in euro area countries perceived to be facing greater policy challenges. Moreover, financial asset price volatility increased and investor risk appetite declined. Such financial risks have raised the chances of re-establishing an adverse feedback loop to the economy, though to date there is little evidence of this.

The most acute market strains have since receded somewhat over the last month or so, but market confidence remains fragile. Traditional safe haven assets like U.S. treasuries, German bunds, and gold have gained in value. Riskier assets such as mature and emerging market equity prices reversed much of the gains posted earlier in the year and have

recently made only a tentative recovery. Commodity prices dropped back to the levels of last fall. And while volatility has declined somewhat recently, it remains higher than prior to the retrenchment.(Figure 1).

**Figure 1. Composite Volatility Index**  
(1/1/2009 = 100)



Source: IMF staff estimates.

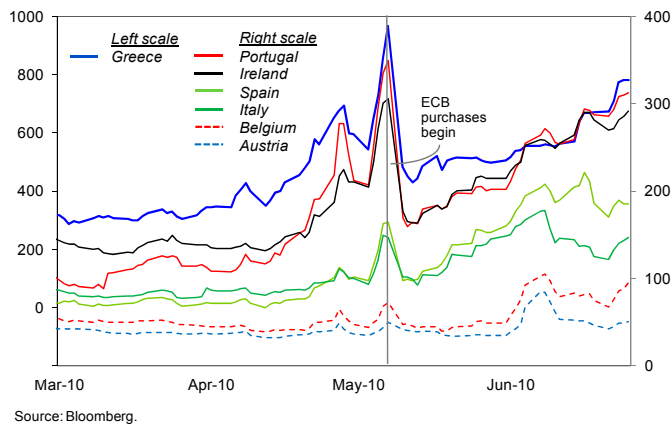
Note: The index was constructed utilizing implied volatilities derived from options on various stock market indices, interest rates, and exchange rates.

## Sovereign Risks Intensify

The market dynamics stem from the continuing intense pressures on some sovereign debt markets (Figure 2). These pressures in part reflect an ongoing reassessment of sovereign credit risk in the euro area. The creation of the

euro resulted in the disappearance of intra-area exchange rate risk and an expectation of fiscal and macroeconomic convergence among the euro member countries. This was reflected in a significant narrowing of regional sovereign spreads until very recently. On the heels of Greece's fiscal troubles, investors are now repricing these risks across the region. This highlights the need for policymakers to continue to pursue credible fiscal consolidation plans and strengthen economic governance in the euro area.

**Figure 2. Selected Euro Area Sovereign Spreads**  
(In basis points)



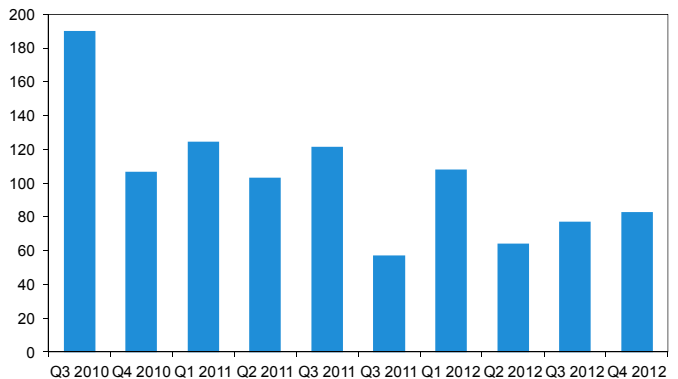
The announcement of the European Financial Stability Facility and the program by the European Central Bank (ECB) to buy securities helped to ease some of the more severe euro area bond market pressures. After the announcement of the securities purchase program in early May, spreads over German sovereign bonds on Greek, Portuguese, and Irish debt narrowed. Recently, however, the effect has been wearing off, and market liquidity in this debt has remained poor.<sup>1</sup> In contrast, the spreads for Spanish and Italian bonds have continued to increase and are now

<sup>1</sup> So far, the ECB has purchased approximately net €59 billion in government debt from the secondary market.

at wider levels than at the beginning of the year. More recently, some differentiation in sovereign credit has also emerged between Germany, which has benefited from safe haven flows, and Belgium, Austria, and France.

In part, the public bond market pressures reflect significant rollover needs. Those countries in the euro area currently experiencing significantly widened spreads to German bunds need to refinance about €300 billion in debt maturing in the third and fourth quarters of this year (Figure 3). In doing so they will face competition from the very large rollover needs of the United States, United Kingdom, Japan, and other euro area countries amounting to a total of about \$4 trillion maturing in the third and fourth quarters.

**Figure 3. Selected Euro Area Sovereign Bond Rollovers, Q3 2010-Q4 2012**  
(In billions of euros)



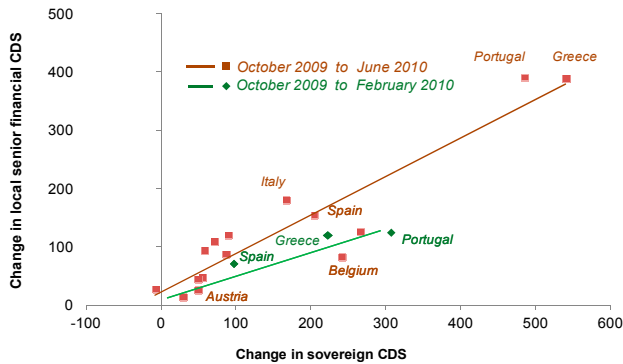
Source: Bloomberg.  
Note: Includes principal and interest payments on both short-term bills and longer-term bonds for Greece, Ireland, Italy, Portugal, and Spain.

## Spillovers to Banks

The financial stability implications of rising sovereign risks have been significant, reflecting the existing exposure of European banks to sovereign debt. Recent co-movements of European bank credit default swap (CDS) spreads with sovereign CDS spreads have intensified since our estimates in the April 2010 GFSR (Figure 4). This reflects the

substantial holdings of sovereign debt by banks, but also the increasing risks of adverse feedback loops between the sovereign and the financial sector and the potential impact on government balance sheets, in case weak banks need support.

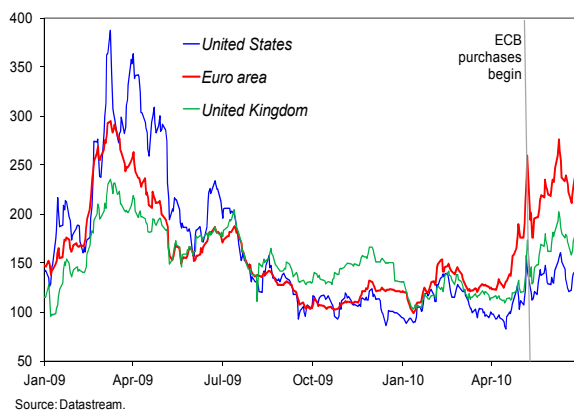
**Figure 4. Sovereign Risk Spilling over to Local Financial Credit Default Swap Spreads**  
(In percent)



Sources: Bloomberg; Datastream; and IMF staff estimates.

With the heightened uncertainty about the health of some banks, average bank CDS spreads are increasing in the United Kingdom, United States, and euro area (Figure 5). In part, the pressure on banks has been exacerbated by the legacy of unfinished cleansing of bank balance sheets over the last three years—a process that has been slower in the euro area than in the United Kingdom and United States—which has resulted in remaining

**Figure 5. Bank Credit Default Swap Spreads**  
(In basis points)



Source: Datastream.

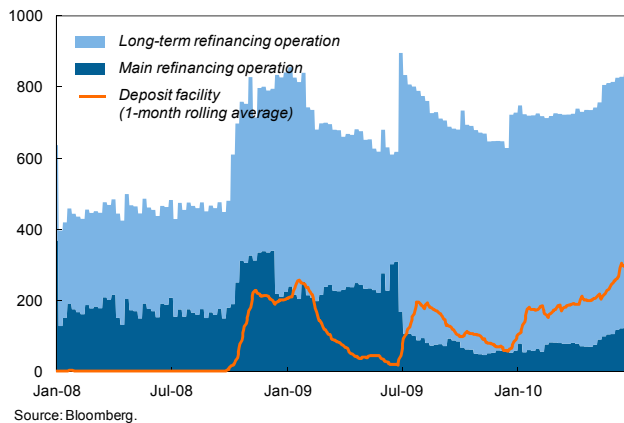
pockets of vulnerability, overcapacity, and poor profitability for at least some types of banks. Moreover, lack of detail about the types of bank regulation or levies that will be introduced and the timetable for their implementation are adding to investor uncertainty.

Cross-border bank exposures provide the means for the spillover of sovereign risks to banks and their further spread to other banking systems in the region and beyond. Although such relationships have diversification benefits in good times, they represent channels for contagion in stressful conditions.

Uncertainty about bank exposures to sovereign debt of the countries facing policy challenges has led to significant interbank funding strains. Increased counterparty concerns have caused longer-term LIBOR-overnight index swap (OIS) spreads to widen again. To alleviate these funding strains, the ECB and the U.S. Federal Reserve reintroduced some flexibility into their liquidity operations. The ECB suspended its collateral requirements on Greek sovereign debt and reactivated some of its long-term operations, while the Federal Reserve reinstated its foreign exchange swap lines. Despite these efforts to improve the functioning of the interbank market, euro area banks are still hoarding liquidity and putting those funds in the ECB's deposit facility (Figure 6).<sup>2</sup>

<sup>2</sup> Some of the buildup of deposits at the ECB occurred in anticipation of the expiration of the one-year long-term refinancing operation on June 30, and there has been some decline in the holdings since.

**Figure 6. ECB Liquidity Operations**  
(In billions of euros)

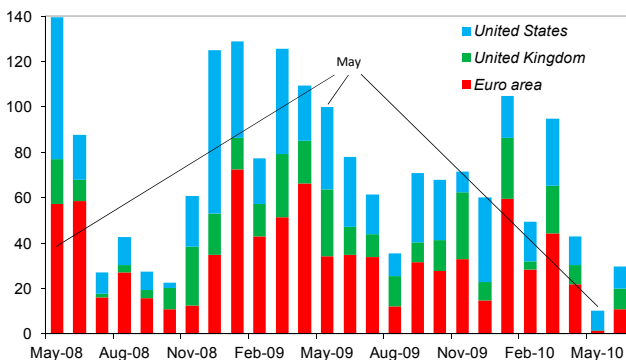


Source: Bloomberg.

Within the interbank market, the demand for short-term dollar funding is high. For example, money market funds in the United States have been decreasing their exposure to European financials, reducing dollar funding sources for European institutions. The central bank foreign exchange swap lines, reinstated to bolster the market, have helped underpin confidence, although they have rarely been used.

Banks are also confronted by significant funding pressures coming from maturing bonds. As was emphasized in the April 2010 GFSR, banks face a wall of maturities in the next few years, especially in the euro area, and the recent turbulence has at least temporarily dampened the primary market for financial institutions' bond issuance (Figure 7).

**Figure 7. Financial Bond Issuance**  
(In billions of U.S. dollars)

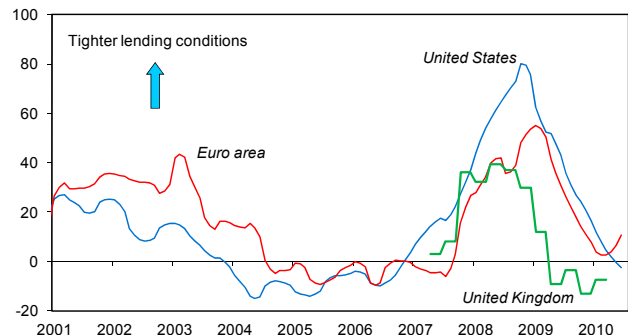


Source: Dealogic.

## Threats to the Recovery

While the current transmission of sovereign risks has been primarily financial in nature, the possibility of adverse feedback loops to the economy has risen. As noted in the July 2010 World Economic Outlook Update, downside risks to the recovery have risen sharply. Bank funding pressures may accelerate the ongoing deleveraging process. It is too early to tell if actual bank lending growth will worsen in the euro area, after recently stabilizing at barely positive year-on-year rates. Early indications

**Figure 8. Lending Conditions**  
(Net percentage of domestic respondents tightening standards for loans)



Sources: Lending surveys by the Bank of England, European Central Bank, and the U.S. Federal Reserve for households and corporates; and IMF staff estimates.

suggest that euro area banks' lending standards have somewhat reversed their downward trend, tightening again (Figure 8).

In addition to the potential adverse impact on bank lending, the recent market turbulence and widening in credit spreads has corresponded with a collapse in nonfinancial corporate bond issuance in May. In spite of a recent rebound in June, issuance from European firms was especially anemic, and smaller than in the period surrounding the Lehman bankruptcy. If these tighter conditions continue, they could begin to have a significant impact on the availability of credit to corporates.

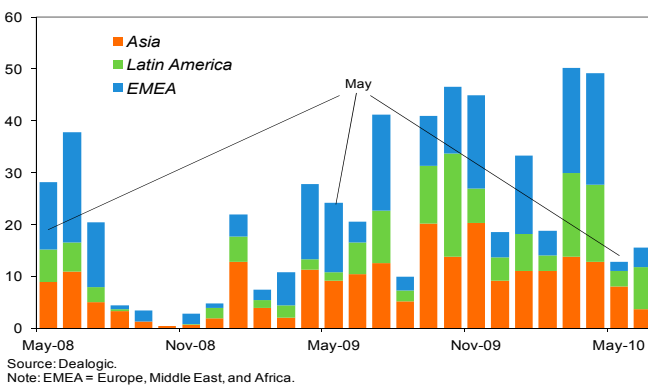
### Exits from Extraordinary Policies Delayed in Some Countries

Potential downside economic risks and the strains in interbank and sovereign markets have complicated exits from the extraordinary fiscal, monetary, and financial policies initiated some months ago. For the major central banks, especially the ECB, markets now anticipate a lengthening of the “extended period” of very-accommodative monetary policy. In fact, the ECB has not only reinstated some of its extraordinary operations for liquidity provision, but it has also announced a program to purchase sovereign debt.

### Emerging Market Financing Conditions Tighten

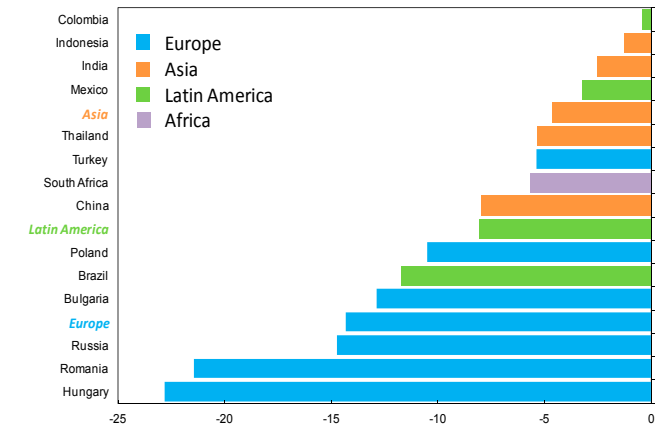
Emerging markets are being affected by the heightened risks in the euro area through the reduction in broad risk appetite, which has led to tighter financing conditions. Portfolio flows to emerging markets have partially reversed, after a significant run-up for almost a year between March 2009 and April 2010, and asset price valuations have declined. Moreover, emerging market sovereigns and corporate bond and equity issuance also stalled in May, although some regions are less affected than others and it may be mostly temporary (Figure 9). Asian issuance, for instance, has not deteriorated dramatically.

**Figure 9. Emerging Market External Bond and Equity Issuance**  
(In billions of U.S. dollars)



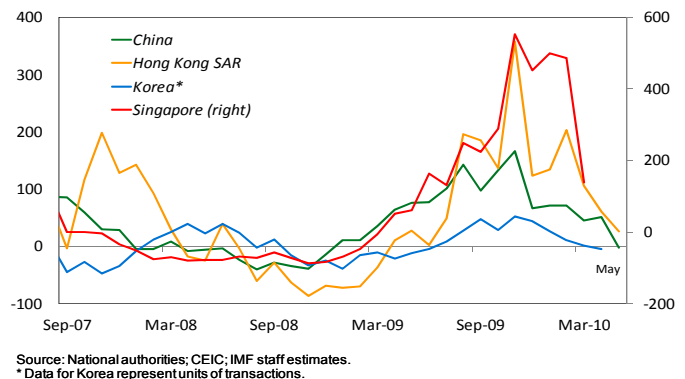
Not surprisingly, the spillovers from mature Europe are being felt most in emerging Europe, where direct linkages are the greatest. The equity markets of Romania and Hungary and those of emerging Europe as a region were the hardest hit compared to other emerging market countries and regions (Figure 10). Mature European banks are most exposed to emerging Europe. These exposures suggest that some emerging markets may experience a renewed credit squeeze if funding strains cause European banks to withdraw their cross-border credit flows.

**Figure 10. Emerging Economies: Stock Price Performance, April Peak - June 28, 2010**  
(In percent)



Earlier concerns about Asian real estate markets are diminishing as prudential measures appear to be taking hold. The growth of real estate transaction values has eased and the share of real estate loans in new bank lending is also falling (Figure 11), although further monitoring of developments is warranted.

**Figure 11. Growth of Real Estate Market Transaction Values**  
(Percent, year-on-year)



## Exchange Rate Risks Rising

The depreciation of the euro has the benefit of partially offsetting the adverse impact on growth in the euro area of heightened sovereign and bank risks. But the confluence of sovereign credit, banking sector, and macroeconomic risks has also increased the potential for a disorderly adjustment in exchange rates. The euro has come under significant downward pressure, now approaching what a medium-term fundamental analysis would suggest as an appropriate multilateral level. At the same time, market volatility has been rising.

## Policy Priorities

Policy action is needed on several fronts to bolster confidence and continue to stabilize financial markets,

The root of the problem—sovereign risk—must be addressed. This applies in particular to the euro area countries that are under intense market pressure. They must make further credible progress on fiscal deficits, together with better strategies for public debt management. Due to funding pressures, these countries already had to embark on immediate fiscal consolidation—and they have already made significant progress in this direction. More generally, fiscal adjustment should be part of medium-term consolidation plans. These plans need to be credible in order to avoid adverse market reaction from forcing yet further front-loaded fiscal adjustment. Market participants see announced fiscal consolidation plans as a necessary but not sufficient condition to achieve debt sustainability, as they remain concerned that governments may have difficulty generating enough nominal growth in a disinflationary environment. Thus there is a

need to combine the announcement of credible fiscal consolidation plans with structural measures aimed at supporting potential growth. Solid movements in this direction are already under discussion in a number of euro area countries.

In the financial sphere, in addition to the strong actions already undertaken, market confidence would greatly benefit from the following measures:

- Make the €440 billion European Financial Stability Facility fully operational, now that the difficult task of establishing it has been accomplished.
- Continue to provide ECB liquidity support for secondary bond markets. Markets are not yet convinced of the central bank's commitment to scaling up purchases if necessary to prevent a further deterioration in market functioning.
- Pursue greater transparency and credible stress testing of European banks. A key issue now is uncertainty about individual bank exposures, including to sovereign debt, which argues for improved disclosure by European banks. The publication of the results of the ongoing stress tests and the extension of stress tests to many more banks by the Committee of European Banking Supervisors is a very important step. At the same time, bank-by-bank disclosures of the stress test results at the national level will need to be complemented by a plan that specifies how capital-deficient

institutions would be handled. Bank reporting and disclosure standards, in general, need to be improved, particularly for banks that are not publicly traded and for those not producing quarterly reports.

- Implement credible solutions to deal with weak banks. These banks are exacerbating the current strains in funding markets, and a more comprehensive mechanism for resolving, restructuring, or recapitalizing institutions is needed. For this purpose, existing or new public mechanisms at the national level should be activated without delay. Where needed, supranational arrangements should be applied to address banking problems.

Forceful pursuit of the above policy measures will be necessary to underpin market confidence, reduce concerns regarding sovereign debt and banking system health, and support the euro area economic recovery.

Equally important is for policymakers to avoid policy missteps. Uncoordinated and one-off measures to halt trading in certain markets only serve to move risks to other markets or jurisdictions and increase uncertainty about what types of measures are coming next.

Elsewhere in many advanced economies the emphasis should be on underpinning medium-term fiscal consolidation. As discussed in the July 2010 World Economic Outlook Update, credible strategies to lower fiscal deficits over the medium and long run are of utmost importance. These countries also need to

simultaneously put forth structural policies raise potential economic growth so as to ease the pressures for consolidation and deal with age-related entitlement spending. Similarly, backstops provided by central banks, including quantitative easing or explicit support for credit and bond markets, will continue to be necessary for the time being.

With the decline of capital inflows, emerging market countries face the uncertainty of whether the instability in the euro area causes investors to broadly pull back from foreign markets, or whether flows to emerging markets will resume as investors look for alternatives to more volatile advanced country markets. These countries are faced with the likelihood of greater volatility around an upward trend in their capital inflows. They thus need to augment their macroeconomic and prudential policies to reduce their vulnerability to a sudden stop or an excessive buildup of credit or asset prices. In addition to sound macroeconomic policies and well-defined prudential policies, structural measures aimed at developing financial systems in emerging market countries are also important. Improvements in financial infrastructure can help provide resilience in the face of volatile flows.

Regulatory reform efforts aimed at making the global financial system safer need to continue in an expeditious fashion. The basics of such reforms—to the quality and quantity of capital and more liquidity—need to be finalized and an appropriate timetable for implementation established. The current level of uncertainty surrounding the final set of reforms is making it difficult for banks to take business decisions about various activities and constraining their willingness to lend. Greater clarity on the



details and timing of intended regulatory reforms is thus required. Moreover, the implementation schedule will need to take into account the current health of the financial institutions and the status of the economic recovery to support trend growth and enhance stability. A crucial complement to regulatory reform is strong supervision. This applies in the steady state, but even more so during the transition period when there may be variances in the implementation of the new rules between jurisdictions. Adherence to strong supervisory principles can help contain the risk of regulatory arbitrage.

In sum, recent global stability gains are threatened by a confluence of sovereign and banking risks in the euro area that, without continued and concerted attention, could spill over to other regions. Rapid implementation of the important and appropriate decisions taken by the euro area governmental authorities will be a key component in calming financial markets. Further credible and swift action is needed to stabilize financial institutions. Consolidation of financial stability will be important to keep the economic recovery on track.