

## Press Points for Chapter 1: *Resolving the Crisis Legacy and Meeting New Challenges to Financial Stability*

Global Financial Stability Report (GFSR), April 2010

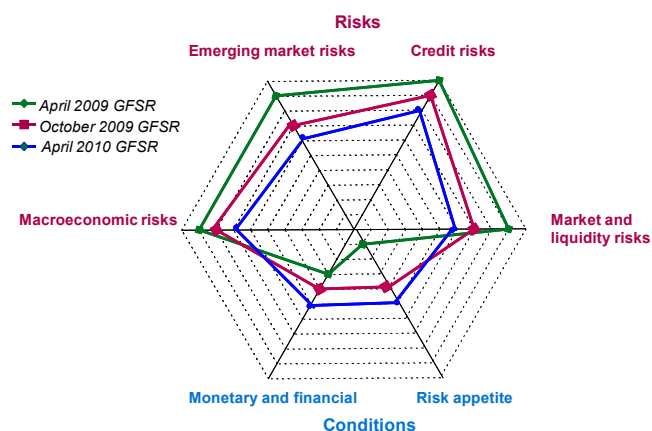
### Key messages

- The health of the global financial system has improved as the economic recovery has gained steam, but stability risks remain elevated.
- Advanced country sovereign risks could undermine stability gains and take the credit crisis into a new phase.
- Policies are needed: to reduce sovereign risks through well designed fiscal consolidation strategies; and to clean up the crisis legacy and facilitate a smooth deleveraging process by ensuring that a core of healthy, viable banks is able to support credit.
- Looking ahead, we need to decisively move forward the regulatory agenda and complete the transition to a safer, more resilient and dynamic global financial system.

The health of the global financial system has improved since the October 2009 GFSR, as the economic recovery takes hold (Figure 1). However, stability risks remain elevated due to the still-fragile nature of the recovery and the ongoing repair of balance sheets.

**Advanced country sovereign risks could undermine stability gains and take the credit crisis into a new phase.** With markets less willing to support leverage—be it on bank or sovereign balance sheets—and with liquidity being withdrawn as part of policy exits, new financial stability risks have surfaced. Initially, sovereign credit risk premiums increased substantially in the major economies most hit by the crisis. More recently, spreads have widened in some highly indebted economies with underlying vulnerabilities, as longer-run fiscal sustainability concerns have telescoped into strains in sovereign funding markets that could have cross border spillovers (Figure 2). The subsequent transmission of sovereign risks to banking systems and feedback through the economy could undermine financial stability.

Figure 1. Global Financial Stability Map

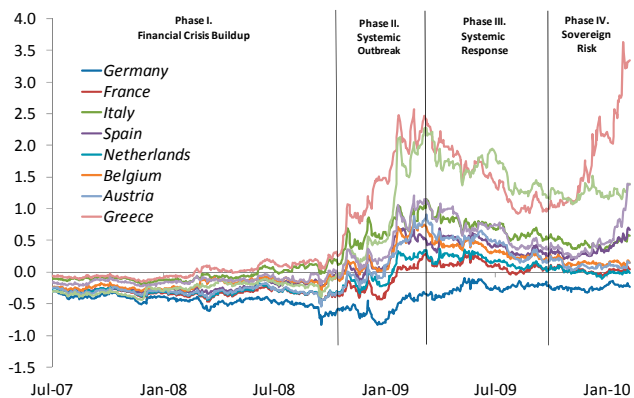


Source: IMF staff estimates.

Note: Closer to center signifies less risk, tighter monetary and financial conditions, or reduced risk appetite.

Figure 2. The Four Stages of the Crisis

(Ten-year sovereign swap spreads, in percent)



Source: Bloomberg L.P.

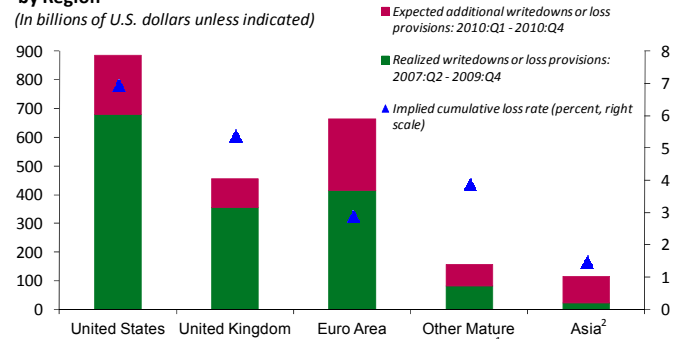
## The global banking system is coping with legacy problems and further challenges from the deleveraging process.

Improving economic and financial market conditions have reduced banks' expected writedowns—from \$2.8 trillion to \$2.3 trillion—and bank capital positions have improved substantially (Figure 3). But some segments of country banking systems remain poorly capitalized and still face significant downside risks. Slow progress on addressing weak banks could complicate policy exits from extraordinary support measures. The failure to deal decisively with weak institutions could act as a deadweight on growth. Banks must reassess business models, raise further capital, de-risk balance sheets and stabilize funding (Figure 4).

**The credit recovery will be slow, shallow, and uneven** as banks continue to repair balance sheets. Notwithstanding the weak recovery in private credit demand, ballooning sovereign needs may bump up against limited credit supply. Policy measures to address credit capacity constraints, along with the management of fiscal risks, should help to relieve pressures on the supply and demand for credit.

**The multi-speed global recovery poses stability challenges for emerging markets.** Prospects for strong growth, appreciating currencies, and rising asset prices are pulling portfolio capital flows into Asia Pacific (ex-Japan) and Latin American countries, while push factors—particularly low interest rates in major advanced economies—are also key. As yet, there is only limited evidence of stretched asset valuations across countries—with the exception of some hot spots in local markets. However, current conditions of high external and domestic liquidity and strong credit growth have the potential to stoke inflation and give rise to bubbles over a multi-year horizon (Figure 5). Policymakers have responded to rising capital flows, but continued vigilance is needed to ensure continued financial stability.

**Figure 3. Realized and Expected Writedowns or Loss Provisions for Banks by Region**  
(In billions of U.S. dollars unless indicated)

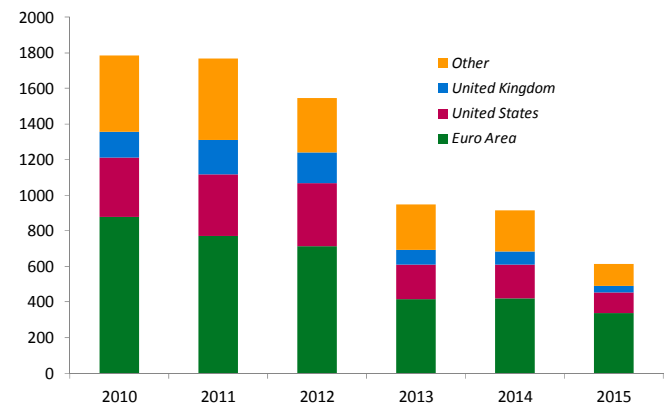


Source: IMF staff estimates.

<sup>1</sup>Includes Denmark, Iceland, Norway, Sweden, and Switzerland.

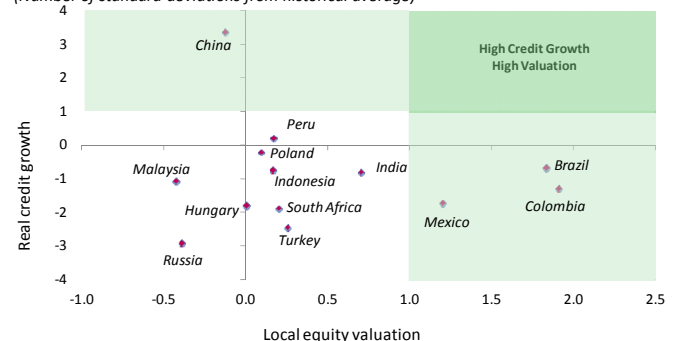
<sup>2</sup>Includes Australia, Hong Kong SAR, Japan, New Zealand, and Singapore.

**Figure 4. Bank Debt Rollover by Maturity Date**  
(In billions of U.S. dollars)



Source: Moody's.

**Figure 5. Real Domestic Credit Growth and Equity Valuation**  
(Number of standard deviations from historical average)



Sources: IMF, International Financial Statistics database; and IMF staff estimates.

**To maintain the momentum in the reduction of systemic risks, further action is required of policymakers in several key areas.** Careful management of sovereign risks is essential.

Governments need to design credible medium term fiscal consolidation plans in order to curb rising debt burdens and avoid taking the credit crisis into a new phase. Policymakers need to ensure that the next stage of the deleveraging process unfolds smoothly. Swift resolution of nonviable institutions and restructuring of weak institutions with a commercial future is vital to enable a permanent exit from extraordinary policy support and to ensure that a healthy core of viable financial institutions is able to support credit.

**Looking further ahead, regulatory reforms need to move forward expeditiously, but be introduced in a manner that accounts for the current economic and financial conditions.**

Continuing to strengthen the banking sector's capital base will help prepare the financial system for changes to the capital adequacy framework. Greater clarity is needed in defining the new financial system framework to give banks more certainty over their future business models. Addressing the issue of "too-important-to-fail" institutions is critical for restoring market discipline and insulating sovereign balance sheets.