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INTERNATIONAL MONETARY FUND  
Minutes of Executive Board Meeting 11/88-2  
2:30 p.m., August 31, 2011

**2. Global Financial Stability Report**

Documents: SM/11/213; SM/11/227 and Correction 1

Staff: Viñals, Brockmeijer, Sheehy, Dattels and Kodres, MCM

Length: 2 hours, 45 minutes

## Executive Board Attendance

J. Lipsky, Acting Chair

### Executive Directors

C. Legg (AU)  
W. Kiekens (BE)  
P. Nogueira Batista, Jr. (BR)  
J. He (CC)

A. Fayolle (FF)  
H. Temmeyer (GR)  
A. Virmani (IN)  
A. Sadun (IT)  
M. Furusawa (JA)  
J. Mojarrad (MD)  
A. S. Shaalan (MI)  
A. Bakker (NE)  
B. Andersen (NO)  
A. Mozhin (RU)

M. Lundsager (UA)  
A. Gibbs (UK)

### Alternate Executive Directors

M. Saho (AE)  
N. Yambaye (AF)  
P. Garcia-Silva (AG)

M. Arbelaez (BR)

C. Balsa (CE), Temporary  
M. O'Dea (CO)

S. Meyer (GR)

T. Shimoda (JA)  
M. Daïri (MD)  
S. Geadah (MI)

A. Al Nassar (SA)  
A. Budiman (ST)  
K. Zajdel-Kurowska (SZ)  
D. Rediker (UA)  
R. Elder (UK)

J. Lin, Acting Secretary

I. Teodoru/P. Walker, Assistants

### Also Present

European Central Bank: W. Coussens, G. Pineau. Asia and Pacific Department: V. Arora, R. Cardarelli, M. Pradhan. European Department: A. Chopra. External Relations Department: T. Callen, N. Laframboise. Fiscal Affairs Department: P. Gerson, M. Guerguil, A. Schaechter. Finance Department: T. Krueger, A. Tweedie. Middle East and Central Asia Department: R. Sahay, G. Sensenbrenner. Monetary and Capital Markets Department: S. Antoshin, J. Brockmeijer, K. Chikada, P. Dattels, J. Fiechter, S. Iorgova, W. Kerry, L. Kodres, S. Mitra, S. Oppers, R. Sheehy, W. Walker, J. Viñals. Research Department: O. Blanchard, R. Duttagupta, J. Felman, P. Koeva Brooks. Secretary's Department: L. Bonato, P. Martin. Strategy, Policy, and Review Department: A. Maechler, R. Moghadam. Senior Advisors to Executive Directors: W. Abdelati (MI), M. Choueiri (MI), N. Des Vignes (BR), K. Eapen (IN), A. Holler (GR), L. Hunter (AU), A. Ismael (AF), M. Jakoby (BE), K. Korhonen (NO), E. Meyer (UA), M. Patra (IN), J. Poulain (FF), M. Sidi Bouna (AF),

F. Spadafora (IT), K. Todani (AE), A. Tolstikov (RU), P. Yeo (ST). Advisors to Executive Directors: J. Szeto (CC), E. Aparici (CE), M. Atamanchuk (RU), K. Beaton (CO), C. Becker (AU), J. Cardoso (IT), Q. Chen (CC), J. Cova (CE), O. Diakite (AF), P. Garcia-Martinez (FF), M. Goldby (UK), A. Jbili (MD), S. Keshava (SA), V. Khramov (RU), A. Kitamura (JA), M. Kollar (BE), W. Lindquist (UA), T. Manchev (NE), P. McGoldrick (CO), R. Mosch (NE), R. Ngugi (AE), M. Sajkunovic (CO), S. Thamnuvong (ST), D. Vogel (AG).

## 2. GLOBAL FINANCIAL STABILITY REPORT

Mr. Saho submitted the following statement:

The risks to global financial stability have disappointingly increased over the past few months, signaling a reversal of the improvement that was noted in the April 2011 Global Financial Stability Report (GFSR). In many advanced economies, balance sheet repair remains incomplete and so does the financial reform agenda. We note that these developments in global financial stability and the reasons thereof have already been identified in the GFSR Market Update of June 2011. We broadly agree with the analysis and highlight the following issues:

### Weaker Growth Prospects and Politics

Weaker growth prospects and rising financing costs have heightened the challenges of coping with high levels of debt in advanced economies thereby increasing the risks related to debt sustainability. We agree with staff that fiscal and monetary policies have limited room for boosting growth. Unfortunately, as the GFSR noted, the political developments especially in Europe and the United States are exacerbating the already tenuous situation. A lasting solution continues to elude Europe due to political tension between those seeking support and those providing it. At the same time the political landscape in the United States, which has already witnessed a down grade of the country's sovereign credit rating by one of the rating agencies, is an obvious impediment to the resolution of growth and debt problems. Now, more than ever, global economic policy makers need to muster the political will to take the painful decisions that will constructively address the problems of the global economy.

### Policy Dilemma

Weak aggregate demand and relatively low inflation rates in advanced economies suggest that loose monetary policy is appropriate. However, low interest rates for long periods in an environment of incomplete balance sheet repair may be generating a "search for yield." This may give rise to deterioration in asset quality which in turn increases systemic risks. We agree with staff that perhaps the best that could be done is to continue repairing the balance sheets backed up by appropriate macroprudential interventions. At the same time however, macroprudential interventions may also have macroeconomic spillovers by dampening the stimulus effect of loose monetary policy. If overly stringent, macroprudential policies may unduly

restrict the availability of credit, thereby retarding economic recovery—an outcome that is not desirable with high unemployment in so many economies. Therefore we would like to underscore the need for the conduct of macroprudential and monetary policy to be closely coordinated and monitored to guard against spillovers.

### Emerging Markets

We note that risks in emerging market economies have also increased primarily owing to rapid credit growth, balance sheet releveraging and rising asset prices that may lead to deterioration in asset quality as the credit market matures. In addition, inflationary pressures in some emerging economies are building up and some central banks have already begun to tighten policy rates. Higher policy rates may provide additional impetus to the already high level of capital flows to these countries thereby increasing the risk of sudden stops. As the advanced economies growth gain momentum, investors' portfolio reallocations may necessitate capital flight away from emerging markets, implying that while emerging markets are playing a pivotal role in generating global growth now, they may also become a drag on global growth going forward, if sudden stops materialize. In this regard we request staff to provide some indication of what the probability might be for sudden stops in emerging markets?

### Global Asset Allocation

We welcome the analysis in Chapter Two regarding long-term asset allocation of investors. The results confirm what is already in the public domain, i.e., growth prospects play a significant role in attracting investments. We agree with staff that this underscores the significance of growth enhancing and macro prudential policies. While we appreciate the focus on long term flows, short term flows are likely to be more susceptible to sudden stops, and thus equally important. We therefore urge staff to also consider the analysis of the determinants of short-term flows.

Additionally, staff mentions that “because balance sheet repair has been incomplete, the ‘search for yield’ is pushing some segments to become more leveraged” (paragraph 3, Executive Summary, page 7). This did not seem consistent with the finding in Chapter Two, (paragraph 55, page 44) which says “the low interest rate investment in advanced economies...has not yet pushed investors into riskier investments to enhance yield.”

The staff's clarification is welcome.

## Financial and Real Sector

We also welcome the analysis, in Chapter Three, of the interplay between the financial sector and the real economy as well as the attempt to find good candidate variables that form the basis of the early warning exercise indicators. We broadly agree with the thrust of the analysis, and in particular that credit aggregates are useful indicators of the build-up to crisis but not to the exclusion of other supplementary indicators.

## Policy Proposals

As discussed in the GFSR, financial stability requires addressing underlying vulnerabilities, mitigating the risks of contagion and spillovers and completing the financial reform agenda. As we pointed out in our April 2011 gray, and also highlighted in some other grays then, these policy proposals are not new. Therefore the problem is either on the efficacy of these policies or the implementation thereof and thus going forward, emphasis should be placed on the analysis of effectiveness and / or the challenges of implementation of these policies.

Mr. Garcia-Silva, Mr. Hendrick and Mr. Maciel submitted the following statement:

We welcome the staff's candid approach on the current political risks and crisis legacies and we support their call to policy makers for strong policy action in advanced economies. We fully share the staff's views that risks to financial stability have increased dramatically over the last few months, and that time is running out to address the vulnerabilities and obstacles to the global economic recovery. In particular, the markets will need to recover their confidence in the advanced economies' ability to deliver on the long-delayed medium-term fiscal reforms in the United States, Japan and in key countries in the euro area. We agree with the staff that reducing sovereign risks and preventing contagion is a priority, but the efforts to strengthen the financial system have not been enough yet. The magnitude of the problem is illustrated by the staff's estimate that if mark-to-market losses were to materialize, the broad direct impact of euro zone sovereign stress on EU banks would be about 25 percent of equity capital. This is a compelling fact that calls for prompt action by policy makers.

The staff's assessment that low policy rates may lead to long-term financial stability risks should be qualified and conditioned on the lack of proper macro prudential responses. Indeed, concerns that "the solution to the

current crisis is the seed of the future crisis” can be overblown, as the key current risk is lackluster output growth and credit risk, to which supportive monetary policy should be the first line of defense. The mirror situation occurs in emerging markets, where capital inflows and booming demand present policy challenges. However, a less-stringent-than-warranted monetary stance by macroeconomic circumstances should not be the policy prescription.

We thank the staff for broadening the stress test exercises to the banking systems in emerging economies. Under the current circumstances, the most damaging spillover from financial tensions in major financial centers would occur if local banking systems are affected. Having said that, we do not share the staff’s view that a 6 percent hit on the capital of banks in emerging economies is a “substantial effect.” On the contrary, given the materially large magnitude of the shocks, this represents a manageable scenario, which would leave capitalization levels still significantly above prudential limits. The staff’s further elaboration on their pessimistic assessment of the stress tests for emerging markets vs. those of the United States and Europe would be appreciated.

The finding that private asset allocation is driven most strongly by positive growth prospects and falling risks in the recipient countries with a lesser role for interest rate differentials has very important policy implications. To the extent that emerging-market economies maintain sound economic policies and a market-friendly environment, they will capitalize on the sustained trend of globalization of portfolios. This factor, combined with policies oriented to sustained economic growth, should maintain the flow of long-term capital inflows to their economies. By the same token, advanced economies will need to pay more attention to their economic recovery and growth prospects. Further deterioration of economic conditions in advanced economies could accelerate the structural trend of investing in emerging-market assets. In the short term, there is a risk that even capital flows with long-term maturity could distort money markets and liquidity management.

The staff’s view that international reserves holdings for many countries exceed that needed for balance of payments or monetary purposes should be qualified. The traditional “benchmarks” to measure adequacy of official reserves were outdated before the recent global crisis, and although quite some discussion has occurred on the “optimum level of official reserves,” there is no agreement on what that level would be. Moreover, country-specific circumstances are also important, as well as the role of the

strong external position on playing a crucial role during the crisis by providing liquidity in FX and confidence to markets.

We have some concerns on the finding that investors with longer horizons appear to have become very sensitive to liquidity risks, rejecting their traditional role of providing market liquidity. Recently, in the last review of the Stand-By Arrangement for Iceland, we discussed the absence of the pension funds in the “second-leg” of the auction. It was a surprise that pension funds would prefer to hold FX denominated assets instead of changing their portfolio with domestic currency denominated assets, with higher returns, and medium-term maturity. More surprisingly, if we consider that, by definition, the pension funds have liability in domestic currency in the long term. This could be explained if the assets were risky, which is also an argument discussed in Chapter 2 but, in principle, this was not the case in Iceland. What are the policy implications if this behavior spreads across countries and pension funds? The staff’s comments would be appreciated.

We welcome the staff’s analysis on macro prudential policies presented in Chapter 3. The empirical evidence, coupled with the theoretical macro financial model presented, go a significant way towards clarifying the practical aspects of macro prudential policies. Indeed, more often than not the discussion on these policies has been stuck in conceptual and broad generalizations. The structural model presented by the staff is quite complete since it also provides the elements to recognize the nature of shocks to avoid, for instance, excessive use of policy brakes when the outcome of the shock is a healthy expansion, not the creation of economic imbalances.

We broadly agree with the staff’s practical guidelines for operationalizing macro prudential policies but further work is needed, in particular with regard to cross-border implications. Whereas the Fund has tackled these implications within the discussions on capital account policies, it has not so far developed a view on these same concerns related to macro prudential policies. However, for small open economies, capital account policies and macro prudential policies are close relatives, and thus policymakers face similar tradeoffs when deciding how to implement them as complements to standard macroeconomic tools. The staff’s views on how to properly coordinate macro prudential policies across countries would be welcome.



Mr. Al Nassar submitted the following statement:

I thank staff for a thoughtful Global Financial Stability Report (GFSR) on recent global financial market developments, outlook, and policy priorities ahead. It is discouraging to note that risks to global financial stability have increased over the past few months amidst an economic slowdown. This is in contrast to the assessment at the time of the April 2011 GFSR when financial stability was seen as improving in the backdrop of a global economic recovery. The reversal in progress toward financial stability has been due to a number of shocks in recent months, including new market turbulence coming from the euro area periphery. Indeed, the Global Financial Stability Map shows that all risks indicators have increased for the first time since October 2008. Overall macroeconomic risks have increased, reflecting a significant rise in sovereign vulnerabilities in some advanced economies. Market and credit risks have risen with spillovers of sovereign stress to banking systems. While a stronger rebound in emerging market economies reflects solid fundamentals and robust growth prospects, the increase in risks in some of these economies since the April 2011 GFSR is a matter of concern and would warrant close attention.

Against this background, the report has identified a number of policy priorities to address the vulnerabilities and risks. In some advanced economies, the main financial stability risks come from high debt burdens and sharply higher funding needs in the backdrop of weak growth outlook, deteriorating market sentiment, and weak sovereign balance sheets. In the euro area sovereign bond markets, spreads have climbed to record levels in many countries. In particular, recent developments in Spain and Italy have been a major concern given the size of their government bond markets and their funding needs. As staff notes, these risks have become key drivers of market conditions, increasing the potential for spillovers across different asset markets. The worrisome developments about the stability of the investor base in some euro area countries have also been highlighted in the report. Indeed, for program euro area countries, the shrinking of the investor base has been a significant factor in the eventual cutoff from funding markets. To enhance the crisis management framework of the euro area, the recent euro area Summit and subsequent announcements by the ECB are welcome developments. Notably, the action taken by the ECB to extend its Securities Markets Program to Spanish and Italian government bond markets has been timely to help relieve market stress, stabilize markets, and lower funding costs. Sovereign balance sheets also remain fragile in several other advanced economies, including Japan and the United States, which face significant fiscal challenges. Overall, to mitigate sovereign risks, the priority in the period

ahead is to implement credible medium-term fiscal adjustment plans based on conservative revenue and growth assumptions, and on full accounting of unfunded and contingent liabilities.

In Europe, despite some improvements in balance sheets of banks, confidence in the stability of the banking system has not yet been restored and banks continue to face considerable strains. Indeed, I note that banks in Europe continue to face funding challenges, and some banks in peripheral countries with little or no access to wholesale funding markets remain heavily dependent on the ECB for liquidity support. Furthermore, many banks are vulnerable to a possible further tightening in funding conditions and spillovers from sovereign risks. In this regard, I welcome staff analytical work on spillovers using a mark-to-market framework as an indicator of banks' access to private funding markets. While the framework is not intended to be a measure of bank solvency or capital needs, it is a useful complement to traditional stress tests. In this connection, I welcome the recent stress tests conducted by the European Banking Authority and note staff conclusion that "they have not forced the decisive recapitalization or restructuring that is needed for the banking sector (with some notable country-level exceptions)." Therefore, credible measures are needed to strengthen the resilience of the financial system in Europe. Here, I agree with staff that banks need to continue to build their capital buffers to ensure creditor and depositor confidence, mitigate deleveraging pressures, and sustain credit to the real economy. To this end, it is appropriate to suggest that additional capital needs should be covered from private sources wherever possible, but this might be difficult in current market conditions in some cases. In those circumstances, public recapitalization may be necessary and appropriate. In this regard, mobilizing funding from the European Financial Stability Facility to recapitalize banks would help mitigate pressures on vulnerable sovereigns.

As regards net capital flows to emerging market economies, these inflows remained relatively strong during the first half of 2011 in view of brighter growth prospects and stronger fundamentals in emerging market economies, combined with low interest rates in advanced economies. However, I note that these inflows have not been excessively strong by historical standards. At the same time, it is important for policymakers to remain vigilant against overheating and a buildup of financial imbalances, as underscored by staff. However, it should be emphasized that macroeconomic policies in the wake of increased capital inflows would remain varied, complemented with appropriate macroprudential tools and use of capital controls, depending on individual country circumstances. Specifically, the focus should be on addressing specific risks associated with certain type of

capital inflows, especially their impact of certain asset markets or their short-term nature, while encouraging more stable, long-term, and productive capital flows, and guarding against sharp sudden reversals of investment flows.

I welcome the analysis in Chapter 2 on the forces driving global asset allocation by institutional investors. It has been suggested that, for both flows into equities and bonds, investors are focused mostly on growth potential when choosing investment destination countries, although country risk has a clear negative effect. In this regard, it is essential for recipient countries to monitor these flows closely to guard against asset price bubbles and credit booms, and to enhance the resilience of their financial systems.

Finally, Chapter 3 provides a useful contribution to the ongoing discussion on the design and operation of macroprudential frameworks. While it is essential to identify appropriate set of variables on which to base early warning indicators for systemic events, it has appropriately been recognized that attention to country specific circumstances would be important to consider.

Mr. He and Ms. Szeto submitted the following statement:

The GFSR's message is clear: all the risk indicators have increased and the crisis has entered a political phase. The window of opportunity open for policy action is narrowing, and the room for policy maneuvers is shrinking. As the crisis entered its fifth year, we agree that political will and courage is now vital if we are to resolve the crisis. Political commitment is necessary to tackle the deep-rooted issues that have led us to the crisis in the first place and have continued to threaten global financial stability. Without appropriate and decisive action, the message from the next GFSR would be more alarming. What is most urgently needed for breaking the negative feedback loop is to have a clear and credible political strategy to put a brake to the worsening of public and financial sector balance sheets, with a greater focus on the former for the United States and Japan, and on the latter for much of Europe.

While many different factors contribute to the recent round of market volatility and heightened financial instability, it is the persistence of political uncertainty and a misplaced policy focus that has especially undermined market confidence. The crisis has evolved to a stage where an increasingly larger share of our system is now subject to macroeconomic and financial stability risks: both public and private sector debt levels are climbing; major

advanced economies such as the United States, a number of euro area economies, and Japan are all facing debt sustainability issues; close to half of the euro area economies are experiencing financing pressures to various extents; and as advanced economies run the risk of stagflation, emerging market economies are faced with inflation and overheating risks. We welcome the analysis on the interplay between sovereign and banking sector risks in the euro area and would appreciate staff comments on the risk of a severe tightening of credit conditions in the euro area.

Since the onset of the crisis, other than efforts to safeguard their banking systems, crisis-hit advanced economies have mainly focused their policies on countering cyclical weaknesses, such as on preserving consumption and investment demand with fiscal stimulus and monetary accommodation. While these countercyclical policies might have helped provide short-term relief, the recent turn of events suggests that they are far from being sufficient. For instance, notwithstanding high corporate profitability and cashholding, the exceptionally loose monetary conditions did not seem to have been translated into investment spending or meaningful employment growth. Meanwhile, we are seeing early signs that prolonged low interest rates and large liquidity injections could be leading to longer-term financial stability risks. In any case, these countercyclical policies may soon outlive their usefulness and the capacity for further fiscal stimulus and monetary easing is limited.

As the crisis lingers and market tensions increase, the last straw that will break the camel's back is for the policymakers to allow what little confidence left to go down the drain. The key to resolving the crisis is to address the long-standing structural issues that have brought about the crisis in the first place. These are the real legacy issues, and not only the ones that surfaced during the global financial crisis, such as balance sheet difficulties. As we have emphasized before, advanced economies with debt sustainability concerns would need to establish a credible medium-term fiscal consolidation strategy that would restore a sustainable fiscal path. Such a strategy should seek to tackle the core of the issue, such as entitlement programs in the United States. Also, some economies may need to enhance their competitiveness to help increase public revenues and, more broadly, to boost their longer-term growth potential.

It is only by providing clarity and credibility about medium-term prospects that crisis-affected countries can bolster the confidence of corporates to invigorate private investment and create employment, which, in turn, would help break the negative feedback loop between poor public and

financial sector balance sheets, weak private investment, high unemployment, declining house prices, and depressed private consumption. It is only then that the economies can resume their growth momentum. And it is only with economic growth that public sector debt ratios can come down in a sustained manner. We wish to call on the crisis-affected advanced economies to build the political commitment needed to implement credible structural reforms and restore confidence in medium-term prospects. We note that while the growth projections of some crisis-affected advanced economies have been revised downward in the WEO, the projections assumed medium-term fiscal consolidation, and if these are not implemented, the growth projections for 2012 could yet be revised down further. Also, as both the public sector and banks are facing large financing needs, and with risk aversion remaining elevated, there is a risk that funding costs could be brought up. The staff's comments are welcome.

We note the staff assessment that emerging market credit risk is being “exported” to international investors as domestic regulators have tightened prudential regulations (page 52). There are, in fact, both push and pull factors driving such developments, and the ability of emerging market corporates to attract international investors at a time of market uncertainty suggests that they are offering a favorable rate of return relative to the level of credit risk, and probably also diversification benefits. We would welcome staff comments on the share of such debt issuance in international markets and if such exposures justify a systemic concern.

Mr. Gibbs and Mr. Goldby submitted the following statement:

We thank staff for a good WEO and GFSR. We broadly share and welcome the main messages and policy recommendations in these two surveillance pieces. We have some views about the fiscal and financial sector policy advice which we set out below, along with some comments on the individual chapters, in this joint statement on the two products.

#### Fiscal Policy

We agree that the key fiscal priority for major advanced economies is to implement credible and well-paced medium-term consolidation plans focused on long-term debt sustainability. The staff argues that crisis-hit countries should ideally implement such reforms that ‘create policy room for more growth-supportive policies in the short run’ (page 6). But it is less clear what this means in practice for different countries, because as the GFSR acknowledges, ‘strained public finances force policymakers to exercise

particular care in the use of fiscal expansion to boost growth.’ Reading the draft WEO, it is not always clear at different points in the text which countries are being referred to as able to “consolidate at a slower pace” (for example, page 100).

As the Managing Director said in her speech at Jackson Hole, fiscal policy “must navigate between the twin perils of losing credibility and undercutting recovery.” The point we would stress in this context is that fiscal credibility is hard won and can be easily lost. It may be harder for countries with high or rapidly increasing levels of debt to earn credibility if their consolidation is deferred too much into the future. And in countries where credibility has been won by plans that are now being implemented, it would be very risky indeed to depart from them. So policymakers in crisis-hit countries need to err on the side of caution and sustain the credibility of their medium-term consolidation plans by demonstrating that they are being delivered.

In addition, assessing when and to what extent a medium-term fiscal plan will create near term ‘policy room’ for new supportive measures seems to us to be fraught with difficulty, given how hard it is to judge ex ante how financial markets will react. Where fiscal consolidation rests on expenditure-based measures, there will be less scope for fine tuning from year to year given the importance of setting spending budgets in advance.

#### Financial Sector Policy

The GFSR rightly highlights the need for standard setting bodies to agree new regulations as soon as possible. However, we note that there is no mention of the Basel Committee’s agreement on the need for a long transition path to higher capital standards, and we think this point merits inclusion. Given the weakness of credit growth in many countries which may well be holding back economic recovery, there may be dangers inherent in advising banks and regulators to ‘front-run’ the transition to new standards. Our view is that having a long transition path to new regulatory standards is sensible.

In Box 1.6 on regulatory reform and SIFIs, we thought the point that Basel III is an internationally agreed minimum level for prudential standards should be emphasized. The Basel III agreement does not preclude national authorities from exceeding those standards if justified by the needs of financial stability.

## Global Macroeconomic Outlook (Chapters 1 and 2 of the WEO)

We agree that the outlook for global activity has deteriorated since April, and that downside risks have increased. The staff rightly highlights two major threats to the recovery: an intensification of the crisis in the euro area, and further setbacks to the U.S. growth. There seems to have been a lot of news in macroeconomic data in recent weeks, and our sense was that this draft, understandably, had not quite caught up with events. We would welcome staff comment on how the draft Chapter 1 might be revised to take account of recent data outturns and asset price falls, together with their implications.

We welcome the call for continued efforts on rebalancing, and agree that there are a set of emerging economies that need significant currency appreciation alongside structural reforms to boost their contribution to global growth. It is concerning that staff projections suggest that consumption in emerging market economies will make a lower contribution to growth from 2011 through 2016 than they did before the crisis.

On a technical point, we note that in these forecasts that the discrepancy between the sum of global exports and global imports is assumed to increase quite sharply (Figure 1.20, top panel, page 39). Could staff comment on why this has been assumed, and whether the discrepancy makes it more difficult to assess the prospects for rebalancing and make policy suggestions?

The IMF is right to highlight the need for structural reforms everywhere to boost potential growth. Indeed, we think the WEO would have benefited from more material on these topics. We encourage the Fund to produce a comprehensive assessment of their view on how potential capacity has fared over the crisis, which could update the material in the Fall 2009 WEO. A future analytical chapter on this topic would also allow the Fund to expand on the good advice that they have been offering countries on structural reforms designed to boost potential growth in the context of Article IV consultations.

This WEO sets out a clear IMF line on spillovers from low policy rates in advanced economies (pages 42/43), drawing on the good analytical work presented in previous publications. Given the finding that the share of national factors explaining inflows into emerging market economies in the 2000s is around 70 percent, we wondered whether the conclusions of Box 1.2, which

finds that net capital inflows are the main explanatory factor behind credit booms, might need to be nuanced.

#### Outlook for Financial Stability (Chapter 1 of the GFSR)

The main message of the GFSR is that downside risks to financial stability have increased dramatically, and we would broadly agree with the risks and vulnerabilities that staff highlights.

We welcome analysis of sovereign vulnerabilities and contagion risks. We agree that if more vulnerable European banks raised more capital they would likely have better access to funding markets. We also think that improvements in disclosure of banks' exposure to, and accounting treatment of, sovereign debt holdings would enable market participants to better differentiate between strong and weak banks, and reduce the chance of indiscriminate contagion.

While the Fund is rightly tackling this topic, there are legitimate questions around the methodology used to estimate the impact of lower periphery government bond prices on European banks. It is important that when the IMF publishes striking numbers—in this case on the impact of marking periphery sovereign exposures to market—that the caveats to such uncertain estimates are suitably prominent, and not merely in footnotes. In addition, the IMF should compare their numbers to existing estimates and explain the differences and strengths and weaknesses of the different approaches. Experience with this sort of analysis has shown that a range of numbers is more likely to give a fair assessment than a point estimate.

The other main point we would make on Chapter 1 was that while considering the risks from low interest rates and the search for yield is entirely appropriate, the conclusion that risks are significant seems overdone. The suggestion is that some segments of advanced economies are becoming increasingly vulnerable and overleveraged. However, with the exception of the government sector, the high stock debt-to-GDP ratios (household, bank and corporate) highlighted in Table 1.1 were all built up prior to the cuts in interest rates that followed the recession; those ratios have generally fallen during the recovery, with low interest rates helping that process by supporting nominal GDP growth.

We thought that some of the text contained in the section from pages 42-61 would probably need to change to take on board recent developments. For example, we have seen very large flows out of emerging



market equity and debt funds in recent weeks, and we wondered if the balance of the text is tilted too much towards an overheating risk rather than the risk of a sudden stop in capital flows.

Finally, we would ask both the WEO and GFSR teams to pay particular attention to the risk that the recent financial turmoil spills over in to the real economy. Which channels are likely to be important? What are the best indicators of emerging problems? It is probably too soon to tell, but this will clearly be a key issue in coming months, and one that should be a clear focus of the forthcoming consolidated multilateral surveillance report.

#### WEO Analytical Chapters

The chapter on commodity price swings and monetary policy was clear and well written. We strongly agree with one of the headline messages that monetary policymakers should look through short-run volatility in inflation and try to understand where inflation might be heading in the medium term (underlying inflation in the language of the chapter). In the United Kingdom, inflation has been above the target for some time, in part reflecting commodity prices, but the MPC have judged that bringing inflation back to the target too quickly risks generating undesirable volatility in output and would increase the chances of undershooting the target in the medium term. That said, we would caution against using too mechanical a technique in estimating underlying inflation. The pass-through from commodity prices to headline inflation is not directly observable and may well vary over time. As a result, estimating underlying inflation requires considerable judgement, and this generates non-trivial challenges for communication. As ever the key is to ensure that inflation expectations remain anchored on the inflation target.

The chapter on how fiscal consolidation affects trade balances contained some interesting results. It also illustrates the painful aspects of external adjustment in countries where monetary policy and the exchange rate is constrained. Given the pertinence of these issues in some euro area countries with large external debts and deficits, we wondered whether the chapter might have included a little more on the types of additional policies that might be needed, in addition to fiscal consolidation, to improve current account balances.

#### GFSR Analytical Chapters

The main conclusion of the chapter on asset allocation is that interest rate differentials play a relatively minor role in asset allocation decisions by

real money investors, and that a country's macroeconomic fundamentals are more important. This is an interesting and potentially important insight. As the paper suggests, capital flows may be dominated by other investors, so it would be useful to extend this analysis in the future.

We welcome the chapter on macroprudential policies: there is some useful technical work in this chapter on various low and high frequency indicators that might help policymakers identify the build-up of risk. On the policy conclusions, we agree that the set of macroprudential tools can be relatively homogenous across countries, although we can envisage scenarios when a particular jurisdiction needs to make use of tools that have not yet been used by others. We also agree that the calibration of policy instruments will necessarily have to differ according to country-specific circumstances.

Mr. Bakker submitted the following statement:

We broadly share the views and policy recommendations in the report. Clearly, the current situation in global financial markets is dramatic and volatile, and hence both accurate diagnostics and clear messages on policy solutions are needed. This is an area where the Fund's surveillance is especially relevant. We welcome staff's high-quality analysis and frank policy discussions. We share the perception that the crisis is currently entering a phase, when broad political consensus for reforms is necessary.

## Chapter 1

The prolonged expansionary monetary policy in the major developed economies may have adverse effects on other economies. While some emerging markets and small developed economies are showing initial signs of overheating, free capital flows limit the extent to which these economies can adjust interest rates to resist it. As a result, financial and real assets in these economies—including exchange rates—may be overpriced. The two-speed recovery trend in the world economy is expected to persist according to the latest forecasts and exacerbate the problem. The findings in the case of Hong-Kong SAR, indicating that macro-prudential measures such as LTV's have only a transitory effect on residential property prices, imply that interest rate adjustment is a necessary condition for aligning asset prices.

We are concerned with the language in Section II of Chapter 1 about the potential mark-to-market losses of European banks on sovereign debt. We share the view that sovereign debt problem resolution is the main challenge in the euro area. Spillover effects on commercial banks need due consideration.

However, one-sided presentation may lead to misunderstanding and subsequent, unnecessary further deterioration in market confidence. We are not convinced that the methodology used and especially its underlying assumptions, on which the results heavily depend, provide us now with reliable results. Other stress tests have come to substantially different results. In this light, we are concerned about publication of the estimates of theoretical mark-to-market losses for European banks without giving a grant to the strong policy response by policy-makers.

We would welcome if some parts of the analysis would be made more specific and even-handed. We would be interested in an extended analysis on the impact of the U.S. downgrade, especially with regard to potential long-term contagion effects. The same holds for the analysis of the financial position of households, which are generally still able to fulfill their financial obligations.

The discussion of financial stability issues in emerging market economies is highly valuable, especially for the analytics of early warning indicators (Table 1.4, page 57) and credit market dynamics. Nonetheless, we note that some of the contagion risks that staff mentions may already be materializing in the current market stress. Recent equity fund outflows and exchange rate reversals in some important emerging market economies could either be a short-term correction or the start of more long-lasting reversals. We would appreciate if staff could elaborate more on the balance of risks due to such contagion to EMEs via the capital account.

The staff briefly mentions the potential vulnerabilities due to currency mismatches on the balance sheets of financial institutions and other economic actors (page 54 and 66). Recent experience in Europe suggests that foreign currency liabilities can be a major economic risk. We would appreciate more attention from staff on where such mismatches are currently building.

## Chapter 2

Institutional investors have become more conscious of liquidity and market risks and this may reduce their capacity to take on long-term risky assets. This seems negative for financial stability as it may move risks to other actors that are less capable of bearing them. However, as investment strategies of institutional investors are becoming more liability driven, this may also reduce sensitivity to large market shocks and hence the pressure to sell risky assets, whether for liquidity reasons or to limit downside exposures, and engage in a flight to quality. That would be positive for financial stability. On

the other hand, it raises the volatility of revenues and hence increases reinvestment risk. It would be interesting to assess the balance between these effects.

While staff considers some effects of Solvency II and Basel III implementation, one could also think of another potentially large negative effect on financial stability that is not mentioned in the chapter. In the implementation of Solvency II and Basel III in Europe, the standard model assigns a zero risk weight to certain government bonds for the calculation of capital requirements. This might induce strong pro-cyclical and thus destabilizing effects.

### Chapter 3

We welcome staff efforts to develop new approaches for identifying and monitoring financial imbalances and link these to macro-prudential instruments. As such tools are being developed in most countries, it is extremely important to have a good understanding of their effectiveness, because several practical issues underlined in the nature of DSGE model warrant further analysis. It remains very difficult to make real-time assessments of the stylized shocks. Moreover, according to the IMF study on organizing macroprudential policy framework earlier this year, not only the buildup of risks in the financial sector should be included, but also the possible feedback loops between the financial sector and the real economy, and international spillovers. That is why, the final results of the model simulations suggesting low importance of the underlying economic structure should be interpreted with a high degree of cautiousness.

Although the chapter provides evidence that macro-prudential instruments do mitigate vulnerabilities, we would be cautious with firm conclusions on the effectiveness of these tools. In the past, similar instruments have been abolished because they could be easily circumvented in a deregulated and integrated financial system. New instruments will again create strong incentives for regulatory arbitrage. As a follow-up to the useful work in this chapter, it is important to monitor closely how the financial system is responding to macro-prudential policies and to what extent that may undermine the effectiveness of macro-prudential tools.

Finally, we fully support various initiatives presented in this chapter to reduce data gaps and strengthening the monitoring process. We will be looking forward for the follow-ups regarding the implementation of these initiatives.

Mr. Mojarad and Mr. Jbili submitted the following statement:

We thank staff for the excellent set of papers, and appreciate the candid assessment and the hard-hitting policy messages, with which we broadly agree.

Risks have increased instead of abating.

Four years since the onset of the global financial crisis, and following considerable efforts to repair financial systems at enormous costs, the world economy is still facing serious financial sector vulnerabilities with potentially severe consequences. The report does a commendable job in bringing together the confluence of factors and developments explaining this precarious situation. It is clear that the problems that were left to fester in a few areas (household balance sheets and the housing market in the United States, sovereign debt and low bank capitalization in the euro area), run the risk of contaminating other sectors and other parts of the global economy. A reverse adverse feedback loop seems possible, going from sovereign debt problems to the financial system and the real sector, against the background of weak growth and high unemployment in advanced economies. With increased market volatility in connection with the worsening of the sovereign debt crisis in the euro area and following the rancorous U.S. debt ceiling negotiation and the subsequent rating downgrade, the risk of the global financial crisis gaining a new momentum has significantly increased.

We feel that concern about the U.S. sovereign risk is somewhat overstated. The S&P downgrade of the U.S. debt may have been more a reflection on the polarized political process during the debate on the debt ceiling than on the country's capacity to service its debt. This has been confirmed by market reaction, which has been in the opposite direction of what is normally expected following a rating downgrade. This being said, in light of their role in the sub-prime mortgage crisis and the recent decision, the need to properly regulate the rating agencies has come back to the fore.

We are pleased that this GFSR has taken up the issue of the search for yield stemming from prolonged low interest rates and tight credit spreads and their implications for credit risk and asset prices. Maintaining interest rates near zero in advanced economies for an extended period of time to sustain the recovery is likely to exacerbate these risks, especially by triggering large capital flows to emerging market economies, which are at an advanced phase

of the cycle, with attendant risks of overheating and subsequent sharp correction in credit growth and asset prices.

Policy action is urgently needed despite the limited options.

The report rightly notes that the range of available policy options is shrinking, particularly with regard to fiscal and monetary policy, and we support the message that “time is running out” to address these risks. While the policy priorities put forward seem sensible when considered separately on their own merit, it is less clear how they should be sequenced and coordinated across countries and sectors to generate a positive feedback loop and restore confidence. The Fund should send a strong message ahead of the forthcoming IMFC meeting that a coordinated approach in dealing with the legacy of the financial crisis and the new vulnerabilities and challenges is critical to avoid a new round of market turbulence.

We agree that policies in the United States and other advanced economies should give priority to accelerating the repair of household balance sheets, namely by addressing housing market weaknesses, encouraging banks to write down distressed mortgages, and expanding programs to assist the unemployed. We are puzzled by the little attention given to distressed homeowners in the United States when compared to total financial resources allocated to the banking sector and in support of the recovery, and would welcome staff indication on the volume of mortgages “under water” and the cumulative size of write-downs. Banks should be encouraged to extend more credit to job-creating SMEs, which they have failed to do in any meaningful way despite the sizable government bailout funds they received. The finding that the gap between small and large enterprises in access to bank credit since the onset of the crisis has increased significantly adds urgency to this message.

In the euro area, top priorities include making decisive progress in tackling the sovereign debt crisis and completing the repair of the banking sector through adequate capitalization, thereby preventing destabilizing debt dynamics and containing potentially severe contagion effects. We agree that the crisis management framework of the euro area has been enhanced, by allocating more resources to the EFSF and giving it powers to recapitalize banks and to buy back bonds in the secondary market, which would reduce yields and the risk of contagion. Market concerns about the adequacy of these measures and the timetable for their implementation have remained, however, and would need to be addressed to avoid further erosion of the sovereign investor base and high funding costs, with potential adverse effects on the

banking sector and the global economy. Moreover, uncertainty remains as to how long the ECB could continue its policy of purchasing sovereign bonds in the secondary market to bring down borrowing costs. The report rightly underscores the importance of recapitalizing or restructuring banks mainly by raising private capital and through public contribution if necessary, including from EFSF resources. We would appreciate staff further elaboration on measures to restrict specific activities, such as limits on short-selling of stocks.

With regard to fiscal consolidation, credible medium-term plans must be adopted, based on realistic revenue and expenditure projections, and should take into account growth and employment prospects. These plans, which should be announced well in advance, should be ambitious enough to anchor expectations about debt sustainability. However their implementation should be well-phased to avoid stifling the nascent recovery and to preserve credibility of medium-term growth and employment objectives.

In emerging markets, policies should aim at addressing the risks of overheating where needed, including by moderating credit growth and stemming the large volatile capital inflows. While progress has been made in these areas, more needs to be done to preserve price and financial sector stability, including where necessary through judicious use of capital controls and close monitoring of asset price developments. In this regard, we take note of the finding in Box 1-5 on the limits of macroprudential policies in containing rising property prices and the dominant effect of housing supply, drawing on the experience in Hong Kong. While Hong Kong circumstances may be very specific, there are lessons to be drawn for several over-populated and land-constrained metropolises. The staff's comments are welcome.

Accelerating ongoing work on financial regulation at the international level, and early and orderly implementation of agreed enhancements is crucial. This should involve strengthening capital and liquidity requirements, properly addressing the risks from large systemic financial institutions, and agreement on home/host regulators collaboration and cross-border bank regulation. We are disappointed by the slow progress in addressing the risks from the shadow banking system and call for more resolute action in this area.

#### Asset Allocation

Chapter 2 sheds light on the changes in asset allocation by long-term investors and the driving factors for asset management decisions. We note in particular the interesting change in institutional investors' behavior toward

taking less risk since the onset of the financial crisis, contrary to the prevailing perception that the search for yield in the current low interest rate environment would push investors to take on more risk. Equally important is the report's finding that acceleration of the long-term trend toward investing in emerging markets reflects better growth prospects and lower perceived risks in these countries rather than interest rate differentials. Would the latter imply that a rise in interest rates in advanced economies would not lead to large capital flow reversals in emerging markets, everything else being equal? Moreover, we wonder whether there is some inconsistency with the findings in Chapter 4 of the April 2011 WEO report that net flows to emerging markets rise during periods of low global interest rates and risk aversion and fall afterward. The staff's comments would be appreciated.

### Macroprudential policies

We welcome staff work toward developing operational analysis and tools for the use of macroprudential policies (Chapter 3). The indicators of buildup of financial stress, including thresholds of credit to GDP growth and other variables, are useful in identifying rising risks of financial crises while differentiating them from episodes of rapid credit growth driven by improved fundamentals. In this regard, we wonder whether expectations about the behavior of market participants in response to asset price rises and credit growth could be included in the model. Such expectations might contain useful information about future pro-cyclical behavior, or shift in sentiment toward risk taking. The staff's comments would be appreciated. Overall, even if we continue to believe that crises cannot be predicted, these tools should help policy makers become aware of looming risks and better inform policy response. We encourage staff to work closely with country authorities to build relevant indicators of financial stress and, where feasible, help develop country-specific models.

Mr. Shaalan and Ms. Choueiri submitted the following statement:

We thank staff for an excellent report which documents the dramatic increase in financial stability risks relative to the last GFSR. Our discussion last September drew attention to the risk of an adverse feedback loop between the financial system and the real economy, reflecting in part the slow progress in addressing legacy problems in the banking sector. This included completing financial regulatory reforms. The present report highlights the slow pace of economic recovery, which reduces the potential for further balance sheet repair in advanced countries, as well as the spillover of sovereign stress over to the banking sector. International cooperation and coordination remain



crucial to ensure effective policy implementation. As emphasized in our statement on the World Economic Outlook, the Fund provides a suitable forum to support such coordination in the interest of safeguarding global stability and prosperity.

In response to recent market developments, the ECB extended its Securities Markets Program and increased its term liquidity provision. At the same time, the Federal Reserve conditionally pledged to keep interest rates low and signaled a readiness to employ a range of tools—further quantitative easing is largely expected by markets. We appreciate the analysis of low policy rates—which staff considers necessary under current conditions—and the potential that they carry longer term financial stability risks. We would be grateful for staff’s views on the potential effectiveness and implications of the other measures mentioned above, particularly further quantitative easing.

European banks continue to face funding strains, reflecting the spillover of risks from the sovereign to the banking sector. The staff’s analysis points to the risk of further disruption to funding markets. This highlights the importance of policy measures to help banks access funding markets without central bank liquidity support. We concur with the measures suggested by staff in this regard (paragraph 11). It would be useful for the report to acknowledge, however, that containing sovereign risks by addressing the fiscal challenges facing governments requires considerable time to be implemented.

The staff indicates that deleveraging pressures risk pushing credit growth even lower than the current anemic rates witnessed in many high-spread euro-area countries. What is of particular concern in the United States and in Europe is the deepening divergence between small and large corporates in their capacity to access credit, as the sources of funding have shifted from banks to markets. The staff’s views on ways to enhance small and medium-sized enterprises’ access to credit would be appreciated.

We found staff’s analysis of credit cycles interesting. We agree with staff’s assessment that higher growth and stronger fundamentals, as well as low interest rates in advanced countries, have been attracting capital inflows. The staff considers that the resulting increase in domestic liquidity and credit could lead to overheating pressures, a gradual buildup of financial imbalances and deterioration in asset quality. We agree that some emerging market countries face the risk of sharp reversals, sudden capital outflows or a rise in funding costs. It would be useful to differentiate between country circumstances, and to take into account motivating factors among emerging

market economies. The report finds that banks' capital adequacy could be affected by up to 6 percentage points in an exceptionally severe scenario combining shocks on GDP growth, terms of trade, and funding costs. It would be useful to indicate in the Executive Summary the exceptional nature of the scenario and the simultaneous shocks it involves.

We take note of staff's finding in Chapter 3 that, among credit variables, annual growth of credit-to-GDP above 5 percentage points can signal increased risk of a financial crisis about two years in advance. We agree with staff that these indicators are far more effective if combined with other variables, as this allows for a better understanding of the underlying cause of the increase in credit. We appreciate the chapter's contribution to the ongoing work on designing and operationalizing macroprudential frameworks.

Mr. Kiekens, Mr. Jakoby, Mr. Kollar and Mr. Mevis submitted the following statement:

The decline of the global financial stability risks reported in the April 2011 WEO/GFSR and the recovery from the crisis were reversed dramatically in the second quarter. The outlook for all major parts of the global economy is deteriorating. The core advanced economies are not far from the double-dip recession. The key factor behind this deterioration is a general lack of confidence of investors and consumers, fuelled by the uncertainty about growth and policies in the major advanced economies. The economic and political uncertainties are reinforcing each other. Defusing this uncertainty is the key pre-condition for lifting the global economic prospects from the current dire straits.

The extent to which financial and real developments are intertwined has never been as clearly demonstrated as now. For this reason, we issue a single statement on the World Economic Outlook and the Global Financial Stability Report.

#### Uncertainty is Growing in the United States

In the United States, private investment is not picking up due to uncertainty about the economic recovery and fiscal policy. Household and financial balance sheets are still hurt by the excesses in the boom years. Repair and adjustments take time, especially for over-leveraged private-sector balance sheets. Increases in the savings rate and household deleveraging are on the way, but more time will be needed before investment and consumption accelerate. The long period of minimal saving in the United States before the

crisis caused the economy to drift far away from equilibrium. Decades of imbalances cannot be corrected overnight.

Artificial stimulation of consumption, particularly through a further unconventional monetary policy easing and wrongly-targeted fiscal stimulus in order to sustain the pre-crisis growth patterns, would be ill-sighted. Private savings need to be rebuilt to foster investments and restart economic growth.

Political uncertainty is slowing down entrepreneurial risk-taking in United States. Failure to come up with a medium-term fiscal consolidation framework by the U.S. authorities creates uncertainty regarding future tax patterns and discourages entrepreneurs to undertake substantial capacity enhancing investments. Unaddressed mortgage market legacies (GSEs, mortgage renegotiations at courts, etc.) and incomplete financial sector reform are adding to the general political uncertainty. The U.S. authorities also need to finalize the pending free-trade agreements with some countries in Asia and South America.

Political and economic uncertainty in the United States is also contributing to the corporate sector not taking on and banks not providing new credit. Moreover, banks feel pressure about changes in capital rules and hold on to capital instead of employing it to support new credit. With large amounts of toxic assets still on U.S. banks' balance sheets, employing capital for new credit growth seems not in the banks' interest.

With supply-side inflation picking up in the face of elevated unemployment, the United States is risking a prolonged period of stagflation. We do not believe that another round of quantitative easing will be effective or desirable in this situation. Given the abundance of dollar liquidity we do not share the staff's emphasis on the Fed's readiness to "deploy more unconventional support." The U.S. authorities need to ease the political uncertainty with a growth-friendly medium-term fiscal consolidation framework that also takes into account entitlement liabilities and the need for a more efficient taxation system. This will in turn, as staff points out, create additional fiscal space that could be used, if needed, for additional targeted growth-enhancing stimulus. Fiscal consolidation in the United States should be accompanied by pro-growth structural policies aiming at raising potential output.

## Uncertainty is Growing in the Europe

In Europe, political uncertainty is the dominant drag on economic recovery. The July 2011 commitment of the euro area authorities, which still must be implemented, will not be enough to resolve the sovereign crisis in euro area.

The determined policy actions should address underlying problems rather than symptoms such as market volatility. Any efforts to “stabilize” the markets through direct interventions without remedying the underlying ailments imply a delay of the full outbreak and dramatically increase the financial burden on the public balance sheets. An impression that Europe is “behind the curve” will ultimately contribute to a deterioration of the situation.

The recent EBA stress tests demonstrated progress in terms of transparency compared to previous exercises. However, they failed to restore confidence and many banks are facing difficult funding conditions. Many banks that successfully albeit with only a small margin passed the thresholds of the stress tests are viewed by financial markets as undercapitalized. .

At the current juncture, with meager growth prospects, increased risk aversion, and declining capacity in the public sector to support banks, it is no wonder that undercapitalized banks have more difficulties to get funding from private sources. In previous statements we have warned about weak banks trying to “muddle through” the crisis on cheap liquidity. This strategy is about to fail now. Much more thorough policy action is required to solve structural issues in the European banking sector.

Another cause for concern in this regard is the withdrawal of dollar funding from U.S. MMMF to European banks. Over the past weeks strains in offshore dollar markets were clearly visible to the extent that the ECB dollar funding facility was used for the first time since February. This issue needs to be monitored closely by supervisory authorities. A breakdown of dollar funding could also lead to an abrupt shedding of European banks’ dollar assets including in emerging markets.

The size and flexibility of the EFSF have to be increased so as to take the crisis-resolution burden off the ECB’s hands. In this regard the recommendation for the ECB to continue “intervening strongly” in the bond markets should be, at best, implemented in the very short period. The euro area authorities need to swiftly resolve the sovereign strains and start

addressing the underlying roots of the crisis while safeguarding the ECB's reputation. A credible backstop provided by the EFSF could provide useful assurances to markets. Thereby it is important to signal that the available toolkit is adequate and conflicting signals should be avoided. There should be no doubt to market participants that the EFSF can and will be ready should the situation deteriorate. The staff's analysis on spillovers from the financial sector to the sovereign and vice versa is an important reminder of the need for such a backstop. Given the powerful nature of the numbers shown in the analysis, we invite staff to elaborate more on the exercise assumptions and the rationale behind some methodological choices, in particular the use of 5-year CDS spreads as a proxy for the change in the market value of exposure and the end of 2009 as the cut-off date. The analysis by European authorities is based on sometimes significantly different numbers. We encourage staff to work with European authorities to reconcile their numbers and to enhance transparency about assumptions.

While correct and possibly revised numbers help avoid confusion in the markets, such corrections cannot be a substitute for financial repair nor for credible fiscal adjustment in the countries with overstretched public finances and the structural reforms to ease the rigidities in the production input markets, enhance competition and unlock the growth potential. This crisis cannot be solved by constantly re-shifting the risks to the ever more-overburdened public balance sheets.

We thank the staff for their useful follow up on regulatory reform in Box 1.6. of the GFSR. Like staff we see the major issue in the implementation of these reforms. In particular, capitalization and transparency rules need to be implemented faster. For example, a more ambitious timeframe for Basel III in 2010 could have mitigated the current market turmoil in the euro area.

Mr. Andersen, Mr. Korhonen and Mr. Sutt submitted the following statement:

As per previous practice we issue a single statement covering both the WEO and the GFSR.

#### General Assessment and Outlook

The world economy and economic policy making are yet again at a crossroads. Dealing with long-term underlying challenges has become increasingly urgent in order to bolster the confidence in the short term. Weakening growth prospects make the ongoing balance-sheet repair process in advanced economies even more challenging

The tone in staff's assessment of the world economic outlook has become more cautionary. We agree that the weakened global outlook is mainly due to developments in the United States, where the expected shift from public to private demand seems to have stalled, as well as more severe sovereign debt problems in Europe. These changes have made the previously forecasted economic upturn in advanced economies less self-sustained.

Looking forward, global growth prospects depend on the appropriate rebalancing of U.S. economic support with medium-term fiscal consolidation, containment of the euro area crisis, and avoidance of escalation of financial volatility. It is equally important that home-grown overheating risks are addressed in earnest in emerging economies.

The recent market turmoil may suggest that markets are losing patience with the lack of momentum on financial repair and reform. This leads to a situation where central banks are forced to take emergency decisions which add to their risk exposure. We agree that policymakers have to address long-standing financial weaknesses. At the same time, the financial reform agenda has to lead to credible long-term solutions in order to enhance financial stability.

We welcome the analysis of sovereign vulnerabilities and contagion risks. Recognizing increased financial stability risks in the euro area, we note that staff's assessment of these risks could have been analyzed in a more nuanced way, e.g., by taking into account policy measures already undertaken, increased bank provisioning, and other possible methodological caveats. While strongly supporting transparent analysis by the Fund in this area, it's important for the credibility of such exercises that appropriate care is taken in its communication, as also emphasized by Messrs. Gibbs and Goldby. Furthermore, as a general remark we prefer that the scope of such stress-tests in multilateral surveillance is sufficiently broad-based, for example covering banks from all 25 systemically important countries.

Finally, it remains unclear to us whether the WEO incorporates a feedback loop based on the GFSR's risk assessment. We also miss a concise evaluation of how the earlier policy advice has been implemented and what impact it has had.

#### Specific Comments on WEO

The revisions to the baseline growth outlook raise several questions. While the projections for advanced economies are revised down markedly, the

forecast for emerging and developing countries have been left largely unchanged. Whether this is a decoupling story or whether there are countervailing forces at play—e.g., lower growth in advanced countries matched by the lower commodity prices is unclear. The staff's comments are welcome.

The downward revision to the forecast for the U.S. economy is particularly large in comparison to other major advanced economies. Given the downside risks, the Federal Reserve should, according to the WEO, stand ready to deploy more unconventional monetary policy support. As the monetary policy is already expansive, staff comments are welcome on what the preferred unconventional policy measures would be, and to what extent such measures would prove effective in the current low interest rate environment.

We agree that the adoption of a credible medium-term consolidation plan in the United States is crucial to guard against the risk of losing market confidence. The staff notes that U.S. households are more worried about future income prospects than in many years and that major entitlement and tax reform is necessary with a view to create more room for fiscal policy to support the economy in the near term. We would like to hear staff's views on the optimal balance between entitlement reform and revenue-raising measures (tax reforms) in the required U.S. fiscal consolidation.

EU countries' current fiscal plans are deemed broadly appropriate by staff. We agree that the implementation of credible economic programs in euro area crisis countries is of paramount importance. While we also agree that the current crisis has illustrated the importance of strengthened EU cooperation on financial sector reforms and more credible implementation of fiscal plans within the existing EU framework, we believe that this can be achieved while respecting national autonomy on e.g., fiscal policy.

The increased uncertainty in financial markets about global prospects has contributed to softer commodity price developments, including for oil. However, the inflation outlook in the WEO is more or less unchanged for advanced economies, while revised upwards for emerging and developing economies. We concur with staff that there is a risk of overheating in some emerging economies. In advanced economies, today's relatively high headline inflation is likely a temporary phenomenon. Inflation is still fairly low measured by core rates. With persistently low core inflation and a stalling recovery that might be accompanied by continued commodity price deceleration, does staff see new risks of deflation in advanced economies?

### Chapter 3: Commodity Price Swings and Monetary Policy

We agree that a policy that targets core inflation, or inflation in the medium run, makes it easier to build monetary policy credibility, particularly in inflation-prone emerging and developing economies with no well anchored inflation expectations. However, because food price shocks are likely to have larger second round effects in emerging economies, monetary policy should actually respond more aggressively.

### Chapter 4: The Twin Budget and Trade Balances

We agree that fiscal policy can be effective with respect to adjusting external imbalances. However, we are not convinced that adjustment is more “painful” with fixed exchange rates, or with limited scope for monetary stimulus. We believe that one needs to proceed with caution in suggesting the path and outcome of future adjustments rather than jump to conclusions on the back of a model-based analysis. Adjustment in real exchange rates is a complicated process that runs through several prices, not only the exchange rate. The compression in purchasing power following currency devaluation also leads to loss of output and imports caused by an inflexible response of prices in the short run. Recent experiences in Latvia and Ireland with adjustment through changes in nominal or real wages (“internal devaluation”) as a response to domestic and external imbalances are encouraging both with respect to the flexibility and the speed of adjustment although the cost in terms of lost output was quite high. This is contrary to staff’s analysis.

Given the U.S. consolidation measures as currently planned, and the fiscal adjustments plans in the United Kingdom and the euro zone, it would be interesting to know how much U.S. public savings must increase, as percent of GDP, to stabilize the U.S. current account deficit.

### Specific Comments on GFSR

While recognizing the need for clear policy messages in the GFSR, we find the language in the executive summary somewhat decoupled from the main analysis in Chapter 1. In particular, the pessimistic undertone does not seem fully in line with the fact that most of the “downgrades” in the dimensions of the Global Financial Stability Map (Figure 1.2 in Chapter 1) are “only” by one notch. Although, we recognize that the deterioration concerns most of the key variables and that some of the risk indicators are close to their 2008 peak. In addition, we feel that there is a need to explicit rolling follow-up of provided advice in a transparent format e.g., in a summary table



incorporating also any newly issued advice. It would ease communication challenges apparent in this edition.

It is of essence to give a balanced view on the overall situation as well as on the direction of the change in financial stability risks. Sovereign stress has spilled over to banking systems. Some European banks continue to face funding strains with increased spreads in the interbank market and reliance on central bank liquidity support. However, it should be noted that some banks had already lost their access to private funding markets in early spring 2011 and, in this sense these, funding strains are not entirely new. We agree with staff that a set of coordinated policy responses is required, i.e., measures are needed to address and contain sovereign risks by addressing fiscal challenges, and some banks need to raise capital and reduce their reliance on short-term wholesale funding to restore confidence. But this is not limited to only European banks as we have seen from recent analyst reports, which calls for similar analysis on the systemic countries (the systemic 25) here for the sake of completeness.

We welcome the regulatory proposals from the Basel Committee and the Financial Stability Board and emphasize that uncoordinated regulatory reform would have an adverse impact on economic growth. However, some regional discretion for imposing stricter requirements is necessary in order to retain the possibility for countries to use most appropriate macro-prudential tools and retain existing best practices.

Prevailing uncertainty and high market volatility prevent investors from assuming a more assertive stance with respect to risk taking. In light of the economic environment in many advanced countries, the continued implementation of low-interest-rate policies seems to be appropriate in the current circumstances. However, the implementation of those policies should be closely monitored as these may give rise to disproportionate risk taking, raising financial stability risks.

We generally agree with the policy messages for emerging markets in risk of over-heating and of build-up of financial imbalances that emphasize the need for traditional macroeconomic policies as well as macro prudential measures. The GFSR (paragraph 80) notes that a limited use of capital controls can also play a supportive role in managing capital flows in some cases. Could staff kindly elaborate on in what cases and what kind of controls they foresee such a role?

The use of a structural model in Chapter 3 to illustrate systemic risk build-up and provide advice on operationalizing macro-prudential policy is an interesting and helpful exercise. These kinds of models will be important if we are to understand the costs and benefits of different policy choices. However, the assumptions underlying the model influence the results. Considerable work remains before we can be reasonably sure that we can describe the relevant complex macro-financial feedback loops, intra financial dynamics and other relevant features of systemic risk in relatively simple, stylized models. Could staff elaborate more on how the selected model approach and specific assumptions influence the advices?

### Suggestions for the Future Work Program

Greater focus on long-term trends over short-term developments is warranted. While global activity has slowed significantly since the April reports, the world output is still expanding on average at a robust pace. This divergent growth performance is not a reflection of the recent developments between April and September but rather the crystallization of underlying weaknesses in governments' and private sector balance sheets and reflection of changing patterns in the global distribution of labor.

Given that most advanced countries are increasingly exposed to aging problems, staff could, in future, build on the Chapter 2 of the GFSR and develop further analysis of the sustainability of pension finance systems and service provision.

We also found the credit boom-bust analysis in WEO Box 1.2 interesting but somewhat limited in scope. Credit expansion/contraction is a main factor driving the business cycle also in large economies that are less dependent on net capital flows. It would be interesting to look more closely at monetary policy and the role of the banking system in creating credit cycles.

Mr. Assimaidou submitted the following statement:

We welcome the September 2011 Global Financial Stability Report, and note that financial stability risks have increased substantially over the past few months, as the global financial system continues to be affected by a series of adverse shocks, including renewed market turmoil in the euro area, the credit downgrade of the United States, and signs of a global economic slowdown. Weaker growth prospects, in turn, have contributed to further deteriorating public and private sector debt outlooks, making the task of addressing high debt burdens more daunting. The current state of public

finances rightly underscores the need to exercise caution in using fiscal expansion to boost growth.

We agree that the current crisis is entering a new more “political phase.” The report rightly emphasizes that in the euro area in particular, durable solutions to the zone’s fiscal challenges remain to be found due to political differences between the economies under adjustment and the ones that are providing support. In the United States, as revealed by the recent political stalemate over raising the debt limit, there are also doubts over the capacity of the political establishment to reach a consensus over medium-term fiscal adjustment. We therefore agree with the main recommendation of the report in this regard, that policymakers particularly in the United States, Japan, and part of the euro area need to focus on a coherent strategy to reduce sovereign risks and prevent contagion. Repairing household balance sheets in the United States has become critical to the recovery and this should include measures that address the weaknesses in the housing market, which seems to be acting as a drag on the whole economy.

Given the limited room for maneuver for monetary policy to provide additional economic stimulus, we welcome the caution stressed in the report, that low policy rates can lead to longer term financial stability risks. Indeed, as many advanced economies continue to repair their balance sheets, the search for yield has increased leverage and vulnerability. We agree that such conditions risk raising the potential for an abrupt credit cycle, and could further deteriorate asset quality, should new severe shocks occur.

As a consequence of the deteriorated state of public finances in advanced economies, we note particularly in the euro area, that sovereign risks could launch an adverse feedback loop between the banking system and the real economy. We note with concern that if mark-to-market losses were to be realized, the direct impact of euro zone sovereign stress on EU banks would reach approximately 12 percent of equity capital and almost 25 percent of EU bank equity capital if the impact on the market value of total bank debt is included. As noted in the report, these findings could be amplified by the fact that banks in some countries have already lost access to private funding markets, raising the risk of more severe deleveraging and credit contraction, unless capital buffers are increased. We therefore share the recommendation, that banks need to continue to build their capital buffers to ensure creditor and depositor confidence, mitigate deleveraging pressures and sustain credit to the real economy. However, in the present environment, raising private capital may not always be possible and publicly supported mechanisms may be needed to recapitalize the banks and prevent contagion.

We welcome the fact that emerging market economies have stronger fundamentals and that their growth prospects are solid. As a result, they have continued to attract capital inflows. These flows, in turn, have helped to fuel expansions in domestic liquidity and credit while also boosting asset prices. However, as also highlighted in the report, they could also lead to overheating pressures, a buildup of financial imbalances and deterioration in credit quality. Furthermore, as global growth weakens, emerging markets could face the risk of contractions, capital outflows, and a rise in funding costs that could impact the financial soundness of domestic banks. Capital adequacy of banks could be affected. Emerging market policymakers therefore have to guard against overheating and a buildup of financial imbalances. Efforts to strengthen financial regulations and supervision must be continued.

We appreciate the well-researched Chapter 2 which provides a timely investigation of the fundamental drivers of long-term investors' behavior, with the view to identifying risks to global financial stability. We note emerging trends which could have a bearing on financial stability:

First, as investors put a higher premium on countries' prospects for growth and inflation, the globalization of portfolio flows increases the risks of sudden reversals of flows, in the event of an unexpected deterioration of growth and inflation outlooks. Enhancing growth and implementing sound macroeconomic stabilization efforts are therefore needed to control these risks.

Second, the increasing share of the official sector, including sovereign wealth funds and central banks, in global financial flows. The official sector's traditional preference for safe and liquid assets tends to strengthen financial stability. However, the recent crisis highlighted the potential for pro-cyclicality in the behavior of sovereign asset managers. Moreover, these investors risk appetite tend to increase once their reserve tranche needs are covered. In order to mitigate these risks, initiatives aimed at inducing official sector investors to step in as liquidity providers for long-term asset classes would be welcome.

Third, the increased sensitivity of investors to risks, particularly of sovereign and liquidity risks, in the aftermath of losses due to the financial crisis. Translating this heightened risk consciousness into improved risks management practices would help strengthen the stability of the global financial system.

Looking forward, we encourage a regular gathering of data needed to assess the microeconomic drivers of investors' behavior as they allow policymakers to evaluate the effectiveness of their actions, and identify early trends of consequence. The continued lack of data and coverage of developments in low-income countries, in particular from Sub-Saharan Africa, is unsatisfactory considering their preeminent place in commodities markets, and their strong growth and diversification potential for investors. Further progress in initiatives aimed at closing data gaps would be welcome.

We welcome the findings in Chapter 3 which examines the interplay between financial institutions and the real economic sector to try to find a set of variables on which to base early warning indicators for systemic events. We note in this regard that annual growth of credit-to-GDP above 5 percentage points can signal increased risk of a financial crisis about two years in advance. The chapter also highlights that credit-based indicators are far more effective if combined with other variables.

The application of policy instruments to mitigate the buildup of systemic risks is also addressed in the chapter. How countercyclical capital buffers can prevent destabilizing cycles in particular, are examined. An interesting finding is the fact that the ability of countercyclical capital requirements to reduce procyclicality of credit is unaffected by exchange rate regimes which makes this tool effective across different types of economies. We welcome the practical guidelines provided in the chapter for operationalizing macroprudential policies.

Mr. Sadun and Mr. Spadafora submitted the following statement:

We thank staff for another high-quality issue of the GFSR. We broadly share the report's main messages on the risks to macro-financial stability and the attendant policy recommendations. We also very much appreciate the insightful analytical chapters.

## Chapter I

A downward revision of expected growth in key advanced economies confirmed early fears about a slowdown of the recovery, in the context where scope for further countercyclical macroeconomic policies is generally limited. Market sentiments further deteriorated because of the uncertainty on the future course of fiscal policy in the United States and the persistency of the sovereign debt crisis in Europe.

Starting in mid-July, these developments triggered a new round of severe volatility in global financial markets and a reassessment of public debt sustainability, notably in the euro area. As warned by staff in the April 2011 GFSR, the materialization of downside risks to growth has led to more adverse debt dynamics and higher funding costs than in the baseline scenario for both sovereigns and banks. Heightened investors' nervousness has increased the risk that sovereigns face a sudden shift from a "good" equilibrium to a "bad" one, i.e., from a situation where governments are able to refinance heavy debt burdens to a scenario of sharply higher sovereign borrowing costs and liquidity risks, even in the presence of credible fiscal consolidation plans.

Against this background, the GFSR signals an increase in all risk indicators and a reversal of previous progress toward restoring financial stability in the aftermath of the 2008-09 crisis. Negative spillovers on the real economy, mostly through impairments to the supply of credit, are the main risks posed to the ongoing recovery. We share the sense of urgency on the policy priorities that the GFSR aptly conveys, including the need for addressing structural impediments to faster growth.

In the euro area, a key driver of the recent market turmoil is the fact that sovereign risks have spilled over into the banking system, as banks are large holders of sovereign bonds and are experiencing rising funding costs. It is thus paramount to break the negative feedback loop between sovereign risk and banking risk, while remaining mindful that fully severing the two risks is virtually impossible.

We agree with staff on the need to foster fiscal consolidation in order to mitigate sovereign risks, coupled with a strengthening of capital buffers for undercapitalized banks, so as to limit contagion from sovereign strains and minimize deleveraging pressures. Increased transparency can be a powerful additional tool to mitigate the risk of very adverse market dynamics triggered by uncertainties on where sovereign exposures reside: transparency on European banks' exposure to sovereigns are indeed part of the 2011 EBA EU-Wide Stress Testing Exercise. Rigorous credit and risk management practices must complement a strengthened capital base in helping separate sovereign and bank risks.

Over the longer term, changes in regulatory policies may have a role to play in breaking the link between sovereign and banking risks. Does staff believe that regulatory policies that provide banks with incentives to hold sovereign debt should be revised? Moreover, effective implementation, at

both the national and international levels, of financial regulatory reforms is another key priority to strengthen the global financial system.

The mark-to-market framework developed in Section II estimates the potential spillovers from the sovereign to the banking sector in the euro area, an issue that is very market sensitive. As they appear closely dependent on a number of key underlying methodological assumptions, these estimates should have been accompanied by extensive sensitivity analyses. Given the current fragile market conditions, we are concerned that the publication of the staff's estimates in the present format could cause adverse market reactions.

We share the staff's concerns that a low interest rate environment can sow the seed of future financial instability. As corporates in emerging market economies are increasingly tapping international capital markets, effectively exporting credit risks abroad, it is imperative to closely monitoring the rising symptoms of excess risk taking and the soundness of lending standards.

#### Market Discipline and Market Pressures

Effective market discipline, most notably its ability to highlight, early in advance and gradually, unsound macro-financial developments, is an essential pillar to foster, inter alia, fiscal sustainability. The summer rise in European sovereign spreads has prompted the acceleration of fiscal consolidation measures in those countries with higher levels of government debt. These pressures can help in strengthening the credibility of fiscal adjustment plans and, ultimately, the sustainability of public finances. However, in some circumstances one could not rule out the risk of markets' overreactions, which in adverse scenarios may trigger unwarranted liquidity problems. In fact, abrupt and potentially self-fulfilling market pressures, possibly fueled by well-known market failures such as herd behavior as well as by unfortunate rating actions, may push a debtor toward a bad equilibrium of destabilizing debt dynamics, as recognized by staff. In some cases, a forcibly fast pace of fiscal consolidation can make it harder to strike a balance between supporting an already-fragile recovery and ensuring fiscal sustainability.

More generally, while market pressures are a key channel to exert macroeconomic discipline, taking all market assessments of countries' fiscal positions at face value at all times (good and bad) may not necessarily be advisable in light of the many failures of market discipline before the crisis. From an empirical viewpoint, some evidence on the non-linear nature of a number of market reactions raises questions on the markets' ability to fully

reflect fiscal sustainability at any point in time. In the context of the sovereign debt market, a few quantitative studies point out a relatively weak correlation between sovereign spreads and fiscal fundamentals before the crisis.

Against this background, staff should bring to bear fully their analytical leadership and should probe some market assessments, as appropriate. In present circumstances of heightened market uncertainty and high risk aversion, which may fuel phenomena such as contagion and herd behavior, staff could have included a word of caution on the possibility that an element of overreaction may be present in some market assessments of sovereign risks. The latter may unduly underestimate efforts to advance fiscal sustainability in some affected countries and their fundamentals.

We thus reiterate our call on staff for an updated and thorough analysis, in one of the next GFSRs, of the role and effectiveness of market discipline in the run-up to and the aftermath of the crisis.

Mr. Virmani and Mr. Eapen submitted the following statement:

The risk indicators of global financial stability have increased dramatically over the past few months, since the April 2011 Global Financial Stability Report (GFSR). It is quite interesting that staff terms this as a “political” phase of the global crisis, though the political aspects of the crisis were evident right from the beginning, both in the response (or in the lack thereof) of authorities during each phase. We could alternatively look at the present phase as a result of the consolidated effect of earlier political inaction and also as an outcome of how sharp divisions, particularly within and among advanced economies, appear to have finally derailed the chances for appropriate responses. We have not noted any specific political reform recommendations in the GFSR; this may well be required in future editions. We, however, acknowledge a small recommendation in paragraph 91 of Chapter 1 that the United States should act to place its debt on a credible downward trajectory over the medium term and if this is achieved, congress should consider abolishing the federal ‘debt ceiling’ as a control device as it can raise near-term concerns over a technical default while inducing artificial liability management operations by the U.S. Treasury.

Our concern is, as articulated in the section on policy priorities, that the set of economically and politically viable policy choices is shrinking. On the whole however, we broadly agree with the technical analysis and highlight a few related issues.



## Overcoming Political Risks and Crisis Legacies

We agree that the major issue at present is the difficulty in reaching a political consensus in the advanced economies (AEs) on fiscal consolidation and its time path. A major part of the problem appears to lie in the lack of credibility of assertions made in the past by analysts as well as in the political ground level realities. There is no gainsaying the fact that in AEs, macroeconomic risks and associated market and liquidity risks have risen along with credit risks in the private sector. There is a pullback in the risk appetite, though monetary and financial conditions have remained unchanged. For emerging markets (EM), as stated in the report, risks have increased mainly due to rapid domestic credit growth, balance sheet releveraging and rising asset prices in some EMs.

The problem in AEs is that balance sheets have not been ‘cured’ and the financial system remains vulnerable. We would recommend, as brought out in the September 2011 WEO, that there is need to rebalance from public to private demand and policy makers in crisis-hit economies must resist the temptation to rely mainly on accommodative monetary policy to mend balance sheets and accelerate repair and reform of the financial sector. They should implement medium term fiscal adjustment plans and entitlement reforms coupled with more growth supportive policies and expenditure in the short run, particularly in the United States. In Europe, fragile FIs should be asked to raise more capital, accept injections of public capital or be closed.

Further as brought out in the GFSR, in Europe there is a spillover of risks from the sovereign to the banking sector and a framework which marks-to-market bank’s sovereign and inter-bank exposures to euro area countries shows that these spillovers are significant. The extensive cross-border bank and fund holdings of sovereign debt have facilitated the rapid transmission of shocks across financial markets. In fact the specific challenges facing the euro area and the concentration of the turmoil in European debt markets bring out the political challenges facing currency unions. The epicenter of sovereign risk is Greece, as stated in the GFSR, but the impact on the banking sector from others is no less significant. There is an immediate need to address the fiscal challenges facing governments, for banks to raise private capital to restore confidence and also for adequate public backstops—such as an augmented EFSF—to recapitalize banks when needed. In this connection, we would be cautious in recommending that the Fund develop any backstops beyond certain limits and would call for primarily a European solution to the crisis in the euro area. We have often stressed that U.S. policy makers need to pay more attention to addressing the legacy of the

financial crisis reflected in household balance sheets and encourage banks to write down distressed loans and reduce principal on mortgages.

With regard to policy priorities at the international level, we agree that regulators should act to introduce the higher capital and liquidity standards of Basel III, particularly for the large global SIFIs. EMs need to be cautious that the low interest rates in the AEs could carry some financial risks as large international banks in the search for yield, push corporations in EMs to increasingly make use of foreign currency financing. EMs should make judicious use of policy rate changes to maintain lending standards and limit the pace of credit growth; we agree that capital controls, targeted reserve requirements and increases in capital risk weightings should be judiciously implemented. Indeed the responses of many EM authorities have been very much in line with these recommendations, unlike in the AEs.

#### Long-Term Investors and Their Asset Allocations

We welcome the analysis in Chapter 2 of the GFSR on the motivations that lie beneath the asset allocation decisions of long term investors. The major finding is that, in the background of globalization of portfolios, asset management decisions by investment companies and an enhanced role for SWFs and international reserve managers, the global crisis has resulted in private asset allocation being driven strongly by positive growth prospects and falling risks in recipient countries while interest rate differentials play a lesser role. The crisis has made investors more risk conscious but risk of reversals cannot be discounted if fundamentals change.

The staff states that the implication of these findings for policy makers are that asset allocation decisions are grounded mostly in the responsiveness and consistency of economic policy geared to macroeconomic stability and low inflation and not to specific policy actions. On the other hand, we note the search for yield has also been an important motivation in the flows to EMs as mentioned by staff in Chapter 1. In paragraph 55 of Chapter 2, staff mentions that the low interest rate environment in advanced economies since the crisis has not yet pushed investors into riskier investments to enhance yields but may do so if, as expected, interest rates in AEs stay low for an extended period. Thus EMs may have to be prepared for sizable capital inflow pressures in the near future and adopt appropriate measures. However, the greater role advocated by staff for SWFs to take up some of longer-term risks by investing in less liquid assets is belied by actual performance of such funds which, with a few exceptions, do not appear to play more than a marginal role in stabilizing the international financial architecture. The worldwide trend

towards greater fiscal consolidation and risk aversion would affect the growth and role of the SWFs at least in the near term.

#### Towards Operationalizing Macprudential Policies: When to Act?

We also welcome the practical guidelines in operationalizing macroprudential policies outlined in Chapter 3 as a step to identify the triggers and indicators for risk build up and for designing and using macroprudential tools. We generally support the conclusions drawn about using the credit to GDP Ratio, asset price increases, the behavior of the trade balance and trends in bank capitalization in developing the appropriate policy tools. We note that in most countries an overall threshold of 5 percent for credit-to-GDP growth works reasonably well in signaling a crisis; but has to be combined with other variables and characteristics of specific countries. We encourage further analysis including presenting a separate board paper outlining possible policy options in this area.

Mr. Legg, Mr. H. Lee and Ms. Hunter submitted the following statement:

In keeping with our long standing efforts to encourage a more integrated approach to the WEO and GFSR, in particular, in identifying and communicating the key messages to policy makers, this statement addresses both documents.

The key message we take from our reading of these two documents, which maintain the high standard of analysis by Fund staff of the interrelated challenges and risks confronting the real and financial sectors, is that threats to the fragile global recovery have multiplied while available policy space to respond—including most importantly, in terms of political constraints—is narrowing rapidly. Policy choices to be confronted over the coming months will determine whether there is a chance of getting ahead of the curve and restoring confidence—in the sustainability of sovereign debt burdens, financial system stability, and the outlook for demand and employment growth—or whether we will become locked in an escalating cycle of political impasse and denial, the further erosion of policy credibility, and heightened risks of financial instability, contagion and a return to recession as we confront the high costs of playing policy ‘catch-up.’ Such a scenario would also raise the specter of a revival of the protectionist pressures successfully held at bay to date, with far reaching consequences for the quality of any longer term global recovery.

The importance of the forthcoming IMFC meeting as an opportunity for Ministers to send a clear and unequivocal signal about the need for decisive and well focused policy action, cannot be understated. The Chair's Consolidated Multilateral Surveillance Report (CMSR) will be a crucial document in ensuring this opportunity is not missed. It is a concern, therefore, that IMFC Deputies, who are meeting at the end of this week, have as yet not seen a draft of either this or the MD's Action Plan, the other key document they are to discuss. The policy messages should be clear: there is a need for action now to support demand in key advanced economies in the short term, including through assistance for household balance sheet adjustment, alongside credible advanced economy commitments to medium term fiscal consolidation; the repair of weakened financial system balance sheets must be facilitated as a priority; and emerging market economies need to accommodate a sustainable shift towards domestic demand as the driver of activity, while managing the challenges posed by capital inflows and the risk of overheating in a manner which facilitates, rather than resists, needed longer term structural change. The challenge is to ensure that these messages are communicated in a way that achieves strong and credible buy-in by Ministers and domestic authorities.

We also offer the following comments on more detailed aspects of the two reports.

### Outlook

The major change in the outlook of the WEO relative to the June WEO update is the sharp reduction in the GDP growth forecast for the United States. With regard to the risk that U.S. households could come under pressure to do more deleveraging, we note the potential trade-off between internal rebalancing from public to private demand and private sector balance sheet restructuring. There is clearly scope for the exploration of policy options to help manage this trade-off. Looking to the rest of the world, beyond the United States and Europe, we are struck by the resilience of the growth projections for some smaller advanced economies as well as for emerging and developing economies. It is not clear to us whether this reflects a technical delay in adjusting these projections to fully reflect the downward revisions to growth in the major advanced economies, or Fund staff's judgment that activity in the smaller advanced and emerging market economies can be insulated from these developments. In this regard, for example, we note that concerns are emerging about the space available to major EMEs such as China to repeat the aggressive policy response demonstrated in 2009 (see for example, Box 1.4 in the GFSR.)

We also wonder whether Japan's rebound in the second half of 2011 should be highlighted as one of the key drivers of the global economy over the near term, given the uncertainties surrounding electricity supply from nuclear power and the lower GDP base, following Japan's second quarter slump. And we would be interested in staff quantifying the effect of lower oil prices on global growth through this year and into 2012.

More generally, while we welcome the staff's efforts to integrate some of the key themes from the recent spillover reports into these reports, and in particular the WEO, more could be done in this regard. For example, the section on "Spillovers from Global Demand Rebalancing" does not incorporate much of the analysis from the spillover reports, much of which is directly relevant to this discussion, while the discussion of "Multilateral perspectives on Policy Challenges" could have included more by way of how the findings from the analysis from individual spillover reports interact at a regional or global level. (The analysis of synchronized fiscal consolidations in Chapter 4 is a good example.)

#### Fiscal Policy

We share the staff view that the United States and Japan need to preserve fiscal support for short-term growth while implementing credible fiscal consolidation plans for long-term debt sustainability. But this involves a delicate balancing act, not only in terms of policy design and implementation but, arguably more so in terms of building a workable political consensus in support of such nuanced policy settings. An effective communication strategy is therefore crucial and the WEO's message would be strengthened by explaining in more detail how these seemingly conflicting objectives can be mutually reinforcing. For example, it is important to demonstrate clearly how strong commitment to reform major entitlements and taxation might create more room for fiscal policy to support the economy in the short term, while support for growth and jobs can make a commitment to longer-term austerity more credible and politically viable.

The lack of confidence in current efforts by major governments to address structural problems underpinning unsustainable fiscal balance sheets is a major concern. Entitlement and tax reform, and enhancements where needed to fiscal institutions (key elements for medium-term consolidation), will require broad-based political consensus and public support. The recent political impasse related to lifting the debt ceiling in the United States illustrates the difficulty in agreeing and implementing workable fiscal

adjustment plans. Consideration could be given to whether re-affirmation of the G-20 Toronto commitments to halve the deficit by 2013 and stabilize debt-to-GDP ratio by 2016, and a call a new round of international fiscal commitments to address the recent fiscal and economic developments, could help support political leadership and policy momentum in individual countries.

With regard to Chapter 4 of the WEO, and the relationship between fiscal and external deficits, we would also stress the importance of ensuring that domestic policies are consistent with minimizing distortions between domestic and foreign saving in order to foster the efficient allocation of resources. This may or may not imply an adjustment in the external balances of some countries, even if there is a need for fiscal consolidation. We would also suggest that the analysis would benefit from including movements in the exchange rate and monetary policy, given that the current account deficit is inseparably sensitive to these other variables in an open economy. Exclusion of these variables is likely to overstate the importance of fiscal policy in influencing the current account deficit of a country, as well as the duration of the specific effect of fiscal policy on the current account.

### Monetary Policy

The lack of fiscal policy space to address short term demand management, in some key economies primarily a reflection of political constraints, is matched by technical bounds on the efficacy of monetary policy. With the Federal Reserve committing itself to low interest rates until 2013, the ECB resuming bond purchases, and the Swiss and Japanese central banks intervening in their respective exchange rates, the scope for additional non-standard monetary actions which are likely to be effective, beyond emergency liquidity provision to financial markets if needed, is becoming increasingly limited. And potential unintended spillover effects of any such policy options would need to be carefully assessed.

The analysis of food price shocks in the context of inflation targeting in Chapter 3 in the WEO is useful in mapping out some of the options for emerging and developing economies as they try to absorb exogenous food price shocks. We are particularly interested in thinking about the issue of food price shocks in terms of low-income countries (LICs) and found the discussion on Africa useful in that context. We would suggest that there is a more important role for income effects than what is emphasized in the chapter. In particular, we would be interested to hear the staff view on how important income per capita and proximity to subsistence levels would be in

informing the policy choice given a more limited degree of flexibility. A brief listing of possible policy options to complement the interest rate response might prove to be informative. In the context of LICs, we would also suggest that establishing policy credibility is more closely related to overall socio-economic stability than to specific targets for monetary policy.

### Global Imbalances

The assessment of global imbalances appears to be very heavily focused on CGER assessments of exchange rate misalignments. Given the wide confidence intervals around these estimates and the nature of global imbalances we also recommend that other channels for adjustment, including consumption and investment structure, productivity growth, and fiscal balance, be brought into the analysis.

### Financial Stability

The GFSR makes clear that the sovereign debt crisis, in part the progeny of earlier policy responses to the global financial crisis, poses a significant and growing threat to global financial stability. It is clear that financial stability risks have increased in recent months, even though Figure 1.2 arguably does not quite capture the same sense of urgency as the text. We would encourage the Fund to pay more attention to evaluating the relative likelihood and severity of the individual risks it identifies. (For example, while it is clearly a risk, my authorities are skeptical as to whether there is much actual evidence of ‘search for yield’ behavior at present, especially given the existence of ‘flight to quality’ tendencies also identified in Chapter 1 of the GFSR. Paragraph 55 of Chapter 2 of the GFSR, also questions the current extent of ‘search for yield’ behavior. Similarly, it is unclear that Latin American valuations and emerging market Asia corporate fundamentals are already on the cusp of a new downturn, notwithstanding the striking depiction of the credit cycle in Figure 1.30. With regard to the latter, there may be merit to explore further how the credit cycle relates to the business cycle.)

At the same time, we wonder if the GFSR could lead a discussion of policy options in more detail. For example, what specific “macro-prudential measures should be strengthened” (page 8)? And what sort of specific “targeted measures” to reduce debt in the United States (page 64) should be contemplated? (There is scope in this regard for the GFSN to complement the relatively brief discussion of options on page 94 of the WEO.) There are also a number of relevant “live” policy—issues of direct relevance to the

challenges facing the euro area that could usefully be drawn out: the arguments for and against PSI; revisions to the functionality and size of the EFSF; the risk of credit rating downgrades to other assets in the wake of S&P's actions; pros and cons of different types and levels of European integration; risks surrounding member countries leaving the euro. These are difficult issues, but the Fund has the experience and expertise to help shape a better understanding of the technical trade-offs involved. We also agree with the Fund that public rescue and recapitalization of distressed banks may prove necessary in extreme cases and encourage the Fund to press this case more explicitly, in this and other forums, such as the FSB.

Equally, however, some policy messages in the GFSR, such as the potential role sovereign wealth funds could play in taking on more risk and thereby filling an emerging gap in the spectrum of investors, may need to be considered in more detail, in terms of compatibility with individual SWF's roles and mandates.

#### Capital Flows and Macprudential Policies

We are not surprised by the finding, in Chapter 2 of the GFSR, that the asset allocation decisions of long term investors is primarily driven by growth differentials and prospects than interest rate differentials, although the latter are clearly likely to be relevant in driving some short term flows. (Over time, of course, the distinction between growth and interest rate differentials may become less relevant.) This may allow scope for EMEs to realign monetary policy settings better to fit domestic circumstances. Nevertheless, a number of EMEs currently have to contend with large and volatile gross capital flows, and to the extent that this tests their ability to efficiently absorb such inflows, face risks of economic dislocation from capital inflow surges and sudden stops. (In this regard, the reference in the WEO to emerging markets being net exporters of capital is potentially misleading as it does not, of itself, reduce the policy challenge faced by individual EMEs in managing the potential volatility associated with large gross flows, or in addressing absorptive capacity constraints. Indeed, the tone of the WEO's message appears somewhat out of step with the GFSR on this point.) While greater exchange rate flexibility would assist, we also acknowledge that for some EMEs, excessive exchange rate volatility is just as problematic (for shallow and poorly developed capital markets and other domestic rigidities) as volatility in capital flows. In such cases, recourse to appropriate macroprudential policies may be well justified.



Nevertheless, the definition of macroprudential remains unclear and a potential source of confusion in terms of the degrees of additional policy freedom actually offered to authorities. We continue to see macroprudential policies as a sub-set of financial stability policy, largely drawing on traditional microprudential tools, with limited need (assuming an effective existing financial stability framework) for significantly new governance or institutional arrangements. And while the choice of exchange rate regime may not affect the effectiveness of macroprudential policy, it is clear that greater reliance on the latter reflects a decision to eschew greater exchange rate flexibility.

### Employment and Structural Reform

Recent events have also highlighted deeper seated structural issues that need to be addressed in both advanced and emerging economies. .

Figure 1.12 in the WEO shows that unemployment rates in the United States, the United Kingdom, and Mexico are much higher than the typical rates during the six-year average before the crisis. In particular, job losses in the United States during the crisis were unprecedented and came on the back of the worst employment performance during the past decade. The WEO would benefit from exploring the structural underpinnings to these findings to cast light on how to address high unemployment, notably for the young, in those countries.

On the issue of competitiveness in the euro area periphery countries, we reiterate that significant structural change is required to allow markets to adjust more flexibly to asymmetric shocks, mainly through labor migration and cross-border competition in goods and services. In addition, reforms should reduce labor market duplicity and wage-setting rigidity in the region. Notwithstanding current challenges associated with weak fiscal discipline, inadequate supervision, and inflexible markets, the EMU has been generally successful in lowering transaction costs and providing price stability for its members. We see further economic integration, aimed in particular at closing the competitiveness gaps among members, as a prerequisite for enhancing the long-term growth potential of the euro area. We remain hopeful that a positive outcome from the current crisis will be a stronger consensus on needed reforms.

Finally, we fully concur with staff that there is the need for many EMEs to strengthen social safety nets to protect the most vulnerable in the face of social tensions emerging from youth unemployment and high food prices. Active labor market policies, including the expansion of vocational

training and job matching efforts, also need to be strengthened. We hope that recent examples of more populist policies in some EMEs, such as increased pension, civil wages, and food subsidies, are not allowed to distract the policy debate from building a consensus in support of structural reforms needed to promote long-term competitiveness and sustainable private sector-led growth.

Mr. Pérez-Verdía submitted the following statement:

Since the spring reports perspectives for the global economy have deteriorated and downside risks have undoubtedly increased. In general, we agree with the staff's analysis and policy advice. This analysis appropriately highlights not only the inherited risks from the crisis' legacy, but also the more preventable risks that have resulted from lack of appropriate policy responses. In our view, the membership is best served by this type of thorough review that presents staff's un-subdued analysis of the economic environment. Given the complementarities of both reports, we have chosen to formulate our comments in one joint statement.

In a risk scenario, the continued crisis in the euro area and the potential deterioration of confidence in the United States resulting from a highly uncertain environment may derail the global recovery. In a situation of weak growth, as the one currently observed, a fall in confidence can have dramatic effects on economic performance. We also agree with the view that risks for emerging and developing economies seem less severe, but volatility in commodity and oil prices, and a potential reversal of capital flows resulting from deterioration in market confidence may have significant negative effects.

A resounding theme in past WEOs has been the urgency to implement appropriate policies ahead of the narrowing policy space. This formulation requires that policymakers in crisis-hit economies continue implementing an accommodative monetary policy when possible, as well as pursuing further reform in the financial sector and, finally, strong medium-term fiscal adjustment which, at the same time, maintains growth-supportive policies in the short run.

We agree that in the current environment it may be wise to maintain a supportive fiscal policy in the short-run in countries able to do so, notwithstanding the fact that fiscal consolidation and reform are needed in the longer term and credibility is of the essence. For this to be possible, a credible medium and long-term debt sustainability strategy is necessary in order to open space for countercyclical policies at present. This is a very important message from the Fund. At the same time, however, we take note of the

message that “because major progress in cutting future spending has proved hard to achieve, however, postponing near-term consolidation is not an option in most advanced economies.”

We notice that, as the environment has changed, staff’s advice has also been retailored: in the previous WEO, the staff suggested that a credible strategy for the United States required a down payment on fiscal consolidation starting in 2011, while at present the staff suggests “to commit to a credible fiscal policy agenda that places public debt on a sustainable track over the medium term, while supporting the near-term recovery,” and fiscal consolidation to start in 2012 at the earliest.

It is important to recognize that despite strong demand growth being factored into the baseline for emerging markets, their contribution will not be enough to make up for the lower consumption of advanced economies. At the same time, rebalancing from external to domestic demand will need to take into account risks of overheating in some emerging market countries which, in some cases, may require currency appreciation. We concur with this view and the policy recommendations included in the report regarding overheating and the negative spillover effects from a current environment of low long-term interest rates.

With constraints to the role of monetary policy in the recovery, a protracted low interest rate environment in advanced countries is a main factor behind the so-called “search for yield.” This development could have important negative effects in domestic sectors that are becoming more leveraged and therefore more vulnerable. At the same time, the “search for yield” is causing credit creation to be diverted to the shadow banking system, as rightly pointed out by the staff.

In this context, provided that many emerging market countries continue receiving important capital inflows, the “search for yield” may lead to increases in domestic liquidity and credit growth, causing imbalances to their domestic financial systems and complicating macroeconomic management. Against that background, international policy coordination aimed at preventing economic and financial spillovers is crucial.

This highlights what we believe is a notable absence of a strong message—otherwise found in previous reports—on the need to maintain global policy coordination. For instance, an interesting area where collaboration can be established is international risk-sharing mechanisms, as indicated in the WEO report, which may help address liquidity disruptions in

global financial markets. In this same vein, given the dire situation in many labor markets, the WEO could have benefited from more detailed analysis on the factors holding back job creation and on the different policies being implemented across countries to remedy the situation.

The staff rightly points out the need for advancing reform in financial markets and repairing the banking sector balance sheets in many advanced economies. Problems in the financial sector are at the center of the current global financial crisis, and continue to be a main drag to confidence. Policies suggested, including recapitalization and restructuring of weak banks and repair of wholesale funding markets, as well as facilitating adjustment in housing markets, are sensible. We are glad that such avenues for reform are analyzed in the GFSR report. However, we think the report could have highlighted some of the positive messages from the European stress tests. EBA identified pockets of vulnerability and a timetable for addressing them; in fact, EU banks participating in the stress test increased their CET1 capital by approximately 50 billion euros in the first months of 2011 to pass the rigorous test. Likewise, the analysis to determine the mark-to-market impact of sovereign spillovers on financial balance sheets is methodologically complex, as can be seen by the multiple caveats in its presentation. Legitimate questions can be raised on the methodology and the results that alternative assumptions and different approaches could offer. In this regard, it is essential to avoid misleading messages by the Fund.

Facing the recent surge in international commodities prices and the prospects that they will remain elevated for a sustained period is undoubtedly an important challenge for monetary policy, particularly for countries with a significant pass-through of price shocks given the composition of their CPI index baskets. Therefore, trying to find an appropriate monetary policy response besides the standard advice of “accommodate the first-round effect of food and energy price swings on the CPI but not the second-round effects on other CPI components” is welcome, especially when the shock is considered persistent. However, without disregarding the excellent technical work in Chapter 3 of the WEO, we believe that policy makers would benefit from further development into the insights gleaned from the painful lessons learned during the 2008 food and energy price surges. Could the staff elaborate more on the main intended messages to policy makers?

We welcome the analysis on the twin budget and trade balances in Chapter 4 of the WEO, and find most of the findings interesting. We also see merit on the innovative approach to identify fiscal policy changes (the historical approach) and channels for external adjustment. Nevertheless, we

think it is necessary to be more careful in sending messages that could be seen in contradiction with other messages in previous chapters, such as insisting in the need for fiscal consolidation in some countries (including Germany and Japan) where an intensification of their current account surpluses is a concern. We believe that this apparent contradiction simply reflects the complexity of the current situation for many policy makers.

Monitoring systemic risks and operationalizing macro prudential policies (MPPs) summarize a work in progress. The staff's contribution is a promising step forward to timely account for the linkages, weaknesses and tensions in the financial system that could nurture adverse impacts in the real sector. A feedback loop that is improperly attended could be further translated into a stalling economic growth phase, undermining confidence across countries, hitting public finances, exacerbating debt woes and worsening job creation prospects.

The effectiveness of MPPs is crucially contingent on the collection of relevant data. Its availability is key to anticipate better and informed judgment about prevailing forces and the prospects for future financial instability. Larger than expected lack of data highlights one of the conspicuous challenges policymakers face in providing responses to existing (or envisaged) conditions intrinsically related to the health of financial institutions. Therefore, it is indispensable for policymakers to improve the data collection and interpretation process.

We would like to emphasize that the use of MPPs raises several issues related to costs, timing and calibration. In particular, the costs of implementation must be contrasted with the social costs and substantial distortions in the real sector that stem from the improperly attended presence of lax standards or, alternatively, the absence of sound MPPs.

Mr. Fayolle submitted the following statement:

We thank staff for these new editions of the World Economic Outlook and the Global Financial Stability Report and we broadly share their main messages and recommendations. The recent spillover reports have rightly underlined how interconnected the global economy is and how the financial channel is a major channel of transmission of shocks worldwide and to the global economy. We therefore continue to believe that the best way to discuss economic and financial development is in a single WEO-GFSR discussion, like during the January and July updates. In this spirit, this statement will once again cover the issues raised in both the WEO and the GFSR.

## Global Outlook

We share the views that the current shocks are more likely to translate to a weaker growth than a double dip recession in advanced economies. This being said, downside risks have increased significantly since April and could jeopardize the recovery while the legacies of the crisis for sovereigns, banks, potential growth, and unemployment remain to be fully addressed. Recent history also suggests that we should be particularly cautious to the risk of an adverse feedback loop between a weakening growth outlook and increasing financial tensions.

Not only the level but also the nature of growth seems to significantly differ among advanced economies: while the euro area keeps growing in spite of a sizable overall fiscal consolidation and financial turmoil, growth in the United States remains dependant on accommodative policies. Political tensions here have been clouding the policy response to the multiple challenges that remain to be addressed: how to design a credible medium-term consolidation plan while supporting growth and job creation and finally addressing the root of the crisis, i.e., the remaining weaknesses in the housing market? Given the role of the United States in the global economy and financial markets, such questions are of paramount importance.

We share staff's views regarding the sources of risks in several emerging market economies, namely rapid credit growth and asset price increases, risk of capital flows reversal, and risk of a sharp decrease in commodity prices. In some countries, there is a close link between all these risks, so that the situation may be close to that of the summer 2008. But the room for maneuver is smaller today, which calls for a close monitoring of risks.

## Sovereign Risks

We agree with the message in the two reports that advanced economies remain vulnerable to adverse feedback loops between sovereign risks and banks' balance sheets. This is the case in the euro area and this is why all Member States have already engaged in ambitious consolidation plans across the area, as rightly underlined in the Fiscal Monitor. The EBA stress-tests have also underlined that several banks need to be recapitalized.

But we have strong reservations regarding the methodology choices used to assess the impact of sovereign spillovers on European financial

institutions' balance sheets in the GFSR. As the report is a leading opinion maker in the financial community, all published quantitative analysis needs to meet the highest standards of robustness. Equally importantly, it has to take into account the need to handle extremely carefully the highly market-sensitive analysis. Although the GFSR is mentioning some of the drawbacks of its own approach, it ultimately validates its conclusions and falls short of ensuring there will not be any misinterpretation of the analysis.

More specifically, the methodology is questionable in many respects:

The staff overestimates the impact of sovereign spillovers on European banking sectors by double-counting losses on risky sovereigns as some of them have already been recognized in banks' balance-sheets;

The model largely overestimates the contagion effect using a leverage ratio based on gross exposures for derivatives which inflates the size of the European Banks balance sheets. As we already mentioned in previous discussions, the differences in U.S.GAAP and IFRS tend to strongly overestimate the European leverage ratios as derivatives are not netted (in that respect Table 1.1 is wrong as it compares two radically different types of measures).

Many mitigating factors that should also have been taken into account in the model are ignored. For instance: safe heaven effect that generate benefits under mark to market accounting, the choice of the cut-off date for price variations, the choice of CDS spreads rather than bond yields to mark-to-market exposures.

We would like to recall that the decision to make the EFSF more flexible, taken at the July summit. This demonstrates the strong commitment of the European authorities to tackle the crisis. The EFSF would therefore be able to grant loans to non-program countries that may eventually be used to recapitalize banks. This should have been better highlighted in the reports.

More broadly, the GFSR makes a surprising presentation of a currency union by highlighting all its disadvantages without underlining its undisputable benefits (Section 17). According to this paragraph, such an economic organization only heightens spillover risks when stress occurs on markets and deprives member states of their traditional economic tools (printing money to pay debts, etc.). This view does not underscore all positive consequences which outweigh the constraints (such as markets integration and synergies, ability to implement collective policy responses in

times of crisis). Furthermore, independent of whether a country is part of a monetary union or not, there is no case where monetizing debt is a viable medium term policy option.

Finally, we would have preferred to see in the two reports a more balanced treatment of the issue of sovereign risks. The excessive emphasis on the euro area is indeed striking given recent developments in the United States, where the difficulties to raise the debt ceiling eventually led to a downgrade of the “risk free” asset. The analysis on the GFSR is mostly backward looking and centered on the muted response of the U.S. bond market. However, it is highly likely that such event was one of the factors behind the strong sell-off in equity markets in August. The WEO downside scenarios (pages 30/31) do not mention it. The specific role of U.S. treasuries in the global financial system calls for much more analysis on this issue.

### Safeguarding Financial Stability

We agree with staff that abundant global liquidity coupled with low growth in advanced economies create risks for global financial stability. In this regard, we would have appreciated a more in-depth analysis on the issue of global liquidity.

The prominent role of the dollar in the international financial system, underlined in the recent U.S. spillover report, implies that all financial system can experienced liquidity strains when financial tensions arise. In this regard, we fully echo the WEO’s message on the need to beef up the size and scope of international risk sharing mechanisms, which have fallen far behind the size of international financial markets.

To guard against future risks, it is important that all countries move to Basel III in a coordinated way. This is the purpose, at the European level, of the Directive CRD4. We do not agree with staff’s call for a quicker implementation phase given the current economic and financial environment. This timeline has been specifically designed to avoid any negative impact on growth, which seems particularly relevant at the current juncture.

We share staff’s view on the need for the implementation of Solvency 2 not to create financial disruptions. In this regard, we welcome staff’s analysis in Chapter 2 of the GFSR. More broadly, we would invite staff to further assess the macroeconomic and financial stability impact of the introduction of the liquidity coverage ratio.



Finally, we welcome the efforts in Chapter III of the GFSR to design the contours of a toolbox to guide macro-prudential regulators. In spite of many technical difficulties, the chapter provides valuable inputs to this ongoing debate. In future, we would welcome staff's further elaboration on how to respond to the array of indicators developed.

### Global Rebalancing

The WEO rightly stresses that several surplus economies need significant exchange rate appreciation together with structural reforms. We regret the lack of progress on this front, all the more that in some emerging market economies, domestic and global interests are rather well aligned. In these countries, the risk of overheating would call for a monetary tightening, especially in emerging Asia: to what extent such tightening could be partly achieved through exchange rate appreciation? From a global perspective, how does staff see the relative benefits of the various options? We also welcome Chapter 4 of the WEO which underscores the role that fiscal policy in deficit countries can play in the global rebalancing.

### Commodity Prices

We do not support staff's view (WEO) that financial factors do not have an impact on commodity prices. The conclusions of several recent studies are much more nuanced and point to an impact of financial factors on the volatility of commodity prices, at least in the short term.

We welcome the focus of the Chapter 3 of the WEO. High and volatile commodity prices indeed pose a significant challenge for the conduct of monetary policy. The model simulations presented in the WEO show a clear gain from targeting core inflation in emerging and developing economies, whereas in advanced economies targeting core or headline does not produce any difference in terms of macroeconomic stability. Regarding the latter (for advanced economies), one needs to be a little more cautious, to the extent that the WEO analyses the usefulness of using core or headline inflation in the context of a temporary commodity price shock under the assumption that the central bank is a credible one. Following a persistent shock, persistent deviation of headline inflation from the target can impact the monetary authority's credibility, which can lead the central bank to tight policy even if core is still at low levels. As the issue is highly debated, it would be useful to provide more details on the pros and cons of using the two targets for monetary policy making.

## Potential Growth

We would encourage staff to continue their efforts to better assess potential growth and output gaps going forward. Such work is important to calibrate policy responses and avoid policy mistakes that could prove costly. The impact of the crisis on potential growth still remains uncertain. The part of structural unemployment in the overall increase in unemployment would also deserve further work, especially for the United States.

Mr. Meyer and Ms. Holler submitted the following statement:

Global financial stability has deteriorated significantly, in particular, since July. Driven by higher downside risks for the global real economy and a loss of confidence, there have been severe adjustments in the financial markets, including strains in funding markets for some European sovereigns and banks. We fully agree that strained public finances imply policymakers should be very careful to use further fiscal expansion as a means to stimulate economic growth. Instead, private government bond investors need a strong signal for credible plans to achieve sustainable fiscal consolidation in the medium-term. It should be also kept in mind that neither capital increases in the banking sector nor accommodative monetary policy or transfers can be a substitute for the national government's responsibility for sound fiscal and economic policies.

## Chapter 1

We are concerned that the estimates for mark-to-market losses on European banks' sovereign and bank debt exposures could be misinterpreted, especially given some methodological issues. In the report, staff names some caveats of the estimates, e.g., not taking bank profits to increase capital into account as well as assuming that all losses would be realized upfront and, therefore, neglecting that banks may hold assets to maturity. Depending on assumptions and data used, the ECB, the European Banking Authority (EBA) and market participants estimated substantially lower losses in similar exercises. Moreover, the information that the numbers in the GFSR should not be interpreted as a calibration of capital shortfalls is only mentioned in a footnote and could be easily overlooked. Taking all this into account, it cannot be ruled out that these numbers could be misinterpreted and add to market uncertainties, in particular as the Executive Summary only gives the figures without any additional explanation.

We welcome the report's longer-term perspective on financial stability risks, namely, the "search for yield," including shadow banking activities, in an extended period of unusually low interest rates. New imbalances and vulnerabilities could increase the potential for disorderly market corrections. We support ongoing initiatives to improve the data base for monitoring potential systemic risks arising from the shadow banking system, including hedge fund activities. To some extent, the build-up of systemic risks in the shadow banking sector may be prevented by banking regulation, as often banks provide leverage, take the position as counterparty in OTC-derivative transactions and are involved in the structuring of credits and securitizations. However, in addition, there needs to be a continuous, internationally coordinated review of direct shadow banking regulation, taking account of new businesses and innovations.

While many emerging market economies have shown considerable resilience during the financial crises, macroeconomic challenges and associated financial stability concerns are meanwhile increasing. Large capital inflows fuelled by a low interest rate environment and accommodative policies are finally making themselves felt in credit expansion and higher asset prices. Apart from the danger of overheating, there is also the risk of a sudden stop, given the dominance of volatile portfolio and credit-related flows. Strong emerging market debt issuance could be viewed as a sign of strength. Moreover, local bond market development has been on the agenda in emerging market economies for quite a while. Not least in view of the unique global interest rate environment, the possible build-up of risks to the issuing companies and bond investors alike should be monitored carefully. However, given the considerable heterogeneity among emerging markets, there is no policy advice that can hold true for specific emerging market regions or even the emerging world as a whole.

We share the report's assessment that significant progress has been reached in developing an approach to deal with systemically important financial institutions (SIFIs). This is an issue where international consistency is essential and simultaneous implementation would be desirable to maintain a level playing field.

## Chapter 2

We concur with staff that long-term investors currently face conflicting incentives. On the one hand, the experience of the recent financial crisis has raised risk awareness of investors; on the other hand, the low interest environment in advanced economies might push investors to

successively increase their allocation to riskier assets as interest rates in advanced economies might well stay low for an extended period of time. Regulators should continue to monitor the portfolio strategies of institutional investors closely. Regarding Solvency II, we emphasize that a potentially negative impact of Solvency II on investment strategies of insurance companies is mitigated or even eliminated by anti-cyclical mechanisms in the regulation, by the gradual phasing in over a period of up to ten years and by the application of sophisticated internal models used by large insurance groups.

The finding that interest rate differentials do not significantly affect real money investor flows is somewhat unexpected. To shed more light on this result, could staff provide some more information on the impact of interest differentials on investment flows of other investors and on possible differences of the impact of short term and long term interest rate differentials?

### Chapter 3

We appreciate the more rigorous approach to operationalize macroprudential policies based on empirical evidence or structural models. The chapter addresses a key question indeed: when to act? Policy makers are typically confronted with fierce opposition to restrictive measures in the boom phase of credit cycles even if they can produce a solid argumentation for their case. Ultimately, authorities with macro-prudential mandates (in analogy to monetary policy) will have to work hard to build a credible track-record over time with interventions which are widely seen as having been successful. Often it is not the initial market reaction that is relevant for the longer-term track record. What really matters is to set the right incentives for risk taking and correct them if necessary.

We concur with the staff's view on the importance of differentiating carefully between episodes of unusually strong credit growth driven by positive productivity shocks on the one hand and credit growth driven by market failures on the other hand. For example, before the materialization of the global financial crisis in 2007 it was a widely held view that the increasing transfer of credit risk had improved the risk allocation and, consequently, the observable growth of credit aggregates did not imply the build-up of systemic risk. However, we believe it is extremely difficult to capture all relevant aspects for this kind of analytical problem into a formal model. An important element to consider would also be the availability of macro-economic and other policy resources to mitigate systemic risks and counteract

self-reinforcing tendencies of a financial crisis. Furthermore, it would be necessary to include shadow banking activities in the analysis.

With regard to calibrating thresholds for certain market stress indicators it should be noted that market participants are likely to change their behavior if critical measures are being defined publicly. As a result, market participants might abruptly exit popular trades and activities to gain a first mover advantage just before an anticipated threshold is triggered. Effectively such behavior lowers the empirical threshold level and may lead to an earlier materialization of a crisis. Similar concerns have been raised for the use of market based triggers for contingent convertible bonds. Moreover, market participants' reaction to specific policy interventions is difficult to predict (to some extent this is also relevant for rules-based measures such as countercyclical capital buffers). Bad outcomes could be that a macro-prudential measure is simply evaded, or it might be interpreted as keeping systemic risk in check, so risk-appetite could increase even further, or supervisors might be perceived as having better information and if they show alertness, market participants will translate this into a self-fulfilling prophecy. Overall, models can be informative analytical tools, but ultimately the operationalization of macro-prudential policy requires a lot of judgement.

Mr. Weber and Mrs. Zajdel-Kurowska submitted the following statement:

We note that the WEO and the GFSR have returned to their roots, being analytical staff products that do not venture into the political arena. As the crisis has evolved to reach a political stage, as asserted by staff, we understand and agree with staff's hesitation to be too prescriptive. This is not to say that the general messages derived from the analysis and addressed to policy makers are not strong enough, but that policy action—borne out of and legitimized through domestic political debate—will ultimately need to be more concrete than what the Fund staff can offer.

A second observation concerns the fact that we have in the past observed a complementarity of the WEO and the GFSR in that the former's focus on the growth outlook and the real economy was generally more upbeat whereas the latter's probing of lingering systemic risks instilled a healthy dose of prudence. While the two products remain complementary, their conclusion is now equally alarming, a fact that suggests potentially strong negative real-financial sector feedback loops.

We consider it appropriate that the flagship products, and especially the GFSR, put a strong emphasis on developments in the euro area since we

share the view that, at this juncture, the predominant systemic risk stems from an intensification of the sovereign debt crisis there. We nevertheless value staff's recommendations that apply more generally, namely their call to bolster financial system resilience by both strengthening the regulatory framework and building up bank capital and liquidity.

In the following, we offer more detailed comments of the WEO and the GFSR jointly. We found the analytical chapters underpinning the main conclusions to be of high quality and valuable and will provide comments on these analytical chapters directly to staff.

We share the staff's downbeat assessment of a low-growth scenario materializing in advanced economies, at a time when risks are already tilted to the downside. The outlook is for a fragile growth environment, with market confidence in some sovereigns waning and fiscal space in many already exhausted. We concur with staff that greater financial market volatility and the concomitant rise in uncertainty in the short term will strongly influence economic outcomes. Should the downside scenario materialize, addressing the legacy of the Great Recession will become even more challenging.

A weakening of the world economic outlook and increasing financial stability risks call for decisive and prompt policy responses. These responses have to be tailored to countries' (and regions') circumstances. Strong political ownership of measures is crucial to improve investor sentiment and calm markets. We generally concur with the policy priorities for advanced and emerging market economies laid out in the report.

Continuing sovereign vulnerabilities and market tensions in Europe call for a prompt implementation of the recent EU summit commitments. In particular, the expanded mandate of the EFSF must be implemented fully, the debt crisis in Greece must be solved expeditiously, and the public debt overhang in the euro area must be addressed decisively. Meanwhile, as noted by staff, the European Central Bank has little choice but to intervene in sovereign bond markets to avoid a sudden loss of investor confidence and limit contagion.

We consider the risk of renewed weakness in the United States also relevant but somewhat less consequential for systemic stability, as the scenario of a sudden increase in the risk premium for U.S. debt seems unlikely so far. However, a medium-term fiscal consolidation plan for the United States is imperative. The staff suggests that if the U.S. debt is placed on a credible, downward trajectory over the medium-term, congress should

consider abolishing the federal debt ceiling as a control device (paragraph 91). We would appreciate staff's comments on possible alternative measures to replace the debt ceiling.

Policy makers have to strike the right balance between setting an adequate pace of fiscal adjustment and not choking off economic activity. In some countries, fiscal consolidation is happening at an appropriate pace. In many others, in particular those that are subject to market pressures, the pace of fiscal adjustment is not sufficient and more determined policy action is needed. While fiscal reforms over the medium term are paramount, policymakers should not shy away from announcing and legislating such reforms now in order to guide public and market expectations and restore confidence. It is also desirable to modernize the frameworks for fiscal policy with stronger and credible fiscal rules as well as medium-term budgetary frameworks.

As long as financial markets have not returned to normal, unconventional monetary policies continue to be needed to ensure properly functioning markets. We should not forget, however, that this short-term need places strong pressure on central banks to compromise their price stability mandate. Monetary policy support should not become a permanent substitute for financial repair and proper market functioning. We caution that a continued low-interest rate environment is likely to give rise to excessive risk-taking and feeds asset bubbles.

Strengthening the resilience of the financial system through higher capital buffers and more effective financial sector regulation is crucial. Regulators should strive to introduce the higher capital and liquidity standards of Basel III in a timely manner. As the global financial system remains vulnerable, financial sector repair and reform—in particular of global systemic financial institutions—should be accelerated. A coherent and coordinated implementation of financial sector regulations is essential to mitigate the risks of contagion and prevent cross-border spillovers. However, some regulations designed to strengthen the resilience of the system may have unintended consequences. The staff concludes that initiatives like Solvency II for European insurances companies may push these institutions away from the traditional role of taking on longer-term risky assets (GFSR, Chapter 2). We would appreciate staff's comments on possible ways of balancing these trade-offs.

Ms. Lundsager, Mr. Rediker, Mr. Lindquist and Mr. Malloy submitted the following statement:

Risks to financial stability and global growth have increased recently, in line with the intensification of sovereign/banking sector strains in Europe and weaker U.S. and European growth outlooks than previously expected. We concur with the importance of decisive steps by the European authorities to address the twin challenges of sovereign and financial sector strains. The challenge for the United States is to support growth in the near term while taking further steps to secure medium-term fiscal sustainability. Meanwhile, global rebalancing is not progressing, an important risk to the medium-term growth outlook. As the Managing Director stressed in her recent op-ed, close international cooperation will be needed to bolster growth and avoid the downside scenario outlined by the staff in the WEO and GFSR.

Overall, the WEO and GFSR clearly outline the risks to the global economic outlook, including those related to fiscal challenges and European financial sector strains. However, we feel that these surveillance products continue to provide very limited analysis on the role of external economic policies on global rebalancing and stability.

#### Sovereign Strains and the Financial Sector in Europe

We share the concerns raised in the GFSR regarding the continued strains in Europe. The negative feedback loop between sovereign and banking sector stresses has still not been broken, despite attempts to increase the transparency of bank assets through the recent European Banking Authority's (EBA) and previous stress tests and the efforts of some countries to raise capital ratios and restructure weak institutions and sectors. Meanwhile, wholesale funding market pressures have only increased in recent weeks.

Among the key factors behind continued European banking sector stress is investor and counterparty uncertainty regarding banks' holdings of sovereign assets. We thus welcome the GFSR's focus on the difference between the book value and market value of banks' sovereign assets and the potential size of this wedge. We understand that this is a stylized analysis and not an attempt to estimate capital needs. Nevertheless, it is useful in illustrating that, in aggregate, potential sovereign spillovers to the banking sector are significant and deserving of focus. It also helpfully supplements the analysis of the recent EBA stress tests, which did not adequately consider the full potential for sovereign-related losses in the banking book.



By looking at the mark-to-market impact in the aggregate, however, we wonder if the staff misses an opportunity to provide a more targeted view of where potential write-downs may actually be large enough to cause significant capital losses. In this regard, Figure 1.18 is informative, though incomplete. It illustrates that peripheral euro area banking sectors face the largest potential losses on their sovereign holdings relative to their capital levels, since they naturally hold higher levels of peripheral sovereign debt. For banks in core euro zone countries, it is not clear what ultimate losses related to peripheral sovereign debt would be. A fuller presentation, including second-round impacts from counterparty exposures to other European banks (including derivative exposures), on a country-by-country basis, would be needed to make this analysis truly meaningful. The staff's comment is welcome.

Given the high level of interconnectedness of the European banking system, both within Europe and elsewhere, it is critical that the European authorities move decisively to address sovereign risks and also to increase confidence in banking sectors. Banks need to raise capital, and if they cannot do this in private markets, national governments should be prepared to step in where necessary, in some cases accompanied by sectoral or institutional restructuring. We understand that some sovereigns may not be in a position to provide needed capital. We thus welcome the July 21 European Council decision to allow the EFSF to finance the recapitalization of financial institutions in the euro area through loans to governments. The ECB also has a key role to play in providing liquidity against collateral to solvent institutions that cannot access wholesale funding.

Still, to be fully successful in quelling market pressures, capital raising should be part of a comprehensive crisis response strategy. To this end, we also welcome the decision to allow the EFSF to intervene in secondary bond markets in case of threats to financial stability and provide sovereign financing on a precautionary basis. We urge the euro area authorities to implement these changes to the EFSF swiftly and in a manner that maximizes their effectiveness.

More broadly, we concur with the call in the GFSR for national authorities to remain focused on international financial regulatory reforms, with the emphasis now shifting to implementation. Reforms should continue to be coordinated to prevent opportunities for regulatory arbitrage. The United States strongly supports Basel III and is committed to implementing it on schedule. We also welcome the BCBS agreement on a capital surcharge for global systemically important banks.

## U.S. Growth

Since the U.S. Article IV Board discussion, GDP estimates indicate that growth in the first half of the year was weaker than expected. GDP in the first quarter increased at a 0.4 percent annual rate and at a 1 percent annual rate in the second quarter. These revisions also indicate that aggregate output has still not returned to the level achieved before the crisis. Persistent factors for slower growth include weak growth in the housing sector and financial sector stress associated with advanced economy sovereign balance sheets, while temporary factors included higher commodity prices and the impact of the earthquake in Japan.

As indicated by the staff, the output gap in the United States remains wide and unemployment is unacceptably high. U.S. policymakers and Fund staff both recognize that the normalization of accommodative policies is not yet appropriate and that the U.S. authorities should stand ready to take additional measures to boost growth if needed. The Federal Reserve has indicated that its baseline economic outlook warrants exceptionally low levels for the federal funds rate at least through mid-2013 and that it is prepared to employ tools as appropriate to promote a stronger economic recovery in the context of price stability.

We fully agree with the staff that it is critical for the United States to develop a medium-term fiscal consolidation plan that stabilizes debt by the middle of the decade. The recently-passed Budget Control Act of 2011 makes significant progress towards this goal. The Congressional Budget Office, a non-partisan government organization, estimates that this legislation will reduce the U.S. federal deficit by \$2.1 trillion in the period from 2012-2021 (roughly 8.3 percent of 2021 GDP). We also agree that the near-term fiscal stance should remain attuned to the cycle. In light of this, the U.S. Administration supports the extension of unemployment benefits and the payroll tax reduction for next year.

## Global Imbalances

Continued weak growth in the United States also reflects, in part, the lack of progress in rebalancing the sources of global demand. The staff estimates that the contribution of consumption to growth in emerging market economies from 2011 through 2016 will be smaller than before the crisis, and global imbalances are projected to re-widen. This is not surprising, given that policies in some emerging markets (EMs), particularly in Asia, remain

broadly similar to prior to the crisis. The charts on page 39 of the WEO indicate continued rapid accumulation of FX reserves by emerging Asia, as well as the maintenance of undervalued currencies.

While the staff does briefly address the issue of exchange rate policies in global rebalancing in the WEO, the depth of analysis in this area has again been very disappointing. There is essentially one page of charts associated with exchange rate policy and global rebalancing and limited discussion in the text. On the other hand, there is a full chapter in the WEO devoted to the role of fiscal policy in rebalancing, as well as the 100-page Fiscal Monitor to address fiscal trends and policies. While we agree that fiscal trends and policies are important, this should not preclude any research and discussion on the role of exchange rate policy on global growth and rebalancing. To assess the staff's views on foreign exchange intervention trends and the drivers of reserve accumulation in EMs, one must resort to combing through the statistical appendices, and even there, the information is limited. The statistical appendix, for example, indicates that:

- The staff projects that 63 percent of global reserve accumulation in 2011 will come from EM Asia, compared to 50 percent in 2007.
- In 2011, reserve accumulation in EM Asia is projected to be at its highest ever aggregate level and is projected to rise further next year.
- The majority of FX inflows driving this reserve accumulation in EM Asia still originate through the current account, not the capital account. Non-FDI capital inflows are estimated at only 20 percent of total FX reserve accumulation.

The consistent lack of analysis of the multilateral aspects of exchange rate policies and reserve accumulation in the WEO illustrates that there is a large gap in the Fund's existing suite of multilateral surveillance when it comes to these issues. There has been some improvement in the exchange rate analysis in Article IV staff reports, and we have noted that a number of Article IV reports have included use of the new reserve adequacy metric. However, country reports do not address the multilateral aspects of this issue. The spillover reports addressed the spillovers from China's exchange rate policies, but did so without incorporating the policy response to China's policies by other countries. The spillover reports are also limited to the S5 economies, whereas there are also many smaller economies whose exchange rate policies cumulatively have a significant impact on global imbalances.

The chapter in the WEO regarding the impact of global fiscal policies on global imbalances provided some useful insights. We call on the staff to similarly look at the role of exchange rate policies and reserve accumulation on global imbalances in a comprehensive way, including:

- What are the aggregate levels of FX intervention in the spot and forward markets disaggregated by country? These data are freely available in countries' balance of payments data and SDDS reserve templates.
- What is the staff's best estimate of the impact of this FX intervention on the balance of payments of countries that are intervening and those that are not, and more broadly on global imbalances?
- How would a reduction of FX intervention by EM central banks impact exchange rates, current account surpluses, and economic growth in major economies over the medium term?

We are puzzled that management and the staff have not considered these questions as sufficiently important for more acute focus and in-depth research while the multilateral aspects of global monetary and fiscal policies are addressed in multiple products.

#### Capital Flows and Asset Allocation

In the GFSR, the staff takes a more complete approach in its analysis of capital flows, in comparison to other recent work, in several respects. First, while Chapter 1 of the GFSR appropriately discusses near-term dynamics related to capital flows, Chapter 2 takes a longer-term view, focusing on the global asset allocation decisions of real money investors. Second, in Chapter 2 the staff includes in its analysis cross-border official sector flows related to reserve accumulation and sovereign wealth funds (SWFs). As we have pointed out in the past, these flows are also capital flows, and we welcome their treatment as such. Third, the staff acknowledges in Chapter 1 of the WEO that the world's major net exporters of capital have for many years been EMs. Given these recognitions, we hope that the staff will avoid the confusing and inaccurate labeling of "source countries" and "recipient countries" in future work. We were pleased to see that the analysis in the GFSR and WEO did not involve this false dichotomy.

We found the results in Chapter 2 of the GFSR interesting, notably that fund flows from real money investors do not seem to respond to interest rate differentials. Rather, these asset allocation decisions tend to be more

affected by destination country economic prospects and the general global risk appetite. Indeed, these results tend to explain well the experience of the past few years. Before the crisis, private capital flows were robust in line with strong growth in EMs and elevated risk appetite, despite neutral or restrictive policy interest rates in advanced economies at the time. Post-crisis, an increase in risk appetite rather than interest rate differentials seems to be the driving “push” factor for the renewal of strong private flows to EMs.

Furthermore, it may be misleading to characterize policy interest rate differentials as “push” factors in the first place. Monetary policy responses are endogenous to economic growth and thus move in response to economic factors that themselves drive global capital flows. Thus, in part, policy rate differentials reflect the differing future growth prospects of two sets of economies—this is just another way of stating Chapter 2’s findings that growth prospects matter in driving capital flows.

We note the discussion in Chapter 1 of the WEO regarding adverse spillovers of low policy rates in advanced economies and whether it would be more optimal for EMs if policy rates in advanced economies were higher. Of course, the global economy would be better served by stronger growth in advanced economies, which would not necessitate accommodative monetary policies. But the reality is that large output gaps remain in many cases, and low policy interest rates are critical to supporting growth as the recovery progresses. To the extent that some countries may be experiencing large capital inflows, we would concur with the GFSR that “an appropriate fiscal and monetary policy mix, including exchange rate flexibility, is the first line of defense” and that capital controls “cannot substitute for appropriate macroeconomic policies.”

Over the past year, we have devoted a significant amount of time discussing the spillovers of advanced economy monetary policies through the spillover reports, the WEO and GFSR, and other Board papers. We note that the work program includes a paper on “The Multilateral Aspects of Policies Affecting Capital Flows.” We look forward to a discussion that includes the spillovers of: (1) capital controls; and (2) reserve accumulation (and the associated capital flows) and resistance to currency appreciation.

#### Commodity Financialization

We agree with the staff that recent research does not provide strong evidence that commodity market financialization has a significant impact on commodity price movements and that these movements are primarily driven

by supply and demand factors. We also agree with the staff's conclusion that commodity market financialization does not call for urgent policy intervention. Reflection of this assessment in future surveillance products would be appropriate.

Mr. Chia, Mr. De Leon and Ms. Yeo submitted the following statement:

We thank the staff for the well-written, thoughtful and relevant analysis in the WEO and GFSR. The two documents are timely and should serve to send a clear and unambiguous message that the risks to the global economy can only be overcome by decisive policy actions that have so far been elusive.

In view of the overlapping themes between the WEO and the GFSR, our chair has elected to issue a joint gray for both publications.

The global economic and financial environment has deteriorated. A number of legacy problems from the crisis have persisted and remain unresolved, whilst new vulnerabilities are coming to the fore. On the latter, we see the crisis having taken two new turns. First, it has evolved into a new and more political phase where the requisite solutions are not only economic, but increasingly demand the marshaling of political will to implement requisite policies. Policy-makers have not delivered decisively on this front, which has led to a faltering of confidence and renewed market strains. Second, low policy rates and abundant liquidity in advanced economies had prompted a "search for yield" that could push investors towards more risky assets, raise the leverage employed and exacerbate capital flows. These flows towards risky assets have proven fickle as recent events have led to an outflow from emerging market funds.

We welcome staff's policy advice on fiscal consolidation and reform, more financial repair, and addressing the crisis in the euro area, as laid out in Chapter 1 of the WEO. The call for implementation and delivery of policy measures already committed is useful. However, that does not close the gap between what the market views as adequate and what has been committed so far. The public discourse on what additional measures are needed to fill this gap has proceeded without the Fund's input. These include timely and appropriately ambitious fiscal consolidation plans in even the euro zone core, a growth-promoting fiscal plan in the United States, a larger and more flexible EFSF, the issuance of Eurobonds and guarantees of bank debt. The common theme among many of these ideas is a strong and unwavering political commitment to the expansion of official sector resources for, and its flexible

use in, crisis management. A robust discussion of these measures in the WEO and GFSR would not only be a useful and important contribution, but also to a large extent expected of the Fund. Thus we would like to see even a set of clearer and unambiguous messages, particularly in the WEO, that call for strong policy action in specific areas so that policymakers get ahead of the curve. The MD in her Jackson Hole speech has delivered a first installment of that clear and unambiguous message. The WEO would be widely anticipated to offer more.

On rebalancing the global economy, we concur with staff that both advanced and emerging economies should contribute to global rebalancing. That is, the engine of growth in advanced economies should shift from public demand to private demand and emerging surplus countries ought to increasingly orientate their economies to promote domestic demand. However, we see this as a medium term issue. The immediate focus should be on stabilizing growth and financial systems in the major economies, and in some cases this may mean supportive fiscal policy in the short-term, particularly in the United States and Japan. The transition towards greater reliance on domestic demand by EMEs will take time and will not in the short-term be critical to addressing current risks to global growth and financial stability, even though reforms should proceed apace over the longer term.

Further, we would caution that staff's policy advice to EMEs needs to be suitably differentiated and nuanced. The risks in EMEs are now not clearly skewed towards overheating, given the deterioration in the global growth outlook. Indeed, the case for using policy rate hikes and/or exchange rate appreciation to address overheating pressures in EMEs has been muddled for several reasons. First, this could inadvertently result in the countervailing effect of inviting greater capital inflows. Second, the WEO analysis in Chapter 2 showed that inflationary pressures are varied across EMEs and broad-brush policy prescriptions should be avoided. As highlighted in the WEO, there could be some instances where a pause from tightening measures was the appropriate response. Third, recent outflows from some EMEs could imply that stalling growth in advanced economies is beginning to impart perceptions of diminished prospects in the emerging world. The MD noted in her Jackson Hole speech that "everyone should recognize that decoupling is a myth. If the advanced countries succumb to recession, the emerging markets will not escape." In this context, EME policymakers must take into account the risks of inducing sharper-than-warranted contractions.

Moving to the choice of policy tools in EMEs that indeed ought to tighten policy, we appreciated staff's views that macro-prudential measures

could have a role to play, although their longer-term effectiveness remained to be seen. Such tools could engender dual effects that are beneficial to EMEs. First, they allow for a more precise set of instruments to constrain excesses in credit and asset markets, thereby reducing overheating risks. Second, they could also strengthen the resilience of banks through, for instance, measures aimed at reducing exposures to bubbly property markets or raising capital buffers. This would in turn mitigate the fallout if risks such as sudden-stops and/or a sharp negative reappraisal of global growth prospects were to materialize. That said, staff's analysis of China's experience in Box 1.4 of the GFSR suggested that macro-prudential tools applied to one sector could divert credit growth to alternative and possibly more opaque channels where such measures yet to be deployed. Overall, policymakers would likely need to continue using a mix of policy tools to confront the challenges at bay. We further echo Mr. Bakker's call for follow-up work to study how the financial system is responding to such policies, which could better inform policymakers as to their utility and risks.

The staff's assertion on global foreign exchange reserve holdings having exceeded that needed for balance of payments and monetary purposes needs to be interpreted cautiously. We share the view of Mr. Garcia-Silva, Mr. Hendrick and Mr. Maciel that there is no conclusive agreement on how the "optimum level of official reserves" should be determined. Further, Box 1.4 in the WEO on "External Liabilities and Crisis Tipping Points" found evidence that higher reserves mitigate crisis risk over and above their effects on the net debt position, suggesting that so-called excess reserves continued to have a precautionary function. The staff's comments on these somewhat diverging statements would be appreciated.

In addition, we share staff's view that the extraordinary vulnerabilities in the global financial system may cause disruptions to financial access. Given the increasing inter-connectedness in financial markets and the heightened stress to the global economy, there is an urgent need to increase the size and scope of international risk-sharing mechanisms, which have fallen far behind the size of global financial markets. We see this as a serious issue that needs to be addressed expeditiously and staff should study if the Fund has a role to play in this.

In conclusion, we reiterate the importance of stronger international policy coordination to address the plethora of challenges before us. The GFSR, for example, contained several frank messages and discussions that advocated useful policy priorities. It also rightly observed that the range of policy options available has shrunk and time is running out to tackle



vulnerabilities that threaten the global financial system and the fragile economic recovery. In this connection, we join other Directors in stressing that the forthcoming IMFC meeting provides an important platform for Ministers to discuss requisite policies and send an unequivocal message advocating decisive action, underpinned by multilateral cooperation.

Mr. Hockin and Ms. Beaton submitted the following statement:

We thank the staff for their excellent work on the WEO/GFSR and appreciate their efforts to further integrate these products. We will issue a joint statement on the documents.

Overall, we are in broad agreement with the global economic and financial outlook. Downside risks to the global economy and financial stability have significantly increased since the last WEO/GFSR and the policy response has fallen behind. The staff has appropriately identified addressing sovereign vulnerabilities as a key policy priority, particularly the need to contain the European sovereign debt and banking crisis to the periphery. We also agree that the global recovery could be derailed if the U.S. recovery continues to lose steam or is negatively affected by a rapid loss in confidence or worsening financial conditions. On financial stability, we agree that the low interest rate environment, while appropriate for macroeconomic reasons, may provide the impetus for more aggressive risk-taking behavior, putting financial stability at risk. Overall, we believe that there are four key challenges facing global policymakers that must be addressed with concerted policy action.

#### Global Rebalancing

The policy response to global imbalances needs to be strengthened to boost the global recovery and reduce the risk of financial instability. Global imbalances appear to be widening again and concerted policy action is needed to address their underlying root causes. Advanced deficit countries have begun the difficult process of defining and implementing credible fiscal consolidation plans, but in some countries the planned consolidations are insufficient and have not convinced markets that fiscal sustainability will be achieved. Inadequate progress on fiscal consolidation and the resulting concerns over sovereign debt have fueled rapid increases in sovereign risk premia and a retrenchment in risk taking in global markets. In emerging market surplus countries, reserve accumulation has accelerated and, in some cases, currencies remain substantially overvalued. Of late, the renminbi has depreciated in real effective terms, contributing to the further build-up of

imbalances. External rebalancing remains an important dimension of sustaining the global recovery, and more emphasis should be given to the role of relative price or real exchange rate adjustment in the WEO. Structural reform aimed at strengthening domestic demand in emerging Asia, particularly China, would also help to reduce internal imbalances and provide much-needed support to external rebalancing. The longer the needed adjustments in the global economy are delayed, the more serious the consequences will eventually be. Balanced sustainable growth and financial stability go hand in hand. As such, we continue to believe that the global imbalance assessment in Figure 1.20 deserves more prominence in the WEO, similar to the global risk map in the GFSR, as it serves to highlight the ramifications of insufficient policy coordination by member countries and the central importance of the G-20 MAP.

### The Sovereign Debt Crisis

Sovereign debt problems persist and market conditions have deteriorated for some countries previously unaffected by the crisis. The policy response needs to be strengthened in some key economies as implementation risks have escalated. Markets have responded with higher sovereign risk premia that are now complicating further the resolution of the crisis. In the United States, there is a need for a credible medium-term fiscal consolidation while fiscal support in the near-term remains appropriate. At the country level in Europe, policymakers need to continue with their fiscal consolidation efforts and with growth-enhancing reforms. Progress on the latter is particularly pressing. At the euro zone level, policymakers must agree to a cohesive response and clearly signal a willingness to do whatever it takes to resolve the crisis. While the July 21 announcement committed to addressing the crisis, implementation of the announced measures has proven more difficult than previously foreseen and the ongoing discussions regarding collateral agreements for the Greek package have only added to uncertainty and reduced the credibility of the announcement. Policy commitments need to be backed up by swift implementation of agreed steps. As suggested by the GFSR, the scope and flexibility of the authorities' toolkit will also need to be further developed. In this regard, the policy advice in the GFSR could stand to be more forthcoming. We note that there is no new policy advice on how to address the crisis.

### Financial Sector Repair/Reform

As the GFSR highlights, five years after the crisis began the financial sector repair and reform agenda remains incomplete, financial markets have

begun to lose patience, and financial stability risks have increased dramatically over the last few months. While some progress has been made on the recapitalization and restructuring of the banking sector, capital levels in some banks, particularly in Europe, remain low and banks need to take further steps to raise capital. Absent additional efforts to raise capital, negative confidence effects will persist and problems in accessing funding are likely to create deleveraging pressures at banks, forcing them to cut credit to the real economy, and further perpetuating the downturn—as is aptly highlighted by the GFSR.

On financial sector reform, while important progress has been made on new global standards through the Basel III Capital Accord, on designing new macroprudential tools such as the countercyclical capital buffer, and on assessment and enforcement through initiatives such as the FSB peer review system and the regularization of FSAPs for 25 systemically-important financial sectors, much more remains to be done. More attention must now turn to expanding the perimeter of supervision and regulation towards market-based financing. This agenda has only gained in importance as low policy rates are beginning to contribute to a search for yield and diverting credit towards more opaque channels like market-based financing, as is highlighted in the GFSR. Policymakers need to guard against this risk. The reform agenda will also need to make further progress towards ensuring that the failure of one counterparty in the over-the-counter derivatives market does not create systemic knock-on effects. It is critically important that the momentum driving financial sector reform be maintained.

### Capital Flows

For emerging markets, the key policy challenge continues to be how to effectively absorb capital inflows in order to preserve macroeconomic and financial stability. However, the messaging in the WEO and the GFSR seems to be somewhat inconsistent as to how this risk has evolved. The WEO suggests that emerging market based risks have become less severe, while the GFSR presents the opposite message. The risks related to the potential for excessive risk-taking in emerging markets merits more recognition in the WEO. Emerging markets need to continue to implement the structural changes needed for their economies to absorb capital inflows. Moreover, in those economies where robust inflows are fueling domestic liquidity and credit and boosting balance sheet leverage and asset prices, policymakers need to ensure that their domestic policy mix is appropriate. For many emerging markets, fiscal and monetary policies remain overly accommodative for this stage of the cycle and should be tightened to help prevent the build-up of

overheating pressures and financial imbalances. Ensuring that the appropriate policy mix is in place will also help to limit the risk of any sharp reversals in capital flows. For its part, the Fund should continue to undertake work on its framework to manage capital inflows including work to better understand the tools at policymakers' disposal. Macroprudential policies in particular are still novel and the Fund should continue its work on operationalizing these policies. Chapter 3 in the GFSR provided an excellent contribution in this regard.

The challenges facing global policymakers are complex. The policy proposals in the WEO/GFSR for monetary accommodation, fiscal consolidation, structural reform, and more financial repair are sound and, if implemented, would help to address the key challenges facing the global economy. Yet, these policy prescriptions are well-known but the pace of implementation has been too slow. The WEO/GFSR could thus benefit from more thought/discussion on the reasons for this, including the challenges/constraints faced by policymakers. While the GFSR sends a relatively strong message that a political solution is needed, the WEO could be more explicit on the political trade-off.

## WEO Specific Comments

### Chapter 1: Global Prospects and Policies

We agree that structural reform needs to remain a global priority and believe that further elaboration on the structural reform agenda, including a discussion of the challenges in implementing these reforms, would be useful. Very limited progress has been made in areas—such as competition policy, agricultural subsidy or entitlement reforms—where reforms might hurt specific interest groups. The feasibility of such reforms during a crisis and the sequencing and priority of different measures could be discussed in more detail. It would also be useful to discuss specific product market reforms, as has been done for labor market measures.

We appreciate the box on speculation in commodity markets and fully support its main conclusions and resulting policy implication—commodity market financialization does not call for urgent policy intervention. Identifying the distinct sources of possible frictions in commodity futures markets is particularly useful. Yet, it does not fully resolve the fundamental tension between speculation in the financial market and speculation in the market for inventories. If non-fundamental forces are driving futures prices, how can there be a disconnect in the market for storage? Fundamentally, the

spread between futures and spot prices provides price signals about the marginal value of storage. If financial speculation distorted futures prices, this too would be reflected in the market for commodity storage.

## Chapter 2: Country and Regional Perspectives

On the United States, we agree that the outlook has deteriorated and downside risks have increased. The WEO could benefit from a discussion of the implications of recent declines in business and consumer confidence and further elaboration on the importance of negative wealth effects associated with the recent fall in stock markets on the outlook. We would also appreciate a discussion of the likelihood of a U.S. recession (independent from developments in Europe and Asia as in the WEO downside scenario). An assessment of the Federal Reserve's recent commitment to maintain the low level of the federal funds rate at least through mid-2013 as well as a deeper discussion of the options available to the Federal Reserve for further unconventional support if needed would also be useful. Such an assessment should also note that more unconventional easing is not without risks and caveats.

On Europe, while we have commented on the needed policy response to the sovereign debt crisis above, we have a few remaining comments. In the periphery, the difficult structural reforms being undertaken can be expected to translate to stronger growth with a lag. Further discussion of these lags is warranted and could be tied into the discussion of support measures in the euro area. IMF supported programs in some countries are providing needed space to implement reforms and a greater emphasis on ensuring that structural reforms are implemented while these countries are receiving support is needed. We are also interested in further comments on potential implications of the deterioration in the German outlook for the European outlook. Contagion risks to CEE also deserve more attention in the report, including a discussion of the region's high foreign ownership of banking assets and large share of foreign-currency-denominated loans.

In emerging markets, monetary policymakers face a challenging environment as excess demand is prevailing and inflation is rising, but activity is slowing. While we agree that dimming growth prospects present very real challenges to growth, the risk of overheating should not be prematurely overlooked. If emerging markets pause their monetary tightening and global headwinds are weaker than expected, then real interest rates in some emerging markets would move even deeper into negative territory. This could fuel more domestic inflation and feed potential bubbles in Asia and Latin America. Hard

landings in some large emerging markets would remove an important source of global growth. We agree with the staff that China should rely more on interest rates as opposed to quantitative measures for monetary policy. In Figure 2.10, we would argue that real interest rates should be calculated using total rather than core inflation as food prices represent around 30 percent of the CPI basket in China. Using total expected inflation, the real interest rate in China is still negative and better reflects the fact that the current monetary stance is too accommodative. In Latin American, further monetary tightening is likely needed in Brazil in addition to Argentina, Paraguay, and Venezuela as identified in the report.

### Chapter 3: Target What You Can Hit: Commodity Price Swings and Monetary Policy

The analysis in this chapter provides meaningful advice to policymakers on the design of their monetary policy frameworks and on the appropriate policy response to movements in commodity prices. However, the analysis could benefit from a consideration of how the appropriate monetary policy response may differ depending on the source of the commodity price shock. Even for a small open economy, a commodity price increase caused by a structural demand shock has different implications for inflation than a price increase due to a supply shock, each of which may necessitate a different policy response. This suggests that monetary policymakers should pay attention to the reason for the increase in commodity prices and formulate a response based on that information rather than thinking solely in terms of the direction of the price movement.

### Chapter 4: Separated at Birth? The Twin Budget and Trade Balances

This chapter provides a timely re-evaluation of the long-standing question on the link between the fiscal and external balance. Not only does the chapter suggest that further consolidation efforts are needed, but it also highlights the importance of other adjustment mechanisms in resolving global imbalances—most importantly the need for adjustment in real exchange rates and structural measures to boost demand in surplus countries. However, the analysis in the paper could benefit from some minor clarifications and suggestions. First, it would be useful to consider a simulation in which sovereign risk premia are rising while fiscal consolidation is being undertaken—as has occurred recently. We would anticipate that the effect on current account balances could be quite different. Second, it would be helpful to provide additional details on the model-based fiscal consolidation exercise based on the current fiscal plans of several economies. Since GIMF is a

perfect foresight model, issues regarding the anticipation of fiscal measures are important in the design of the exogenous path of fiscal instruments used to simulate the current fiscal consolidation plans. Also, it is unclear whether the exercise is fully based on spending cuts, as in the standardized 1 percent fiscal consolidation exercise described in the previous section. It is well-known that the economic effects of tax- and spending-based fiscal consolidations can be quantitatively very different.

## GFSR Specific Comments

### Chapter 1: Overcoming Political Risks and Crisis Legacies

As this chapter points out, risks to global financial stability have increased. The analysis outlining sovereign risks and possible contagion is useful, with the spillovers analysis using the mark-to-market framework of particular interest. Regarding the methodology, we have a few comments. First, we wonder how sensitive the results are to changes in the cut-off date, the sources of data, and the measures of sovereign risk used. Further, the benchmark instrument of 5-year bonds looks dubious. While it may well reflect the mean maturity of sovereign holdings, the median is likely to lie somewhere else as clearly substantial amounts are held at the long- and, especially, the short-end of the spectrum. Given the shape of some yield curves, this may unduly increase the estimate. Certainly, the staff should continue its work in this area, further refining the methodologies at its disposal, and effectively communicating concerns arising out of such analysis. Depending on the robustness of staff's results; however, we would expect staff to be careful in how the relevant results are selected and communicated to the wider public. In this sense, we are concerned that publication of the point estimate, may be unduly unsettling to markets while at the same time being open to wide variations under sensitivity analysis

On the search for yield section of Chapter 1, we agree that the low interest rate environment, while appropriate for macro-economic reasons, may provide the impetus for more aggressive risk-taking behavior. The depiction of various economies and sub-sectors of their economies relative to the credit cycle is a very useful addition to the analysis of this risk. It appears that low interest rates are, indeed, having a cascading effect on various asset classes, whereby yields are being squeezed across a broad section of assets classes and regions. This feature, as well as the increased use of financial leverage, is consistent with the picture that presented itself in advanced economies in 2007. Back then, a Goldman Sachs employee declared his concern over the build-up of double leverage in the system. At present, the shadow banking

sector appears to be an increasingly important conduit for leverage and it deserves greater scrutiny. To paraphrase a statement by a prominent member of this circle made by in 2009, without the demand for assets such as securitized products, they would not have been created. Hence, we would like to ask staff whether there is evidence of particular classes of assets that seem to be increasingly created for the purposes of satisfying demand for higher yield.

Our main comment relates to the lack of concrete policy advice. While the GFSR does discuss some policy options for emerging markets it makes no mention of how macroprudential tools might be used in the advanced economies. Specifically, how can advanced economies maintain low interest rates appropriate to the macroeconomic backdrop while keeping excesses related to the search for yield in check? Are the concerns mostly related to the involvement of shadow banking? And if so, what concrete measures do staff support?

The report also highlights an important change in the provision of capital to markets whereby banks are no longer fulfilling their traditional intermediation role, and as a result SMEs are losing out to larger corporations. If this trend were to become a structural shift, it would warrant specific policy action to ensure that growth led by the SME sector could be adequately funded.

## Chapter 2: Long-Term Investors and Their Asset Allocation: Where Are They Now?

This chapter is a useful review of the asset allocation decisions of “real money” investors and the factors underlying their decisions. As a complement to this analysis, it would be useful to delve deeper into the asset allocation decisions of short-term leveraged investors, which may be driven by different factors with differing implications for financial stability. The chapter’s finding that the low interest rate environment has not (yet) pushed investors into riskier investments to enhance yields is consistent with a recently published CGFS report which found that life insurance companies and pension funds, have not substantially increased their allocation towards riskier, higher return assets.<sup>1</sup> Pension funds in particular, however, are under intense pressure to increase returns, and so some caution is warranted. There is also considerable interest in alternative investments among smaller retail investors (e.g., high yield bonds, leveraged loans, commodities, emerging market assets) that could lead to significantly more volatile portfolios over time.

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<sup>1</sup> Fixed Income Strategies of Insurance Companies and Pension Funds. CGFS Publication No. 44 July 2010.



The staff note that as correlations between most traditional asset classes rose towards 1, the benefits of diversification diminished greatly. The long term impact of this dynamic is worth considering further. During the crisis, a portfolio which began as a well diversified portfolio, transformed into a portfolio of closely correlated assets. Traditional diversification models, which emphasize correlation of returns in determining the degree of correlation, may in the future need to take greater account of liquidity considerations across all asset classes.

We would be interested in staff views on the role of mandated stock selling within portfolios, as driven by rating agency changes. The role of rating agencies has perhaps led to a broad consensus on risk (both in the lead up to the crisis and at the present time).

While the pressures on life insurance companies and pension funds are partly reflected in their asset allocation, they may also appear in other forms. For example, it is also pushing them to shift risk back to their clients or to other areas of the financial system, reflected in the structural shift in product design (e.g., reduced guarantees in insurance policies, or the increased use of defined contribution pension plans) and the use of hedging, securitization, etc. However, this response reduces the degree of risk transformation that they provide within the financial system, and limits the distinct financial services that these funds provide to economic agents—these trends will reduce their longer-term stabilizing impact on income and increase client exposure to wealth effects (with consequences for procyclical behavior). The report would benefit from further discussion of these risks.

As recent global economic and financial developments have increased the likelihood of a sustained low interest rate environment, the interesting question is not where asset allocations are today, but how flows could evolve over the next several years and the potential for the accumulation of risky positions. How well will investors' increased sensitivity to risk hold up? As noted in the report, positions in alternative assets may be vulnerable to high volatility (or worse) in a stress environment given the relatively low liquidity for some of these assets.

More careful monitoring of asset allocations in response to the unusual global financial environment is warranted, supported by an enhanced dataset. However, new data collection activities should be prioritized within the context of the broader need to improve financial data (as in the G-20 data gaps initiative).

### Chapter 3: Towards Operationalizing Macroprudential Policies: When to Act?

This chapter is a useful contribution to the ongoing discussion on enhancing the role of macroprudential policies. The first step in operationalizing macroprudential policy is to have a clear sense of when to use these tools. This document focuses heavily on the use of credit statistics as measures of systemic risk. One finding in the report is that the credit-to-GDP gap that has been described in the BCBS guidance document is not a good indicator to signal a crisis. Conditioning with other variables does not help its performance (page 91). Elsewhere the analysis supports the use of the growth rate of the credit-to-GDP ratio as an indicator. There should be more explanation for why these results differ from earlier work (e.g., Drehmann, Borio and co-authors). For example, is it mostly due the inclusion of a greater number of emerging markets in the panel? How does the timeframe considered compare? Are the evaluation criteria different?

Mr. Furusawa and Mr. Kitamura submitted the following statement:

#### Executive Summary and Chapter 1—Overcoming Political Risks and Crisis Legacies

We thank the staff for the timely review on recent developments in the financial markets amid the fiscal problems in some European countries and the market concerns over the debt ceiling in the United States. In particular, the analysis presented in the report covered the main issues, such as, the pervasive effects of sovereign vulnerabilities on the world economy, the effects of capital flows toward emerging markets resulting from low interest rates in advanced countries. Having said that, the change in risk evaluation is significant compared with, not only the April GFSR, but also the June GFSR Market Update, in that sense, the staff may as well acknowledge that the last reviews leaned too much on the optimistic side.

As the GFSR points out, the public limelight is focusing on the difficulties in rallying broad political support for strengthening financial systems; to achieve this, it is essential that European countries and the United States steadily implement the financial consolidation measures that have been already committed. Furthermore, the euro area must demonstrate not only their collective determination but collective actions and develop more comprehensive measures in order to establish further stable economic

governance, including such measures as strengthening the Stability and Growth Pact and embodying the European Stability Mechanism.

Recently, high-yield bonds, leveraged loans, and corporate bond markets in emerging countries have expanded as a result of investors' "search for yields." We share the staff's view that "Covenant-Light" issuance and insufficient due diligence of these instruments would pose the similar concerns as we saw the sub-prime mortgage loans before they led to crisis. If an economic downturn were to occur, the risks related to investing in these financial instruments could materialize, so we need to clearly disseminate the cautious message so that market discipline properly works to avoid euphoria.

In Section II, the analysis on the spillover of sovereign risks to the banking sector is helpful toward understanding the evaluation of these risks. The EU stress test conducted in July did not sufficiently evaluate sovereign risks, because of its assumption regarding the expected loss, as the lowest non-default rating (CCC-equivalent) benchmarked to that of 15 percent did not reflect actual market conditions. Although we understand that the analysis intended to focus on the impact on funding arising from counterparty risk, rather than the solvency of banks, we see it appropriate to conclude that swift recapitalization of banks is necessary.

Taking the United States and Japan as an example, the report states "some countries are yet to launch the process or even present credible medium-term plans." However, Japan has already launched a credible medium-term plan. The authorities formulated the Fiscal Management Strategy in June 2010 and set out the three-year fiscal plan based on this strategy. The Great East Japan Earthquake was another shock that could negatively affect the fiscal condition, but the authorities are making further efforts to implement fiscal consolidation both in terms of expenditures and revenue, while they expedite the recovery and reconstruction from the disaster. In particular, on the revenue side, on June 30, our authorities decided on a package reform plan for the social security and tax systems. The plan stipulates that by the mid-2010s, the consumption tax rate will be increased from the current 5 percent to 10 percent, with the aim of securing stable tax revenue for social security spending.

Chapter 2—Long-Term Investors and Their Asset Allocations: Where Are They Now?

The chapter provides very useful information on asset allocation by long-term institutional investors through not only data analysis but also

comprehensive surveys. It is notable that, in contrast with “search for yield” behavior presented in Chapter I, the long-term institutional investors allocate their assets focusing on strong domestic economic growth prospects and perceived lower country risks, rather than interest rate differentials. The result of this analysis seems to suggest that short-term leverage investors are the one who seek the “search for yield;” we would have hoped to see additional analyses on this behavior. While downside risks persist in advanced countries and inflation rates are elevating in emerging countries, the interest rate differentials between advanced countries and emerging countries are expected to widen. In this sense, it is hard to differentiate strong economic growth prospects from widening interest rate differentials, in particular when the differential is measured in expected differential rather than the actual one. This observation will make the conclusion ambiguous in that the long-term investors might focus on the expected interest differentials.

Moreover, it includes the analysis that new regulations, such as Basel III and Solvency II, could induce the risk aversion of long-term investors; then sovereign investors such as SWF could act as their counterweight. It is far-fetched to assume that sovereign investors could take longer-term risks because private investors are simply unable to perform maturity transformation in the course of their financial intermediation due to their regulatory constraints. This sort of discussion could lead to moral hazard in that taxpayers could ultimately bear the risks, which is contradictory to the goals of financial regulatory reform and also to the overarching policies to phase out implicit government guarantee, including the reform of GSEs in the United States.

We also see it important to analyze the implications of the new regulation such as Basel III liquidity regulation and Solvency II which could induce the financial institutions to hold more sovereign bonds. If it encourages them to take excessive risks, contrary to its policy goal, the incentive compatibility of the regulation should be duly assessed.

### Chapter 3—Towards Operationalizing Macroprudential Policies: When to Act?

Chapter III facilitates the understanding of the most important element in operationalizing macroprudential policies; how to monitor and detect risks and when to act. At the same time, every financial crisis is triggered by new causes, thus, we should bear in mind that it is risky to generalize the mechanism of a financial crisis only from the lessons learned from this crisis.

Indeed, the timeframe of the discussion is quite different when we discuss the build-up of risks and when we discuss how best to detect market stress where systemic risks have already materialized. In particular, market-based indicators are effective in the latter case, but not effective in the former case; therefore they are not very practical metric for many policymakers. In addition, monitoring credit-to-GDP growth, which is an effective indicator to detect a buildup of risks, was already used as a counter-cyclical capital buffer in Basel III, so it can no longer be considered a new finding. When designing countercyclical capital buffers, credit-to-GDP growth is effective in terms of detecting the build-up of risks, but it is not effective in detect the downturn. In this regard, we would have expected a more practical assessment so as to understand when policymakers can allow lowering countercyclical buffer in economic downturn.

Lastly, the analysis, presented in Table 3.1, of the noise-to-signal ratio implies that the build-up of risks of the shadow banking could bring on a crisis; we look forward to a more in-depth analysis of this issue in the future.

Mrs. Arbelaez and Ms. Des Vignes submitted the following statement:

We thank staff for their well written and candid report. The global financial system has been affected by a number of shocks in recent times and remains extremely vulnerable as the risks to global financial stability have intensified. Enhancing the resilience of the global financial system is urgent as the crisis has entered a new and more difficult phase, underscoring the urgency for advanced economies to complete the balance sheet repairs and the financial regulatory reform. Reducing sovereign risks and preventing contagion are also critical steps in the agenda, given the positive and high correlation between sovereign risk and bank distress. Entering the fifth year of the crisis, the United States, the euro area and Japan are called to undertake a comprehensive and credible package of reforms, with emphasis on fiscal consolidation and financial sector restructuring, in a sustainable and coordinated way.

As reflected in the Global Financial Stability Map all the risk indicators have risen. Weaker growth prospects and increased sovereign vulnerabilities have raised concerns about debt sustainability in advanced economies and have amplified macroeconomic risks. This has also impacted market and liquidity risks as greater volatility in government bond yields has weakened investor base, increased funding costs and heightened uncertainty about future funding conditions. Moreover, credit risks rose as a result of spillover of risks from the sovereign to banks. Consequently, risk appetite has

declined. The monetary and financial conditions have remained unchanged, but the low interest rates in advanced economies continue to drive capital flows to emerging markets, exacerbating credit growth in some economies and increasing emerging market financial stability risks.

Banks' balance sheet repairs in Europe continue to lag those in the United States. We agree that banks should persevere in writing down distressed loans and strengthening capital buffers to help mitigate contagion risks. The recommendations by the Basel Committee and the Financial Stability Board to increase capital requirements in banks and nonbanks now have to be implemented by regulators across the globe. We take note of the progress made on regulatory reforms with respect to systemically important financial institutions and we urge that work in the other areas be accelerated to avoid the transfer of risks from more regulated to less regulated institutions.

Heightened sovereign risks are a significant threat to financial stability and need to be urgently addressed. Although, some advanced countries have begun the process of fiscal consolidation, some are yet to start. A major concern is the difficulties that policymakers are now facing to obtain political support for implementation of credible medium-term adjustment and growth enhancing reforms. We call on policymakers to take the bold decisions required to return the fiscal and debt to more sustainable levels and to avoid adverse market reactions.

The staff has adequately captured the developments in financial markets in the euro area regarding sovereign and contagion risks. The euro area needs to strengthen the crisis management framework to guard against further erosion in financial stability. The euro area summit of July 21 and the subsequent announcements are thus steps in the right direction, although falling short of expectations. The staff's assessment of the spillover of sovereign risks to the European banking system using the mark-to-market framework is highly valuable and estimates that the impact of the spillover is significant. Yet, the estimates still do not capture the full effect of sovereign risks on the banking sector which could be even more severe if risks are realized. The analysis also support our concerns that funding pressures in euro area markets could spillover quickly to banking systems across the globe, including emerging market banking systems. The failure to address contagion risk could lead as well to a decline in growth in the United States and the euro area as deleveraging pressures reduces credit supply. Mitigating this adverse feedback loop between banks and the real economy could be done through central bank liquidity support as in the case of Greece. However, as reflected

in the GFSR a more durable solution requires raising more capital and putting in place adequate backstop.

The fiscal challenges in the United States are also a source of concern with the recent debate over the debt ceiling creating significant market volatility. While we welcome the debt reduction plan, we note that it will not be enough to put the United States on a sustainable fiscal trajectory. The staff's analysis shows the potential impact of the sovereign downgrade, indicating that approximately \$19.2 trillion in outstanding treasury and other government-related debt could be affected. Also market pricing does suggest increased concerns about the build-up of fiscal risks but overall signals are mixed. Going forward, the United States must urgently address its fiscal challenges by undertaking credible fiscal consolidation and restoring growth enhancing employment.

The low interest rate environment in advanced economies along with the incomplete balance sheet repair is sending investors in search of yield that could lead to credit excesses with negative implications for financial stability. Some investors are extending duration, purchasing less liquid and lower quality assets and increasing leverage in an effort to increase yield. We urge that this behavior be more closely monitored by regulators to ensure that it does not become excessive and disruptive to financial stability. Also notable is the move of corporates, particularly in the United States, away from bank to capital market-based financing, while SMEs have remained reliant on banks financing.

Moreover, the incomplete balance sheet repair and low interest rate environment in advanced economies and the positive growth prospects and stronger fundamentals in emerging markets economies are driving significant capital inflows to these markets, escalating domestic liquidity and credit, boosting balance sheet leverage and asset prices. In some cases, portfolio and bank-related flows have dominated these flows which are volatile and can be reversed quickly. The risk of sharp reversals of flows because of weaker growth prospects, sudden capital outflows or a rise in funding costs could impact the financial soundness of domestic banks. We welcome staff's econometric analysis which shows the impact of these risks on emerging market economies. Asia and Latin America are more vulnerable to a sudden stop given that they are at the more advanced stage of the credit cycle. If all the shocks were to occur simultaneously, the capital adequacy of banks in all emerging regions would be severely affected. In light of the above analysis, we agree that policymakers need to safeguard against overheating and strengthen financial resilience by using a combination of fiscal, monetary and

macro prudential measures including capital controls. We welcome staff's recognition of the positive role that capital controls can play in managing inflows and mitigating their negative effects.

Mr. Mozhin and Mr. Palei submitted the following statement:

The GFSR starts with a prominent chart illustrating the claim that the global financial crisis has now morphed into a new political phase. This claim echoes the reasoning behind the recent Standard and Poor's credit rating downgrade of the United States, and reflects popular sentiments about the nature of the problems in the euro area. As Chairman Bernanke mentioned in his recent speech, the United States would certainly benefit from "a better process for making fiscal decisions," but we should also recognize the complexity of the challenges the policymakers are facing. Unfortunately, most of the recent popular criticism of the political leaders tends to ignore the lack of consensus on the appropriate technical solutions to the ongoing crisis. One could point to the Fund's persistent call for "a comprehensive and coherent response" to the euro area problems, but very few observers will be able to explain what this call actually means.

In her speech in Jackson Hole the Managing Director offered a set of priority areas in the anti crisis policies. In particular, she called for an urgent, mandatory, and substantial recapitalization of the European banks. We happen to share this view, and we have consistently advocated this view at the Board meetings. We have to admit, however, that the reaction by the European officials to this speech was somewhat puzzling to us. On the one hand, we note that for a long time the Fund has been rather vocal in its advice to the European members to put in place a comprehensive joint bank resolution framework and also warned them about the slow pace of bank recapitalization, lagging the efforts in the United States and the United Kingdom. The Fund also carried out multiple studies pointing to the significant risks of contagion and widespread distress in the financial sector. Estimates of risk transmission between sovereigns and banks, based on contingent claims analysis, as well as the new estimates of spillovers, based on mark-to-market framework, are just two examples of this strand of work. On the other hand, the Fund has been an active participant in the fora discussing the speed and magnitude of the necessary recapitalization, and the Fund has been working closely with all country authorities in evaluating specific country circumstances and requirements for financial sector fortification. Presumably, after four years of discussions on the financial sector reform, there should be no surprises with respect to the Fund's views on these matters. We would appreciate the staff



comments on the needed scale and speed of the European banks' recapitalization, and on the sector's main weaknesses.

It seems to us that this issue is related to the notion of shrinking set of policy choices. According to multiple studies, fast bank recapitalization could be pro-cyclical. If rushed, it could hamper still anemic credit growth and undermine the fragile economic recovery. Hence, an approach to recapitalization was in a sense similar to the advice on fiscal consolidation. In countries facing immediate or likely market pressures the authorities had to embark on pro-cyclical consolidation, while others had more room and could avoid the pro-cyclical policy response. We note that in previous multilateral surveillance reports the Fund stated that many advanced economies had to start fiscal consolidation in 2011. Similarly, the second attempt to conduct banking stress tests in Europe was supposedly based on a broadly shared understanding of the capital requirements under current challenging circumstances, including the risks of contagion elaborated by the MCM in the past. Yet, judging by the market reaction in August and based on the Managing Director's statements, one may conclude that the whole approach to strengthening of the European banking sector was insufficiently ambitious. Should we attribute this view to the unforeseen change in market conditions, lack of information on disagreements between the Fund and other key participants in the financial sector reform, or something else?

We welcome the analysis of the risks to financial stability due to protracted period of low interest rates in crisis-hit advanced economies in Section III of Chapter I. In this part of the GFSR it would have been useful to bridge the discussion of these risks with the understanding of the stance of monetary policy in advanced economies. The call for the authorities "to shift their focus from accommodative macroeconomic policies towards structural approaches to strengthening balance sheets and reducing debt burdens"(paragraph 54), as well as the notion that "real interest rates are much lower and liquidity is more abundant than is normal at this point of the cycle" are not universally accepted. Quite a few prominent economists continue to insist that the monetary policy in the United States and the euro area remain excessively tight. If our reading is correct, it is also advocated in the WEO that additional easing would be appropriate if additional evidence pointed to a weaker recovery. In this case we see a need for more clarity about staff's views and for better integration of the GFSR and the WEO.

We agree with staff that it is useful to distinguish between lasting reevaluation of the relative attractiveness to long-term investors of various asset classes more generally (Chapter 2), on the one hand, and, on the other

hand, catalytic role in this process of the cyclical factors, including low interest rates and bleak economic growth prospects in advanced economies. As changes in the direction of capital flows could be large and their behavior erratic, the Fund's members, including emerging market economies, have to guard against financial stability risks.

During the crisis some countries, such as Brazil and Turkey, have already been exposed to substantial and sustained capital inflows, which complicated the conduct of macroeconomic policies and led to unconventional policy responses. Although it would be an exaggeration to claim that capital inflows to most emerging market and developing economies are already excessive and overheating is a widespread concern, we appreciate the warnings in the GFSR. Multiple lessons from the previous episodes of prolonged capital inflows associated with excessive credit growth point to the need for vigilance, and potential structural shifts in asset allocation by global investors only add to the urgency of actions by policymakers.

A variety of policy tools should be used to guard against the buildup of financial stability risks. In addition to traditional reliance on more flexible exchange rate policies, where possible, and tighter fiscal policies, macroprudential tools are of great interest to the authorities. The experience of the Hong Kong authorities (Box 1.5) offers insights on the possible measures aimed at protecting resilience of the bank and household balance sheets against excessive risk taking. While it is difficult for the authorities to judge whether the rise in property prices or valuation of other assets is driven by fundamentals or speculation, the authorities should err on the side of caution and pay special attention to financial stability. We look forward to continuous monitoring and analysis by the Fund of macroprudential measures across a broad group of emerging market economies.

From this point of view, we also found the material in Chapter 3 to be very useful, and offering a possible approach to identifying a small set of reliable indicators of systemic risks. The chapter contributes to the literature on the use of specific macroprudential tools tailored to the nature of financial stability risks. The Fund should also continue to pay close attention to the analysis and dissemination of best practices in this area.

The representative from the European Central Bank submitted the following statement:

We agree with the staff's analysis that risks to global financial stability have substantially increased since the publication of the previous GFSR. The

downside risks to global financial stability have been mainly driven by the weaker global macro-economic growth outlook, compounded by elevated stress on fiscal sustainability and financial sector conditions in various countries. Concerns among market participants about a perverse feedback loop between economic, sovereign and financial sector risk have clearly been exacerbated. Other closely intertwined risks prevail as well, most notably bank funding strains, property market fragilities and associated credit risks for banks, and vulnerabilities related to the possibility of an abrupt unwinding of global imbalances or a turnaround in global capital flows.

Concerning sovereign vulnerabilities and associated contagion risks, we broadly agree with the GFSR's assessment of the impact of fiscal policies on financial sector stability and the overall fiscal policy recommendation urging countries to address fiscal challenges.

We also agree with the GFSR's assessment that the prime financial stability concerns in the EU at the present juncture remain the interplay between the vulnerability of public finances and the financial sector, contagion of euro area sovereign debt strains, and bank funding risks. These risks have increased of late, especially in the summer months.

However, we strongly disagree with the mark-to-market framework applied to the EU banking sector presented in Chapter 1, Section II. In our view, the framework suffers from a number of very serious weaknesses related to both methodological and data issues. In turn, these weaknesses lead to an overestimation of the negative spillovers from euro area sovereign stress onto the European banking system, in part by ignoring any positive offsetting elements:

The data sets used—in particular the reliance on (i) unconsolidated BIS data on exposures, and (ii) five-year CDS figures rather than changes in bond prices adjusted for the average maturity (which is actually shorter than five years)—lead to a significant upward bias in the results.

The framework does not take into account losses which have already been recognized in the form of mark-to-market trading losses during the period between end-2009 and now.

In the same vein, it does not take into account the provisions that have already been made by EU banks on sovereign debt exposures. Ignoring provisions and mark-to-market trading losses that have already been made/recognized introduces an element of double-counting in the exercise.

The mark-to-market losses stemming from claims on banks in the high-spread countries and the impact on bank funding markets are overestimated, especially since the analysis derives from total interbank claims which represent a much broader range of liabilities than actual wholesale interbank funding.

The framework applies the sovereign shock in a selective way. It focuses solely on losses associated with exposures to high-spread countries, but disregards gains made on exposures to sovereigns treated as ‘safe havens,’ which would bring substantial relief to a number of banks.

Given these methodological and data shortcomings, the framework produces in our view highly implausible—and exaggerated—results. The ECB has conducted a similar mark-to-market exercise in-house mirroring the staff’s methodology, but correcting for the above shortcomings. This exercise—using EBA instead of BIS figures, cash instead of derivatives prices, and a cut-off date of end-December 2010 instead of end-December 2009—yields fundamentally different results. What is more, the ECB fears that publishing these highly market-sensitive results at the current juncture may fuel market turbulence. It would also raise severe communication challenges, as the scope for misinterpretation by media and market participants is considerable. All things considered, the ECB therefore strongly believes that the publication of this quantitative exercise as it stands is not warranted.

Furthermore, the suggested policy response to break the negative feedback loop—consisting of private capital raising among EU banks (which may not be possible for some banks under current market conditions)—might be perceived as insufficient. It would be important to frame policy recommendations in a broader context where also banks’ business models, size and funding structures should be adjusted where necessary.

Concerning the search for yield and related risks of credit excesses, we generally agree with the IMF assessment that unusually low interest rates and yield compression against the backdrop of a weaker economic recovery provide fewer buffers at the turn of the cycle with a greater potential for future deterioration in credit quality. We agree that current abundant liquidity and the low interest rate environment in the long run risk fuelling renewed build-up of leverage in some countries and sectors and fostering asset price misalignments. This notwithstanding, in the shorter term a low level of interest rates will most likely contribute to limiting banks’ credit losses

resulting from existing credit exposures. Moreover, it could be highlighted that in terms of the build-up of new credit excesses, other crisis-related and regulatory factors (such as banks' solvency and liquidity constraints) and the impact of the forthcoming Basel III regulation are likely to have outweighed the incentives for banks to loosen credit standards in a low interest rate environment. Nonetheless, there is a risk that for some banks low interest rates may have facilitated forbearance on outstanding credits and thus might have delayed necessary de-leveraging by households and non-financial corporations. To safeguard stability, greater emphasis on balance sheet repair and vigilant macro prudential policies in the current situation of low interest rates are clearly warranted.

From a European perspective, we also share the IMF view that Europe remains at an earlier stage of the credit cycle mainly related to a lagging economic cycle but also on account of further needs of households to increase savings (with a focus on the euro area periphery) and for corporations to deleverage. In addition, cost of funds and balance sheet constraints continue to weigh on European banks. We broadly share the IMF assessment of further difficult credit conditions and ongoing funding pressures. That said, generalizing the financial stability risks to the euro area aggregate level can be misleading, as it masks strongly diverging developments at the country level.

The Acting Chair (Mr. Lipsky) made the following statement:

Welcome back, at least, welcome back to most Directors. We open the second of our series of three reports: the WEO this morning, the GFSR this afternoon, and the Fiscal Monitor tomorrow. Mr. Bernes from the World Bank is present. A detail that will be interesting and notable for many Directors, Mr. Blitzler is here, not as a former Fund staff member, but representing the IFC.

All Directors issued grays, and the ECB representative also issued a statement. In a minute I will ask our Financial Counsellor to begin the proceedings with the usual presentation. But, before I do that, I just want to say one word. The draft of the GFSR Directors have received is just a draft. It has data that could be sensitive. I hope everyone in the room will respect the confidentiality of the discussions and the confidentiality of the documents, so that, on the one hand, we can have full and frank discussions of the subject matter, without worrying that it will come out in a partial, anticipated way. So I just want to remind Directors that respecting the confidentiality is important for the process, and among other things to remind Directors that this is a draft, and this is why we are having a discussion, among other things, so that we can

take Directors comments into consideration and adjust the document where we think it is necessary or justified.

The Director of the Monetary and Capital Markets Department (Mr. Viñals), in response to questions and comments from Executive Directors, made the following statement:<sup>2</sup>

Let me just start by saying that I would have liked to present a much rosier GFSR but reality is what it is, and it is our duty to represent reality as well as we possibly can. Let me tell Directors what is going to be our plan for the next couple of hours. I am going to basically start by using three words: confidence or lack of confidence; legacies from the crisis; and political risks.

What we are seeing today is that for the past six months, since our last GFSR, we have gone deeper into a confidence crisis whose sources have to do with weak growth, but also with an inability to address the main issues coming from the crisis in terms of financial repair, reform, rebalancing, and the things that Mr. Blanchard talked about this morning. And this is something for which much stronger politics is needed.

I think that at the time we are now today, it would be important to ask how different is the present situation from that we encountered toward the end of 2008 when we had the Lehman episode, which was also a very fundamental time of confidence crisis.

This time, at the source of the confidence crisis is the sovereign strains as one of the problems in this phase of the crisis. Sovereign strains are becoming much more widespread, even affecting economies like the United States after the downgrade by Standard & Poor's. Markets have started to ask who will be the next in the list of advanced core countries, with strains that have been spilling over into banks in the European Union. I will talk about how strong the strains are and to what extent there may be consequences concerning the devolution of credit and the real economy, at a time when growth is weak.

Then I will say something about the credit cycle. We are in a very different phase of the credit cycle in advanced economies as compared to emerging markets. I will also talk about some of the unpleasant side effects of the low-interest rate policies which are in place now in the main economies

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<sup>2</sup> Following the Board meeting, SEC circulated the staff's additional responses by email. For information, these and the staff's presentation are included in an annex to these minutes.

and how serious these unpleasant side effects are, even if I will not question that these low interest rate policies are absolutely essential to underpin macroeconomic stability at present.

I will finish with a discussion of the policy priorities, with the key message I want to leave Directors with, which is the message that the Managing Director so effectively provided at her Jackson Hole speech, which is that time is running out, but it is not yet too late to undertake decisive political action and policies that will ensure that the recovery can go on and that global economic and financial stability will be preserved.

Let me start with some remarks concerning the confidence crisis. I will use our familiar web map, which looks at various risks and conditions regarding financial stability, and this is where we were last time we discussed the GFSR in April of 2011 and this is where we are now—the red line. There is an increase in the three categories of risk, and a retrenchment in the risk appetite. What is noteworthy is that this is the first time since the Lehman Brothers collapse where we have had such an overall unanimous worsening of financial stability conditions worldwide, even if monetary and financial policies have provided a lot of support, as reflected in the graph.

Behind this worsening of financial stability risks there are basically three reasons, in my view. First, the spilling over of sovereign risk to banking systems, which are threatening even broader global markets; the doubts about the resolve of policy makers in the main economies to adequately deal with the challenges that they face in terms of financial repair and reform, the legacy of the crisis; and third, that weaker growth prospects are making these challenges and these tasks even more complex and difficult to achieve.

When we have a situation of higher risk and retrenchment in risk appetite what investors do is to flee. By the way, this is where we were with Lehman—this is the blue line. We are not there, but this is for comparison reasons. So, when there is all this increase in risk and reduction in risk appetite, investors flee toward safe assets. And since our last GFSR, this is what has happened. There has been a flight starting from sovereigns, then going into banks, even touching commodities, which are sensitive to the cycle, other broad, riskier assets, then going into safe haven assets, gold, treasuries, or currencies like the Swiss franc or the yen.

Let me now say something about what is different from Lehman, going into a little bit more detail. I hope that Directors find these details sufficiently clear. I am going to use red or green to see whether the situation is

better or worse than at the time of Lehman. Let us start with the positive side and start with the green. I will look at the situation in the euro area and in the United States. As compared to the aftermath of Lehman, we can see now that in terms of interbank funding and stress, the situation is better both in the euro area and in the United States.

However, as we go to risk perception concerning banks, the situation is now very different from what it was at the time. Now, the perception on U.S. banks is better, but the perception on euro area banks is worse than at the time. Because, then, Lehman was a U.S. banking crisis, and now we have doubts on the health of European banks, basically coming from the fact that there are sovereign strains. This is reflected also in the increase in sovereign CDS spreads.

Good news is that this is not something which is spilling over to broader markets, as in the case of Lehman. The levels of market prices are in a better shape now and the volatility index in equity markets is also lower. We have a mixed picture, where the greens dominate over the reds, but there are still a number of reds that are worrying and that tell us we should be very cautious and diligent in the management of global financial risks.

So, let me now go to sovereign stress, the first key piece in the puzzle. In a main development since we just met six months ago is that sovereign strains are becoming more widespread because this is not only affecting the three program countries, but also affecting other economies with significantly better fundamentals and very different from the three program countries like Italy, Spain, or Belgium. And key core countries such as France and Germany are also experiencing higher CDS spreads, because they may end up paying a bigger part of the bill for solving European or euro area problems, and this is captured by markets.

So, sovereign strains are becoming more widespread. This is threatening to bring us to a bad equilibrium and we are close to a bad equilibrium, where sovereigns with important fiscal vulnerabilities may be thrown into a vicious circle of increased volatility, which weakens the investor base for the sovereign debt, leads to higher spreads, the higher spreads mean higher interest rates, which affects negatively growth and worsens the dynamics, and we start again. Now, we are dangerously close in that particular red zone in a number of countries, so we need to move to the green part where we have everything going in reverse in a virtuous cycle rather than the vicious circle, but the problem is that for that we need an adequate policy response.



Sovereign and fiscal concerns are not just an issue for European countries, as the Fiscal Monitor very clearly outlines. But, it is also an issue in economies like the United States and also in Japan. Just to say something about the United States on this front, given the prominent role of its economy and the treasury bond market in international financial markets, this is a snapshot of the risks of a number of financial market indicators linked to sovereign risk perception and compared to February 2009. It is not surprising that the situation is now worse than during the aftermath of Lehman, because we did not have a sovereign problem in the United States at that time, there were no discussions on the debt ceiling and fiscal policy. Now we do have that. The situation is worse. It is very close to the high-risk area.

We already had a very serious situation during the debt ceiling discussions, and this is something that would have been even more serious had this meant several notches of downgrade and by more rating agencies. This is just restating the message that the fiscal situation in the United States is the most important issue, both for the world economy and the financial system.

Let me now go to banking and talk about the spillover of risks from sovereigns to banks. Let me start by focusing on Europe, which is where the action is nowadays. Now, this reflects the evolution of some key market performance indicators during the period of sovereign stress in 2010 and 2011. As Directors can see, banks in the European Union have lost, depending on how we measure it, between 30 and 40 percent of their market capitalization. And that is a lot. At the same time, diminished confidence in the banks is reflected in higher CDS spreads.

Now, is that linked to sovereign risk? Well, let me just try the following. This is the change in CDS spreads concerning the sovereign, and what we have done in the GFSR is a simple calculation in order to understand why is it that the strains in a number of sovereigns are having such an impact on market perceptions of the health of European banks.

What we do in the GFSR is a calculation, not a stress test. It is not a supervisory exercise. It is not a calculation of capital needs. It is basically trying to see what is the size of the sovereign strains measured by the mark-to-market impact on the balance sheets of those banks that are holding the debt of the countries that have come under market scrutiny, basically the three program countries and three other countries which, I repeat, are very different from the program countries, but whose high yields reflect that they have come under market scrutiny.

If we look at the mark-to-market impact of this increase in sovereign credit risk, and we do not distinguish between the trading book and the banking book, apply the mark-to-market in a uniform manner as a simple exercise, which is by the way the exercise that markets make, then what we see is the following: if the strains were just restricted to Greece, given current market valuations, we would be talking of an impact that is smaller than 60 billion euros, or 3 percent of the tangible common equity of European Union banks. If we extend the strain to Irish and Portuguese sovereign risk, we go to a larger number, nearly 9.5 percent of tangible common equity. If we incorporate large debt markets like the Spanish, Italian or Belgium debt markets, then we go to 200 billion euros, or 12 percent of tangible common equity. And if we also take into account not only the increase in sovereign risk associated with these six countries, but also the increase in the credit risk associated with the bank debt issued by these countries, then what we have is a total mark-to-market impact that is about twice, about 24 percent of the tangible common equity in these banks.

This is the type of calculation that markets are making. This is nothing but trying to understand what they are doing, because if we want to recover confidence, we need to understand what is at the heart of the lack of confidence to design the right policy measures. That helps us explain why it is that there are now strains in European bank funding. If we look at the left figure, again it is interesting that there is a difference between funding in the European markets, in euros, this is a three-month Overnight Indexed Swap (OIS), and funding by American banks, in dollars, basically proxied by the three-month dollar/LIBOR OIS. We can see the differences in the cost of funding, and this increase in the blue line, in the European funding, is something which is not fortunately back to the levels of Lehman, but it is much more jittery because markets are sensitive. One particular example of sensitivity of markets on the right-hand side figure is the behavior of U.S. money market funds which are important financiers of banks in Europe through the holding of commercial paper and certificates of deposit (CDs) and what we can see, after a rapid build-up in the past three-four months, is that there has been a very rapid reduction in holdings of this type of paper, which is issued by European banks to help finance themselves. So, this is telling us that money market funds are basically reducing their exposure to European banks, and that is something which is showing in indicators of stress in the swap dollar market.

The danger of this is not just that it can hurt financial stability. Financial stability is important, because at the end it also hurts the real

economy. It hurts people. It hurts jobs. It hurts growth. What I am going to present now is a simple exercise, which is rather extreme, and that is the purpose of it. Let us look at the evolution of bank credit growth now. And we take the six countries which have been under market scrutiny: the three program countries and the other three, I repeat, very different countries. What we have is a situation where credit growth has been in most of them either negative or very anemic with the exception of Italy. What would happen if we were to have another Lehman? If we were to have a bank funding freeze where banks were unable to renew their funding? Let us assume the ECB would be continuing to provide the same amount of liquidity today to the different banks. What we will have would be a severe deleveraging, a credit contraction, which will take us into negative territory next year, and this is something that would be very bad for the real economy. The ECB has enough power and enough collateral in the euro system to provide liquidity to avoid the situation, and that I am sure will happen. We do not want to get there in the first place.

This is not a forecast. This is just an extreme scenario to bring home the point that it is fundamental to avoid outcomes like that, that we have to restore confidence, to restore the ability of European banks to fund themselves as well as possible in interbank and international capital markets, and be able to sustain the growth of credit that the real economy deserves, so as to keep the recovery going.

Now, I think to solve these problems, and this is the point that I want to very much emphasize, we need to cut what I would call the Gordian knot between the sovereigns and the banks. For that we need a two-handed approach. The first best is to address sovereign risk at its heart, through appropriate medium-term, credible fiscal consolidation policies which may bring back market confidence in the ability of sovereigns to handle their debts, and this is something which will basically shrink all these circles that I had before in terms of mark-to-market impact. We go from the bad equilibrium to the good equilibrium. Since that cannot be done overnight and credibility cannot be restored magically, we have to also enhance the bank resilience, because that is very important, particularly in the weaker growth prospects that we have. This bank resilience can be enhanced in a number of ways, but the key part is to enhance the capital buffers that banks have in order to have a better prospect and to be able to get funding through capital and through debt more easily in international markets.

If we look at the situation in the European banks—capital ratios and core Tier 1 ratios—and I look at the sample of banks used by the European

banking authority in the stress tests, and I rank these banks from those with the highest capital ratio to the lowest capital ratios, what we can see is that banks are in a very different position. Nowadays, in the present highly uncertain environment, if banks do not have core Tier 1 ratios of at least 6 percent, creditors do not talk to those banks, they do not give them money. So, below that level, it is absolutely difficult, if not impossible, to raise any private funding. That, fortunately, applies only to 6 percent of banks representing 2 percent of total bank assets.

But, if we go to a metric that is more like what markets demand to give reasonable financing, which is 8 percent core Tier 1 ratios, then we find that 28 percent of banks, or almost a quarter of total bank assets, are below the line. In many countries, authorities are saying, it is not 8 percent, it is 10 percent that we need in order to have a good enough credibility before markets. So this is telling us that it is true that there has been significant capital raising in Europe in the last few months in the wake of the stress tests, 50-60 billion euros have been raised, but it is also true that the process is not completed and that there is more to do. The call by the European Banking Authority to raise more capital and better capital—not just for the banks that failed the stress tests but also for many other banks—is very important, and we support this effort and go further. If banks can go beyond 8 percent of core Tier 1 ratios, it would be better, because now the costs of not doing that are much more important than the costs associated with doing that. We will have healthier banks, which will be able to provide credit and not deleverage. That would be good for the economy.

Let me say a few things about the other part of the presentation, which has to do with the credit cycle and the search for yield, and now we go a little bit faster. This is a diagram we use in the GFSR which shows the basic phases of the credit cycle, in terms of four key phases. And, we have tried to look at a number of financial market indicators and balance sheet indicators to place the different economies. What we can see is that for the three largest developed economic areas—the United States, European Union, and Japan—what we have is that they are between the phases of repair and expansion of the credit cycle, depending on what area we look at.

Now, because there is still a lot of uncertainty and a lot of repair to be done in many cases, policy interest rates are very low and it is appropriate, I think. What I am doing here is to convey the point that this is an encouraging phenomenon which is typically known as the search for yield phenomenon, which is that if we have low policy interest rates, and that is what happens now in this cycle compared to past Fed fund cycles, if we have very low

interest rates and we want to have higher returns, we have to go to leverage and we have to go to risk. We may become a little bit too risk prone. And this is happening in some markets. In these markets, like the BBB-rated corporate spreads, what we see is a compression of spreads which is stronger and faster than in previous cycles, but, interestingly, at a time when the present economic fundamentals do not look as bright as in previous cycles. So, the question is whether it is possible that markets in certain segments are again beginning to underestimate risk, as they did before the crisis?

Is it possible that we may have pockets of fragility building up which may not be very sizable yet, but if there is an explosion or a problem they could have big consequences. The fact that there is a shift to capital markets-based financing is good to support credit, but the fact that there are many products which are not well understood—again structured products, with high yield, which come with a lot of leverage and which are produced and intermediated through the shadow banking system—is something which has risks for the financial stability that should be monitored. If not monitored, we could have an exacerbated downturn in the credit cycle when it comes or an explosion of fragilities which may have wider repercussions again.

Let me say something about emerging markets. Compared to advanced economies, emerging markets are considerably further along the credit cycle, as one can see here, except for Latin America. Asia is in the expansion phase of the cycle, also something that can be seen if we look at the evolution of three key indicators for these emerging market countries. I am just going to show the evolution of three indicators: real equity prices, net portfolio flows, and total credit as fraction of GDP. And, these are deviations from the mean suitably standardized. This is in terms of standard deviations. What we can see is that the three of them are in positive territory, which calls for vigilance not because the magnitudes are very high, but because if they continue in this zone, this is something which requires attention down the road.

One thing that I would like to particularly stress is that in many of these emerging market economies, credit is running well ahead of GDP. This is something which is quite important if we look, for example, at the behavior of bank assets. Let me mention that in Chapter III of the GFSR, we find out that credit-to-GDP is a key leading indicator of future financial problems. This is why the evolution of this variable is very important.

If we look at the experience, what it tells us is that rapid credit growth now in good times will lead to rising NPLs later, down the road. Here, when we perform a simulation and predict the value of NPLs in this group of

emerging markets in the baseline scenario provided by the WEO, where nothing goes wrong, we can see that, in emerging Asia and Latin America, they are nontrivial increases in NPLs. Supervisors, regulators, and authorities in general should ensure enough financial resilience to keep with this type of future issue in the baseline.

But, the baseline may not be realized if we suffer external shocks. In the environment in which we live, external shocks may happen. Here, again, what we do is a kind of stress test of a combined macro financial shock on emerging markets coming from a significant reduction in the growth rates, which is about two standard deviations—a terms of trade worsening, very important for many of these markets, particularly in Latin America. And then an increase associated with funding costs, linked to capital flow reversals or other reasons of about 300 basis points higher. What we get, when we look at the impact of that on bank capital adequacy ratios, is that we have a 5-6 percentage point reduction of capital adequacy ratios, and this is something far from nontrivial, especially if we look at the economic capital of these banks. So, again, “watch out!” is the basic message at a time of high uncertainty.

Let me go into the discussion of the policy priorities. And, basically distinguish between the advanced economies and the emerging markets, because in the advanced economies, the key challenge is nowadays to avoid a near-term crisis. For that, they have to work on two sides. They need a two-handed approach. They need to work on the sovereign risk side and on the bank side. And for that they need a lot of balance sheet repair. Balance sheet repair in the public sector in the major economic areas, through medium-term credible fiscal consolidation, balance sheet repair in the case of U.S. households, in terms of mortgage debt, which is not only a drag on the economy, but also a strain on bank balance sheets. And balance sheet repair in the case of European Union banks and, among other actions, capitalization of these banks through the private sector, if possible, and, if not, through national public funds and, if not, through the European Financial Stability Facility as already envisaged in the decision taken by the euro area summit on July 21. This is something that should be coupled with an improvement of the funding structures of these banks. As Mr. Blanchard mentioned this morning, this would be much easier in a context of growth, so whatever actions can be taken to support growth on the macro side, on the structural reform side, or on the rebalancing side, would be very important to make this go through in a smoother and speedier fashion.

How about emerging market economies? Emerging markets basically have to avoid not only a near-term crisis but a future crisis. I think that, again, we need a two-handed approach that contains the build-up of macro-financial vulnerabilities, and credit is a very important element and, at the same time, enhances the macro financial resilience of these economies to cope with external shocks.

Again, we come back to the policy recipe that we have given in the past, that we need to have the appropriate macroeconomic policies in terms of monetary and fiscal policies, which is the guarantor of macro-financial stability, to complement these macro policies, not supplement or substitute them, with macroprudential and, if needed, some other capital flow measures. And as always, structural financial reform to enhance the ability of financial systems to intermediate capital flows and support economic growth.

Advanced economies and emerging markets have also things to do, together. One of them is to advance global regulatory reform, and for that I think it is very important, first of all, to complete the regulatory reform agenda—Basel III, the regulation of SIFIs, shadow banking, macroprudential measures—and to implement these regulation both nationally and also internationally consistently.

We are in a new, dangerous political phase of the crisis where the risks to global financial stability have increased, and we are back into the danger zone. And as I said at the beginning, time is running out, but we still have time to act, but we need to act now, we need to act boldly, and we need to act in a globally-coordinated manner.

Mr. Fayolle made the following statement:

Thanks to the staff for a clear presentation. I have issued a written statement, so let me stress a few points which appear to me a source of concern for the quality of our work, and then the quality of our recommendations.

It is clear that the GFSR is closer to market participants than it used to be, and this is helpful to better understand financial developments. At the same time, the GFSR should be very cautious not just to echo market views. Otherwise, it departs from a unilateral exercise of an international organization. We certainly agree there are risks, that there are adverse feedback loops between the sovereign and banks and that those risks call for adequate policy measures. But, I am afraid that the way it has been presented

in the GFSR, we miss an opportunity to convey this very important message about the risk of adverse feedback loops. We risk to fuel market concerns about potential losses and spillovers, having always a figure attached.

I would like basically to reflect on three questions especially about the work that has referred to—about how to take into account a number of methodological choices made, and how to reflect them to make sure that the caveats of the methodology are clear for the outside world, and how to communicate findings, which I think at this juncture is quite a high risk.

My second point is on this issue of how to make sure that what we are doing is not just reflecting market views. On the need to increase capital, it is clear from the stress test released in Europe, that there are a number of banks that need to increase their capital. What I understand less is the call that it is better to have 8 percent core Tier 1 ratio than 6 percent, and that it is better to have 10 percent than 8 percent. Maybe the market is saying that we need more capital now than they were saying yesterday. My question is, is it up to the IMF to endorse that, and make that as a policy recommendation that we need to increase very quickly capital beyond what has been already agreed in the international community? I am not sure it is completely wise.

My third point is a word of caution about the way currency unions are presented in the paper, because the paper, especially paragraph 17, is emphasizing the cons of currency unions, without saying anything about the benefits. There is also the fact that among the problems facing the currency union, there is the fact that we cannot monetize debt as an option, which is viable over the medium term. I hope this is not a policy recommendation by the IMF for the countries outside a currency union as well. I am not sure, maybe this needs to be looked at in terms of drafting.

Final point, given the role of the dollar in the global financial system, I have a question for Mr. Viñals and the team, to which extent do we think standard econometric analysis is relevant in the case of the impact of the U.S. debt downgrade? We now live in a system where the pool of stress-free assets has just been dramatically reduced. Medium-term consequences and risks stemming from these developments may deserve deeper analysis in the next future.

Mr. Meyer (GR) made the following statement:

I am pretty much along the lines of Mr. Fayolle. I thank Mr. Viñals and his colleagues for the report. We agree on the main thrust of the



challenges, and on the policy responses. Still, there is one issue where we are also quite concerned, and this is what has just been presented, the question of the mark to market losses and the consequences of this analysis. I understood the message and I would share this message. This message to me is that there are banks in the EU or in the euro zone which have done a lot in terms of recapitalization, but much more has to be done, especially if we take the point of view of market perception. A number of countries are doing fine, especially in the core. Banks in a number of peripheral countries are having problems.

I would agree with Mr. Fayolle that on the Basel III framework, we give a long period of time to attain certain levels of capital to get the right balance between credit growth and the right levels of capital. But, reading the report, and especially going into the Executive Summary, we certainly get the impression that it is not about the structure, that there are banks doing fine and others having problems, but the staff clearly gives the impression that it is an overall problem. The sentence is, if mark-to-market losses were to be realized, the direct impact of euro zone sovereign stress on EU banks would be about 208 billion euros. This sentence is not reflecting what is back there in the chapter, where actually a number of weaknesses of computations are raised and explained, and it is much more balanced. But, what I fear is many people will read only the Executive Summary and there I see a big problem that the staff should consider revising the wording.

Let me just state from the speech that the Managing Director gave at Jackson Hole and that the staff already mentioned. There is a crucial sentence. It reads as follows: "An unclear or confused message will add to market uncertainty and magnify the euro zone's economic tensions." This sentence she said with regard to the euro and EU policy makers. I think this is a very crucial sentence that holds true for the IMF as well. So, against this background, I would appeal to go over the wording.

I have two minor issues. Like Mr. Fayolle, I would like to mention the report spends a lot of pages on a number of issues, especially the consequences of the U.S. downgrade, like reducing the reserve status of the dollar. They are touched on, but not really answered. So, staff comments on this are welcome. On the balance between recovery and fiscal consolidation, I just want to highlight that the U.S. downgrade shows that waiting too long and giving mixed signals can have severe consequences and that is why Germany still thinks that fiscal consolidation, especially in Europe, has to be the top priority.

The Acting Chair (Mr. Lipsky) agreed with Mr. Meyer (GR). Although the graphs portrayed a very severe decline in stock prices for euro area banks, there were differences across banks and investors were not viewing all banks the same. They were making very clear distinctions between those banks that were perceived to have problems and those banks that did not.

Mr. Furusawa made the following statement:

I thank Mr. Viñals for the very comprehensive presentation, involving the very clear and strong message. I also thank the staff for the excellent paper which focuses on the most relevant issues today. Adding to my gray, I would like to make two comments. The first is regarding the Japanese situation. The second is regarding the banking sector confidence issue.

First, the Japanese financial system remains resilient after the earthquake and the banks' funding market shows no sign of stress. As I mentioned this morning, the new prime minister is fully committed to the midterm fiscal consolidation. The staff mentions in the report the difficulties for policy makers and political leaders who are badly in need for broad political support for medium-term fiscal adjustment. We are confident that the new prime minister, known as a strong advocate of fiscal consolidation, can get political support.

I also would add to our gray that, despite the downgrade of the JGB last week, the yield is still stable and even declined to 1.02 percent for the benchmark ten-year bond.

Second, I would like to make a few observations as to the regaining of market confidence in the banking sector, drawing from lessons we learned during the Japanese banking crisis in 1990s. We have to admit that we were not quick to address the vulnerabilities of the banking sector. We hoped that the economic growth could ease the problem. We hoped that time would cure it if we took a gradual approach. We had difficulty in convincing taxpayers to take the bold actions such as recapitalization, including through public capital injection.

Finally, we only found that the cost of policy inaction was too high. The three lessons we learned are, one, that prompt policy actions ultimately cost less. Two, the loss should be estimated conservatively without counting on the optimistic prospects. Three, once a loss is recognized, swift recapitalization is the only way to restore market confidence.

Mr. Garcia-Silva made the following statement:

I thank the staff for a very interesting set of documents. First, I have a general comment. The fact that Mr. Viñals was comparing the current situation with Lehman is bad enough. The fact that the result is a mixed assessment, with some areas worse, some areas better, I believe is even more worrisome and should call for the attention of Directors. I have two specific comments.

One, I welcome the stress test of the resilience of the emerging market banks. This is a very good step toward integrating the analysis of advanced economies and emerging market economies within the GFSR. But, I am puzzled about the implications and the actual numbers that are shown, and I believe that we raised this issue in our gray, and do not think it was answered. If so, excuse me for being repetitive. When it is mentioned that the combined shock, which is quite severe, actually reduces the capital adequacy ratio of emerging market banks by 4-6 percent, does this mean that starting from a capital adequacy ratio of 10 percent of risk-weighted assets it goes down to 5 percent, or it goes down to 9.5 percent? Because if it goes down to 9.5 percent, I think the result is quite satisfactory in the sense that even a very significant shock has a very minor impact on the level of capital in emerging market banks. So, if that is the case, I believe the qualifications in the text should be changed in that direction. I think 10 percent is a very conservative benchmark. Emerging market banks, on average, have levels of capital significantly higher than that.

My second comment has to do with the topical chapter on the risks of a low interest rate environment. I think this has been raised a number of times previously in other GFSRs, but I have the feeling that, in the current circumstances, it can come across as contradictory with the main messages raised. I was very much welcoming the emphasis Mr. Viñals put earlier on the need for supportive monetary policy in the case of a further deterioration in financial conditions and also in an environment where further capitalization of banks is necessary, but the topical chapter on the risks of a low interest rate environment seems to me contradictory. To put it differently, it is a good thing that high-risk spreads are rather compressed in the economies actually suffering the smooth patch or an economic downturn.

The fact that low interest rates motivate risk taking is part of the natural transmission of monetary policy. The parallel concern would be that, in a booming economy, having high interest rates may actually cool the credit

cycle. I think that strikes a bit of an odd chord given the broad message in the GFSR.

Ms. O'Dea made the following statement:

First of all, I would like to join with other Directors in thanking the staff for the report which was very interesting and also the presentation today. While the GFSR itself does a very good job of analyzing the risks in the financial system, we believe that it offers less in terms of new or concrete policy advice on moving forward. Indeed, as suggested in contributions in the grays by Mr. Mozhin and Mr. Palei, the Fund has persistently called for a comprehensive and coherent response to the euro area problems, and we support this call. However, we believe the Fund has not specified the policy actions it views as central to this comprehensive response. The appropriate policy response will depend significantly on the extent of the problem as perceived by the IMF. Indeed, in this regard, we would join with Directors, Mr. Fayolle and Mr. Meyer (GR), in urging the methodology used in any calculations is completely robust and defensible, and is well understood with all the caveats.

We believe that the Fund should use this opportunity now provided by the GFSR to lay out its views further, outlining specific policy responses it views as critical, rather than focusing on more general policy advice. I would associate myself with the list of questions on the appropriate policy response asked by Mr. Legg in his gray.

Second, I agree with the importance of continuing to ensure a credible European banking system, and I agree with staff's suggestion that, where possible, this recapitalization should be completed using private funds. In some case, this may not be possible and the public recapitalization may then be needed. This was indeed the case and was necessary in the Irish case, and our banking system is now on the, albeit slow, road to recovery. The decision to allow EFSF to allow recapitalization of euro area financial institutions through loans to governments is welcome in this regard. We also believe, however, that of central importance to any recapitalization exercise is the transparency of this exercise, so that markets are completely convinced by it because this is where we want to move. Disagreement therefore about the scale of the problem will actually have the opposite effect and may indeed exacerbate the uncertainty that is there in the markets. So we would urge the staff again to look at the methodology to make sure it is easily understood and, where there are underlying assumptions, to make sure these are very clear.

Mr. Kiekens made the following statement:

My Japanese colleague had asked for an informal discussion about the developments in the euro area, and developments in Greece. But management decided that it was wiser to postpone that. This would have been a good occasion to have a more informal discussion about these developments. I would like to make some comments that are more of an informal nature. I will not make it too long. But, I would like to expand a little bit on what I see the risk for the silent unraveling of the euro zone and I would like to comment on what could be an instrument for enforcing more credibly market discipline in the euro zone. I would then like to comment a little bit, indeed, on the central call in the GFSR and by the Managing Director in Jackson Hole on recapitalizing European banks.

I see a risk that a monetary union is silently unraveling. The repeated calls for countries to leave the monetary union, be they the economically weaker, or the economically stronger ones, as we have seen one yesterday in The Financial Times, may do more harm than may be observed. Risk managers of large financial institutions, probably no longer completely neglect the exchange rate risk within the euro area. To finance euro-denominated assets of a weaker economy, with euro-denominated funding from stronger euro area economies, may imply a considerable exchange rate risk if the calls for a splitting of the euro area would materialize. Such event may still be a tail risk. We all would confirm that. However, when it materializes, it will be devastating for those financial institutions that have not paid attention to the exchange rate risks within their euro-denominated balance sheet.

The emerging reality of an exchange rate risk within the euro-denominated balance sheet will significantly set back the financial integration achieved so far. Borrowers in deficit euro area countries will see their access to funding from surplus euro area countries diminished, and become more expensive. Even firms with the highest credit rating and located in deficit euro area countries, that want, for instance, to borrow on the Eurobond market, will see that demand from lenders in surplus countries might no longer be available at uniform interest rates for the entire bond issue. Borrowers from deficit countries and in euros might have to opt for issuing debt under the jurisdiction of surplus countries to better protect their creditors against internal euro area exchange risk.

The risk to the integrity of the monetary union stems primarily from an unsustainable public debt. However, the better lesson learned, particularly in Spain and Ireland, shows that the excessive buildup of private debt can rapidly contaminate the public balance sheet. Thus, the single monetary policy must be complemented by diversified macroprudential policies to avoid a build-up of unsustainable private debt. I think that is one of the lessons that are now generally accepted. My call is that Fund surveillance should closely monitor those macroprudential policies that help avoid the excesses of the past in the euro zone.

But with all the attention focused on the need for ever larger financial assistance to sovereign debtors in deficit countries, there is a risk that the no-bail-out principle in the Maastricht treaty is too easily discarded. Market discipline remains the essential component of a well-functioning market economy, particularly in a monetary union as the euro area. The European Union should make the no-bail-out clause more effective by making its enforcement more likely in a market consistent manner.

I am afraid that the proposals for euro area bonds issued with the common guarantee of all euro area member states might result in just the opposite. It is an actual debate. A significant weakening of market discipline in favor of an illusory discipline that would be enforced by administrative control and surveillance, be it from the EU or the Fund. Embarking on such a path would be in my opinion a big mistake. Countries that are jealous about their fiscal autonomy must remain fully responsible for the financing of their deficit spending.

But how can we make the no-bail-out clause more realistic in a market conformed way? This is a seminar-type intervention, so let me expand. European rules should clarify the framework for dealing with sovereign debt in distress. Let me formulate a possible approach. Countries should issue two types of sovereign debt: preferred debt, the amount of which may not exceed a certain ratio of the country's GDP under European legislation—60 percent or lower—and non-preferred debt in excess of that threshold, which should be their own national debt, not European debt.

Market discipline should come from submitting the non-preferred debt fully to stringent market forces. For instance, any access to the exceptional financing by the EFSF or the Fund would require a restructuring of this non-preferred debt in parallel with the terms of the IMF and the EFSF assistance in order to bail in a planned and moderate manner, as a PSI, this kind of debt. But, more importantly, probably, in addition, for banks, exposure

to non-preferred sovereign debt would be treated more or less as commercial debt in terms of capital adequacy requirements, and also in terms of limitation of risk concentration on a single borrower in terms of the amount of banks owned capital. I think that would make the no bail out clause manageable in practice, and enforce market discipline.

Obviously, such more stringent rules cannot be implemented in an orderly manner overnight. But, the gradual phasing in could prove to be critical in preserving the monetary union and in anticipating what I call first the internal exchange rate risk within the monetary union.

A last and short word on one of the central themes of the GFSR, the need for recapitalization of the banks. The call of the Managing Director for forced recapitalization of weaker banks must not be left without more pragmatic considerations, what such action would require on the ground. We need to avoid that the Fund's comments or advice both create further tensions, if not panic in the markets, while at the same time remaining without follow-up because either the authorities disagree and we have seen signs of that, or they have no effective means of implementing this strategy in a rules-based legal manner.

To make it short, what is needed is consistency and agreeing on applying and how to apply accounting standards. I think that the accounting authority has touched the essence, the core of the problem. For instance, prudential supervisors will not succeed in enforcing capital increase if at the same time they accept that valuations of claims on sovereign debtors in distress are what they are, and I would call on consistency in the Fund as well. It is my understanding that, when we discussed the results of the July 21 summit and the first indications of the PSI or the restructuring agreed by the IIF, by and large on a preliminary basis, this Board found this emerging agreement satisfactory. Now, that implied a haircut or a reduction in the net present value of the claims of 21 percent. In staff's accounting, they need to assume a more serious risk, and downgrade, and evaluate claims on countries on a mark-to-market basis, which could show a larger discount than 21 percent. I think we have there also a problem of coherence and consistency in what the Fund would decide in the future on that.

The Acting Chair (Mr. Lipsky) explained that the Greek case, and the PSI in the Greek case, was viewed in the context of the entire program rather than on its own. Notably, the July 21 agreement included the important decision to permit funds of the EFSF to be used for bank recapitalization, outside of program countries. Mr. Kiekens's position on bond

issuance in the euro area was very interesting and the Belgian authorities were on record as supporting the Eurobond as a concept.

Mr. Kiekens made the following further statement:

I said this is more an informal discussion, more of a seminar type. Indeed, the prime minister of Belgium is in favor of Eurobonds, but the president of the Euro Council, who happens to be a Belgian, too, is not in favor. I have argued with the arguments I have formulated, so far. Let me add another, maybe, interesting observation.

For the EFSF, I fully agree, and fully consistent with the Belgian position, that European banks that operate on a euro area-wide basis, large European banks ideally need to become European banks, not a German bank, not a French bank, not a Belgian bank, under European jurisdiction and prudential supervision, under European deposit guarantee schemes, and indeed under a European bailout or a resolution mechanism. Financed with European resources, not national resources that are pooled in an EFSF, but European fiscal resources levied under a new treaty in order to provide European funding for a European resolution. Nobody would imagine that AIG, under the prudential supervision of the New York state authorities, would have to be bailed out by the taxpayers of the New York state. Similarly, a large European bank needs to be, if there is a need for resolution, a problem for European taxpayers. I see no principle objection for levying European taxes for that purpose, just as we should also have contributions by banks for a European deposit guarantee scheme.

The Acting Chair (Mr. Lipsky) noted that those were very interesting ideas which could be discussed on another occasion more fully. Unfortunately, and sadly, the AIG case was even more complicated than Mr. Kiekens had alluded to.

Mr. Sadun noted that the minister from Luxembourg, Mr. Juncker, was also in favor of Eurobonds. An interesting question was whether he was in favor in his capacity as minister of the Luxembourg government or the chairman of the Eurogroup.

Mr. Virmani made the following statement:

Mr. Kiekens's informal intervention has reminded me of an informal question which I once asked the Managing Director. I want to convert it into a formal question for Mr. Viñals.



That is the tail risk, whatever we want to call it, of one or more countries leaving the euro in my view, the probability is nonzero. But, one can only see two possible solutions. One is the political system of the stronger euro countries decide to make a substantial fiscal contribution to saving the weaker countries, three or four countries—I do not include the ones in the middle which the staff has, but at least the weakest three or four. And, the institutional chain needed. Or, the only alternative as far as one can see is some kind of breakup of the euro. So the question is, do we think the probability is zero? If it is not, in a sense, that is a risk, Mr. Kiekens. It was a little difficult to follow his reasoning, but a good point—should we not at some point at least privately be looking at the implications? My informal question was asked of the Managing Director about nine months ago and he categorically stated there is a zero risk and it is too difficult or impossible to contemplate. I am afraid that is no longer true. I put this formal question to the staff.

Ms. Budiman made the following statement:

We join other Directors in thanking staff for an excellent report and insightful presentation. We share that it is time for the Fund to deliver a clear message and policy agenda going forward to address market expectations, as well as to ensure the global economic recovery and financial stability with a good communication strategy. I just have one additional technical question, which I saw also addressed by a few Directors.

We note with interest staff's suggestion that there may be a role for sovereign investors to take on some of the longer term risk that private investors now avoid. However, we are mindful that adding a financial stability mandate to sovereign investors given that such funds already have a very specific mandate such as intergenerational wealth transfers, it is quite difficult. So we just wonder whether the staff already has feedback from sovereign investors as to whether they see themselves playing such a role.

Mr. Sadun made the following statement:

Thank you for the opportunity to contribute to the discussion. Very briefly, I just wanted to make a few comments on the GFSR and the presentation by Mr. Viñals. I think that to put it very succinctly, we certainly would agree with some key messages of the report, certainly, the fact that the risks have increased, unfortunately. We also certainly agree with the call for action by politicians and, particularly, by politicians on both sides of the Atlantic, simply because the two regions seem to be at the focus of the market

attention. And, also, we fully agree on the third component of the message which is that time is of the essence. A crisis or difficulties that would be addressed in a prompt manner can become much more difficult if left unattended.

Other points I would certainly welcome in the presentation is this notion of the time element in the evolution of the crisis. And particularly, Slide No. 18 and 21, which described the status of the repairs, the recovery of the financial system, both in advanced economies and emerging markets. That I found very useful. My comment is that these different phases, unfortunately, are not consequential, are not one after the other. The tasks to address some of the problems are simultaneous, so we have to have first some kind of stabilization. We have to handle repairs and restructuring. All this is not coming in a sequential basis, one after the other. They become simultaneous, which makes everything much more difficult.

On the concern I have of the reports, is that although it is absolutely proper to reflect and acknowledge some market fears, I think that we have to be very careful not to play into the fears of the market. Or fuel what, at least in my personal opinion, have been some overreaction to the situation. In the same vein, I think that we have to be extremely careful in communicating the outcome of some of the exercise, which is very useful to deepen our understanding of the situation, but if they are not properly communicated to the outside world, it might actually play into this risk that I pointed out.

Finally, since one Director has raised this issue, I just wanted to say that I am as anxious as some other Directors to have the chance to discuss the crisis situation in some program countries in Europe. I understand that the staff will issue a report on the recent visit to Portugal very shortly, so we will have the opportunity to do that.

For what concerns Greece, the troika has just started the mission a couple days ago, so I think it would be appropriate and reasonable to wait for the feedback of that mission. Otherwise, if we put on the order of the Board agenda a discussion on the crisis, then we have a risk of transforming this Board in a kind of situation room, which is not the case.

The Acting Chair (Mr. Lipsky) confirmed that management would be providing a briefing on the discussions with Greece as soon as possible, exactly in line with what Mr. Sadun said. Management thought it would not be useful to provide such a briefing as soon as the mission had completed its work and drawn its conclusion.

Ms. Balsa made the following statement:

I thank Mr. Viñals and his team for the presentation today. I have three brief comments. The first one is that I want to support the main comments on the methodological questions regarding analysis of the spillovers in the euro area from the sovereign to banks, which have been already made by Mr. Fayolle and other Directors.

We also support comments on the need to be careful with communication of results, as Mr. Sadun just pointed out. We think the messages from the Fund should clearly differentiate what we see and what we think, and I also think that in the Fiscal Monitor, which we are going to discuss tomorrow, there is a nice effort in that regard comparing fiscal fundamentals and market behavior.

The second comment relates, along the same lines, to the discussion this morning on the World Economic Outlook and the need to engage ministers in discussions and the IMFC. We think the membership is better served not only by candid analysis, but also by candid and clear messages about the needed measures to be taken, not least because the space for policies is much narrower now.

In this regard, despite improvements in this area, we want to stress again the relevance of an integrated discussion of WEO/GFSR, especially one dealing with policy recommendations, because baseline scenarios are scenarios, but policy recommendations should be in line.

My third and final comment is on monetary policy. The analysis of the available tools for monetary policy makers is present in both documents, the WEO and the GFSR, but we think that it seems to take a second line to fiscal and structural policies, and especially fiscal policies. I would like to know if there is some sense that monetary policy is now more limited in what it can achieve, or is there any other reason or maybe we have misunderstood the message.

The Director of the Monetary and Capital Markets Department (Mr. Viñals), in response to additional questions and comments from Executive Directors, made the following further statement:

I thank Directors for the very useful comments that they have made. Not only now, but also in your grants. I think that this has been extremely

useful. I will take up a few points, and leave the rest to my colleagues in this first round of interventions.

So, I will say something on language and communication first. I think that a number of Directors made some very sensible remarks about the need to have very careful, very polished language in providing messages which are carefully crafted, so as to explain but not to fuel anxiety, and to do that not only in the written communication, but also in the oral communication. Let me assure Directors that in the process of revising the GFSR, we will pay attention to all the areas they have pointed out in order to still convey our messages, but to do that in the best possible manner.

That is the first thing. We will be careful and we will pay attention to it. Linked to this there is the issue of whether we are just reflecting or echoing what markets say and not putting in what we think. I think that would be very disappointing if the GFSR were to be interpreted as echoing what markets say. Because, let me tell Directors that if that is the case, this report could have been written by one person in a week. And, let me tell Directors, this has taken considerably more time, with a much bigger staff. But I think that there are times when there is a loss of confidence, when there is a lack of confidence, and we understand that markets may overshoot, and that is often the case, in a good direction, in a bad direction, but this is an overshooting based on the existence of some fundamental issues. What we have tried to do is to look at market concerns without losing sight of the fundamental drivers of these concerns. Unfortunately, market concerns are important. Because this may be the difference in terms of what markets think about whether funding will be provided or not and about whether on good terms or not. And what markets thought was fundamental for Northern Rock, was fundamental for AIG, was fundamental for Lehman, so even if they may be right or wrong, I think it is worth understanding what is behind it.

Unfortunately, in this case, maybe they exaggerate, but they reflect some fundamental problems. What we see is that there are some very fundamental issues, which have to do with the legacy of the crisis, and that these issues have not been addressed in many countries, both on this side of the Atlantic and on the other side of the Atlantic. So, I think that this is very important. What we are trying to do is frame our policy advice in a way that can be useful by looking at all the different pieces, both in terms of market data, and indicators, and also internal analysis.

Now, on more specific questions on the European situation, why is it that we say that banks should have 8 percent core Tier 1 capital ratio at this

stage? Well, if we were living in a situation where we had fewer sources of risk, I would say, there would be no need. The problem is that, as I mentioned, when talking about the need to cut the adverse feedback loop between sovereign risk and banking sector risk, that if we do not address the fundamental problems through appropriate policies, in the case of Europe, by having a sufficiently comprehensive strategy for the euro area as a whole, complemented by sufficiently decisive action at the national level in terms of fiscal consolidation, then we have risk and this risk needs to be taken into account. This is something which has been basically affecting banks. What we are saying is, look at sovereign risk, and address sovereign risks. If they remain after tackling the sovereign risk, because it can be done as forcefully as possible, then we have to look at bank capital. That is an inescapable fact. It is not much of a question. It has implications for funding. Funding has implications for credit and credit has implications for the economy. This is a natural sequence. If there is more room, if there is more action on the sovereign risk front, we will not need so much capital. But, as long as we are where we are, the recommendation is a prudent one. Higher buffers are needed when we are in a more uncertain time.

Now, the question of what is the probability that the euro area may break up, we got an answer from the MD, and the answer was that she could not concede that.

Mr. Virmani noted that the answer held true nine months ago.

The Director of the Monetary and Capital Markets Department (Mr. Viñals), in response to additional questions and comments from Executive Directors, made the following further statement:

Let me also tell Directors that I would be consistent with that view nine months later and basically say that the euro project in Europe is much more than an economic project. I think that goes well beyond that. My hope and expectation also will be that the European authorities would do whatever is needed, in order to solve the current problems, and make that a step on the road toward further integration rather than the beginning of the unraveling of the integration that has taken 50 years to achieve, and which has been so important for the peace and the prosperity of a part of the world which has had two world wars since the beginning of the last century.

In terms of some of the allusions to the language in currency unions, we will revise it. There is absolutely no intention to pass judgment on

currency unions, or the euro project. The language may not have been totally balanced. So, certainly we are happy to take care of that.

There was also a question on the specificity of policy advice in these reports and the GFSR, the WEO, so on. One has to recognize that there are different surveillance tools that the institution uses, both multilateral surveillance tools and bilateral surveillance tools. There is a certain division of labor, where in the multilateral surveillance tools, attention is called to the general problems, pointing in a particular direction, basically have a very impressionistic road map, and it is the bilateral surveillance which takes up the discussion with individual countries. This distribution of labor is important, and that comes to the essence of having a very articulated multilateral and bilateral surveillance at the Fund.

There were questions on the search for yield, and to what extent the GFSR is contradictory. It is still the case that in certain parts of the world, particularly in the most sophisticated financial markets, in the United States, we are beginning to see in the context of low interest rates which I completely agree, are absolutely essential, given the situation we have in mature economies, but, I think that there are side effects for financial stability. This is precisely where macroprudential policies come in, so you can have the monetary policy you want, but take care of the side effects in terms of macroprudential stability, and let me just offer an example: synthetic exchange traded funds. This is a very toxic product. It is beginning to take shape. It is beginning to be distributed to many retail investors through a particular number of agents. This is something where the due diligence is not properly exercised. These are extraordinarily leveraged instruments. Again, as in the subprime, we can see that small cells, if they get sick, can cause bigger problems. Our duty is to call attention not only in the problems that we see in sovereign risk in certain parts of the world, but also in mature economies like the United States, which have these signs of emerging vulnerability in the shadow banking system, and we need to call attention to those. This is very important—the application of macroprudential policies to preserve systemic stability—and that was our idea in trying to do so.

Finally, there were a number of methodological issues that were alluded to very generally in the oral interventions of some Executive Directors, and also the grays. Let me be very frank with you. We are open. First of all, we thank the European Directors who have made comments on the methodology, and the ECB that has provided very specific comments. We think it is very useful and very constructive. We are very happy to have gotten these comments. We are processing these comments with an open mind. And

then, we will take up these comments in the manner which is most appropriate in the revised version of the exercise. And we are even considering the publication of a range of estimates taking into account the different choices that you may make in terms of assumptions and parameters, but let me tell you one thing. From what we know, the analysis we have undertaken so far, and we are in very useful bilateral discussions with the staff of the ECB, there is nothing now that would indicate that a message would be different from what it is today. The numbers may be different, but the message remains the same.

Mr. Virmani noted the possibility of countries having to leave the euro area.

The staff representative from the Monetary and Capital Markets Department (Mr. Brockmeijer), in response to questions and comments from Executive Directors, made the following statement:

One question was directly related to the main theme of our GFSR, the link between sovereign risk and banks' balance sheets. The question arose what implications should this have for the central role that government paper plays in regulation? And should that role be revisited? In principle, yes, one should take into account changed circumstances, especially when initiatives are started that would increase the role of government paper in the management of risks by banks. For instance, rules that are being considered with regard to liquidity risk, which very much encourage banks to hold larger amounts of government treasury paper. The question does arise whether the countervailing disadvantage that this brings with it should not be taken into account more carefully in the ultimate implementation of these rules. Also, the logic would have it, if you have capital requirements that are risk sensitive, if it becomes apparent that also in sovereign risk there are credit risks represented, then the present system of risk weighting really should be revisited, including the zero-weighting of some government paper.

I am saying this in general terms. These are all decisions that would have to be taken very carefully, and one would have to go through the consequences with great care. It seems inevitable to me that one does have to take these implications into account.

There was a point made that we should be providing much more country-by-country and in-depth analysis of second-round effects on banking systems than we have been able to do in the GFSR. I think that point is valid in general. In order to be able to assess the risks properly, one has to perform that kind of in-depth analysis. Whether the GFSR is the right place to do it,

just because of the confinement that you have in the space, is another matter. I would also emphasize in this context the importance of avoiding generalization, because countries also within Europe are quite different, and within countries the composition of the banks and their condition is quite different. Just as an example, markets have focused as part of the recent turmoil on, for instance, banks in Italy, and one sees that the core issue there is the large holdings of domestic sovereign paper that Italian banks hold. Markets also focused on French banks, and there it is quite a reverse to the Italian case. The French banks do not hold large domestic treasury paper at all, they hold more treasury paper issued by other European countries. Then markets turn to Austria, for instance, and they have neither. They do not have large holdings of the domestic sovereign paper, and they do not have large holdings of peripheral sovereign paper, but they are heavily exposed to Central and Eastern Europe. Just as an illustration, there are very important differences in the type of risk and vulnerabilities that one sees in European banks. Even though there are also some very prominent common factors, in each of these three countries. For instance, capital levels are relatively low by international standards, and profitability is rather low by international standards also. So there are common themes, but nevertheless one has to be careful to be too generic in one's conclusions.

I would also like to say a few words in response to questions with regard to how serious and prominent is the search for yield. Is it a result of credit excesses? I think the answer to that is that it is still in a relatively early stage, but nevertheless, there are signs that there is indeed such a process going on. In particular, one sees increased use of leverage, shifts to alternative assets, structured products, and also in the retail domain, one sees demand for leverage loan, mutual funds, and also the more complex types of exchange traded funds. So there is definitely a move going on here, which is something that we should be monitoring closely, including the move toward emerging market corporate debt, which has attracted very strong flows recently.

Turning to emerging markets, the question was raised how to assess the likelihood of sudden stops occurring? Here the answer is that these are rare events, if they occur. And, as a result they are very hard to predict also. If one looks at recent developments, one can see how quickly the atmosphere and the climate can change in markets, and that does emphasize the potential risks that are out there. In particular, because the flows are now much more in the form of portfolio and bank debt related instruments, which tend to be more volatile than other forms of capital flows.



I would like to turn also to the use of macroprudential instruments and this is related to the question on the constraints on monetary policy under these circumstances.

In very general terms we have learned a lesson from the lead-up to the crisis that monetary policy, even though it is effective in maintaining price stability, in and of itself is not a sufficient condition to avoid the build-up of risks in the financial sector. The conclusion that we have drawn from that is that a supplementary set of macroprudential instruments would be a potentially efficient and effective way to address those risks. I think also when you now ask yourself in the present juncture what still can be done with monetary policy, one can say that the opportunities in the advanced economies to lower interest rates are limited. But, you can try and push monetary policy maybe a little further than you could have done under other circumstances, if you have available a number of macroprudential instruments that can help you contain the undesirable side effects that might result from persistent low interest rates, or maybe a return of nonconventional monetary easing through quantitative easing.

When it comes to macroprudential instruments, the GFSR touches upon those, and it also has a box on how effective, for instance, loan-to-value ratios were in the specific case of Hong Kong. But the staff will be delving much more deeply into the question of macroprudential tools in a week or two, at the time of an informal session in which the staff will be describing in detail the experiences so far. We will have an opportunity to answer Directors' questions more at length at that opportunity.

The staff representative from the Monetary and Capital Markets Department (Mr. Dattels), in response to questions and comments from Executive Directors, made the following statement:

I will focus my remarks on the methodology, and the issues brought up by Executive Directors. Mr. Viñals in his presentation outlined the basic approach. Its focus is on sovereign stress and spillovers to the banking system, and quantifying that stress. It is not a full-fledged stress test; it does not derive capital need numbers that might result from that stress, or indeed other stresses that are occurring on banks at present.

Within that exercise we have a number of methodological aspects that have been raised by the ECB, and other European colleagues, and they are grouped into five issues: the range of assets that would be included; the choice of price at which you calculate potential mark-to-market impact; the treatment

of loss recognition, and provisioning; the treatment of bank claims on other banks in the EU; and the general data limitations in terms of the aggregations. I will go through these one by one.

On the first point, the observation was made that staff is looking at this in a very selective way that focuses on exposures in high spread Europe, which is the GIIPS plus Belgium, but disregards gains from sovereigns who benefited from safe haven flows. We believe the notion of offsetting this sovereign stress with safe haven assets is misleading from the point of view that it would mask the problems that we are actually trying to focus on. What do I mean by that? If we look at the evolution of this crisis, as Mr. Viñals presented in his chart, it started out with Greece, which has a bond market size of 440 billion, compared to the outstanding size of the euro market of about 6 trillion. Had we done a similar exercise then, what would we have done? We would have taken the small amount of losses and looked at the safe haven flows and we would have had a massive positive number. Where are we now? The extent of sovereign stress has spread through the euro government market, to 50 percent, 3 trillion euros, half of the market. So it is hardly a surprise, then, that banks holding what was considered a short time ago a risk-free asset are now looking at credit risk on the portfolio. Sovereign stress has spread from the program countries onto the outer periphery and is now encroaching on the core.

If we come to this exercise in another six months, it may not be clear what part we would call the save haven, or what part we would call the area more under stress. Indeed, if we took our current methodology measuring credit stress with either bond spreads or CDS, and extended it to the core, our numbers would actually be larger, not smaller, and why? Because we are seeing the spread of that credit stress. There are other reasons why not to offset. One is the more temporary nature of safe haven flows. I do not think we should be particularly encouraged by flows into safe havens, and counting that as a benefit, because that is a parking place for flows that are likely to move out of the system, not back to the periphery but into potentially other assets.

Finally, if one is considering other assets that net off from those losses, why not consider corporate debt securities that are held in the periphery? It makes it difficult to confine the analysis.

The second point made is the choice of price—whether you use CDS or bond spreads. What we are trying to do is isolate the credit risk component

of the sovereign stress. That is why we use CDS. We could have equally used bond spreads from bunds, or swaps.

If we use bond prices, that would distort the analysis, because you would be including the safe haven flows and changes in the risk-free rate. But nevertheless, we have done those calculations and we show their impact in the box, for transparency.

Regarding provisioning and losses, we make the following points. We are looking at the overall amount of sovereign stress, from the end of December 2009, and pick up the losses from 2010 until now. The extent to which some of those losses were realized is an important factor we would clearly like to reflect into the report. Hopefully, working with our colleagues in the ECB, we can have some illumination on the extent to which some of these potential mark-to-market losses have actually been realized, and we would be happy to put them into the report.

There is a lot of ambiguity as to the degree to which losses have been recognized and the degree to which regulatory filters are applied, so that mark-to-market losses are not, therefore, reflected in regulatory capital. The treatment is quite inconsistent across countries. Indeed, that is why the EBA exercise was restricted to the trading book, plus some provisioning on Greek debt, which was well below the mark-to-market prices. Indeed, in recent days, the IASB came out with some criticism of the approaches applied by banks, particularly to Greek debt.

On the interbank claims the ECB made an excellent point about the range of maturities. We have gone back and we have worked through some of the numbers using a range of maturities. We have applied that, and there would be some downward adjustment there on the interbank side. Just in summing up and to reiterate what Mr. Viñals said, we are happy to consider adjustments. We will have presentational devices to show different ways of calculating these.

The staff representative from the Monetary and Capital Markets Department (Ms. Kodres), in response to questions and comments from Executive Directors, made the following statement:

I wanted to raise two issues on Chapter 2. We talked about the aspect of search for yield, and both Mr. Viñals and Mr. Brockmeijer emphasized that in the context of Chapter 1, but several comments have indicated that it looked like there was a discrepancy between Chapter 1 and Chapter 2 regarding this

issue. Let me just note that Chapter 2 really focuses on real money unlevered investors, and the investors talked about in Chapter 1 are levered and short-term oriented.

The reason we focused on these longer term investors is because they are very large, and even though they are very slow moving, when they do move their changes in behavior have more lasting effects. So we wanted to take a longer term view and focus on what changes, particularly given the low interest rate environment that these particular investors will have to cope with. This is taking a longer view.

One of the outcomes of our study suggests that a number of factors, including the recent crisis have moved these investors to be more short term in their orientation and to look for more liquid-type investments. This provides for us an avenue to talk about sovereign wealth funds and reserve managers, as potentially other types of investment groups that can take up the void that these other pension funds and insurance companies are leaving. But, let me be very clear: the chapter does not aim to take a stand on what the optimal level of international reserves are. It notes international reserves have been growing quite steadily over the past decade and one specific metric, the metric Executive Directors saw in the Board paper in March, suggests that many countries do in fact exceed the level that they need to do balance of payments types of adjustments. So, if a country, and not the GFSR team, determines that there are additional funds available, they could be used to invest in less liquid longer term assets, potentially earning higher returns, as well. Indeed, some of the reserve managers in the world have taken their excess funds and have established what they call investment tranches, which are separate from the balance of payments needs of the reserves, and are using a less conservative investment mandate, with those particular funds.

These new investor types could add to financial stability, because they might perform the role of a deep pocket, but we do not say that they should necessarily do so. The reserves would be invested in slightly less liquid assets than the traditional ones, but still need to be accompanied by a very carefully constructed mandate. That mandate need not be inconsistent with intergenerational transfer. In fact, if you have intergenerational transfer and you are a very solid fund that does not liquidate very much very frequently, you could, in fact, take less liquid positions and earn higher returns and it would be a benefit to the whole portfolio.

This would not necessarily go against intergenerational types of arguments. I would point to Box 2.4 and Fig. 2.7 in the report that show the

variety of types of sovereign wealth funds out there and the different goals and mandates that they already have, even with the same mandate they sometimes hold very different types of assets, so there is lots of room for diversification there.

Let me make one remark on Chapter 3. As noted, the Board will have a chance to discuss macroprudential policies on September 12, with two informal papers. Those will cover some of the items we covered in the GFSR chapter. But there is one comment I would like to make for clarity on the chapter that is not covered in those two papers, and that deals with the use of structural models in evaluating the effectiveness of macroprudential policies.

There were a number of Executive Directors concerned about the applicability of such models, our model specifically, to the practicalities of designing macroprudential tools. In the spirit of Mr. Kiekens's seminar, let me note models are helpful to policy makers if they allow a deeper understanding of the issues they face, and provide guidance about their solutions.

For this new set of macro financial models that build on the more traditional dynamic stochastic general equilibrium or the so-called DSGE models it is important to recognize the challenge is to put in realistic financial sectors and individual behavioral assumptions that mirror what is happening in the real world. That is the only way these models are going to be helpful in allowing us to understand what is going on. While this is not easy, I think we have made pretty significant progress, and the models we are building here allow us to provide some guidance to look at macroprudential indicators and a very specific macroprudential tool which is counter-cyclical capital requirements, which fortunately is one that is widely used already.

Unfortunately, we did not have space to put in all the details and one of the risks of putting in some of the details but not all the details means that we probably raise more questions about what is in the black box than we might have if we had just left it all aside. Let me just emphasize two things about it. It is not a standard DSGE model and not standard because we have tried to integrate these things that are very specific to financial markets. We have put in more realistic features of financial markets. We have collateral in the model, which also is a driver for the types of leverage and deleveraging we have seen. We do not have in there all the bells and whistles we would like to have. We would like to put in some sort of trend following the behavior of the household sector, and some other investments. We are not completely there yet. But it is a consistent way of looking at what is going on in these

particular types of models. The model is calibrated, which some people view as a negative, that it is not fit to the data.

On the other hand, all of the parameters we used in the model come from experience with data. So, even though we were not able to show all of the underpinnings in terms of how we arrived at the calibration we used to help structure the parameters of the model, we did try to make it more realistic. A Director asked about the length of shocks, whether that was realistic. We took the length of shocks we have seen in terms of asset price bubbles and in terms of credit, and in terms of productivity shocks, we calibrated the model using the actual data that we have seen in the past.

So, in sum, these kinds of structural models can tell us quite a bit, but they only tell us these things if we carefully unpack the black box. We will have a working paper where we unpack the black box a little bit more thoroughly for people interested. The models will not tell us everything, but they give us some intuition for what is going on. If we combine that with the empirical work, which much of the chapter is focused on, and combine that also with non-quantitative information, such as surveys or interviews, we will probably make significant progress in building a set of macroprudential tools which are useful usable and effective.

Mr. Bakker made the following statement:

I thank staff for all the excellent work and the excellent answers. The main issue for discussion as formulated by staff is how we can generate the political support for the needed policies. I think for that we need to be, first, more specific; and second, we cannot afford any flaws or controversies over methodologies. Otherwise, we will not be effective.

I still remember the criticism on the Fund before the financial crisis. First, had we not foreseen the crisis? Second, had we not warned enough? Third, if we had not warned strongly enough, were we specific enough? What should be done by whom and by what time?

Now, Mr. Viñals says this is more for national bilateral consultations. I do not think that is the way the GFSR functions. We also do not have these discussions each year. We do not have FSAP updates each year. And, it is not taken up in that way in our countries. So, I feel we are still vulnerable. We are doing now two out of three. We foresee what can happen and we do emit very strong warning signals. Two out of three is not enough. The communication

challenges us to better focus on policy recommendations in order to have the decisive impact we need.

We are now in a political phase where political action is needed, and that is a very tough job. We should make life easier for politicians to make a very clear prioritization, and I do not feel that is sufficiently done.

It should be based on staff's assessments. I very highly value the independence of staff and how they see the balance of risks. If they feel that what has been agreed in Basel III should be sped up, and then taking all the risks for the recovery, then that is fine. But then they should spell that out. Just to give not determined or not clear messages on speeding up is not helpful for the authorities. So we should do better there.

Then second, on the methodology, I do not want go into all the issues, but I feel that we should take into account the fact that supervisors have been working extremely hard to improve balance sheets. Banks have moved a very substantial part of some of their books to mark-to-market. I would not accept that we propose a back-of-the-envelope calculation in which you forget about the provisions. We tried to simulate what the provisions have been and then we give a range, but the conclusions stay the same. That is very difficult to swallow on a general basis for countries in Europe. We need to be more specific. I think we need to try to do better. So if, as the Acting Chair said at the beginning of the meeting, he still feels on the basis of discussions that it would be good to change some of the outcomes, then, only on that basis, on his judgment, I think I would take it; one would take a long look at the conclusions being drawn of that.

Mr. He made the following statement:

Just one substantive comment and one procedural comment:

The drivers of capital flows and reserve accumulation have been extensively studied and discussed. Currently we have been focusing largely on the short-term seeking for yield and different interest rates across countries. But, I think that right now it is quite relevant that some medium-term factors also should be taken into consideration in looking into the drivers for those two. For instance, the medium-term uncertainty about growth prospects, about cleaning up of public sector and private sector balance sheets, and all those, because flows are in relative terms, given the destination situation unchanged, some change in the prospects of medium-term prospects of the source

countries, that was also driving the flows. Also, other factors like investment protection, whether those also affect the flows, and reserve accumulation.

I want to mention a procedural point, a question. I think that this paper is very well focused and the messages are very sharp and truth telling. I was just wondering whether the publication can be earlier than planned, even in electronic form, whether that would be possible, because it would benefit policy debate earlier than later and the risk of leak would be also minimized.

Another procedural question, I know some colleagues issued combined grays on WEO and GFSR. Some specifically said that this is a combined gray, some do not say that, they just issued under a separate topic. So, I was just wondering, when the Secretary's Department writes the summing up, whether there is a risk of double counting. Because, in that case, we would also like to have two grays to be counted both ways.

The Acting Chair (Mr. Lipsky) noted that the publication of the GFSR, and associated press conferences, had already been scheduled.

Mr. Gibbs made the following statement:

I very much welcome the frankness and the clarity of the report and the presentation today. I share much of the analysis and the policy recommendations, in particular, the comment that it is important to focus on the sovereigns as a first best option alongside capital measures. I do not want to repeat what I said this morning, but I think a bit along the lines of Mr. Bakker. I do see a key role for the Fund in pulling together a much more coherent set of specific policy recommendations to help policy makers get out of the credibility gap that has emerged. I think we still have a way to go on that based on the papers we discussed today, although the building blocks are nevertheless there.

Finally, in my gray, I did share some of colleagues' concerns about the mark-to-market numbers, in particular on the communication, and the difficulty of doing that effectively. Also it seemed to me that some reasonable points have been raised on the methodology. I very much welcome what Mr. Viñals said today about communication and the commitment he gave to reflect on that very carefully.

On the methodology, I welcome Mr. Dattels's answers. It sounds as though this is a debate which may have some way to run. I would encourage the team to continue to engage, because I hope that we can figure out the best



way to present the staff analysis by publication day, in a way that gets across a valid message, but I think we are all clear that this is something that calls for careful handling.

Ms. Lundsager made the following statement:

I want to thank the staff for the papers, and for the presentation today. Mr. Vinals's comments were very helpful, particularly his point that the staff is not reflecting the market but trying to discern what concerns the market. They are trying to ferret out that information in order to make some sensible policy recommendations that would then change that sentiment if it is incorrect. I appreciate that they are trying to do that. Frankly this is what the GFSR has been trying to do for the past several years, since the Acting Chair has been here. Certainly it has been a key theme of his. I recall over the years the many efforts, the many special chapters on developments in the United States, the ABS markets, the financial sector as a whole, which I think were helpful to start the debate and to promote action.

What I also think is very important that you have been emphasizing today is something we have all been struggling with for several years, namely the financial sector and the real economy linkages. That analysis is becoming stronger. The discussion this morning was certainly a little bit downbeat in terms of the revised downward growth numbers (WEO) and the difficulty of trying to get us all back on a good growth trajectory. The emphasis is on growth and job creation, not just numbers for themselves, but for enhancing the financial sector's contribution to real economic growth. I very much welcome that you are strengthening that analysis and that is coming across much more strongly.

Finally, I would just suggest in terms of policy recommendations, I felt Mr. Furusawa made some very good suggestions.

Mr. Fayolle made the following statement:

Let me read an article that just has been published in The Financial Times.

The title is, "IMF Sees Serious Damage to Euro Banks on Sovereign Debt." And, "IMF and Euro Zone Clash Over Estimates." And then it gives a lot of information, including figures in the GFSR, and it says that this issue has to be discussed by the Executive Board this afternoon.

I see that as extremely damaging for the credibility of this institution, and for the credibility of its Board. And, I hope that we as an institution react to this.

The Acting Chair (Mr. Lipsky) noted Mr. Fayolle's announcement and agreed that the development was disappointing.

Mr. Palei made the following statement:

This is related to the discussion today about this notion of European banks lacking capitalization and the need for urgent actions from the authorities in this area. I think the discussion was very useful in clarifying what could be behind this generalization or general claim that is present in the media now, and I think that this discussion is unfortunately missing in the GFSR itself. What we have just heard about the leak, and the availability of this text to the general public, makes me think about this issue of communication we have also touched upon today. I understand that the text could be edited a little and then additional text added to clarify what is meant by the urgent need for mandatory recapitalization of banks, or what kind of banks are depending on which factors, and so on.

I think this is a very sensitive issue now, and I would like to better understand where we are moving now in light of today's discussion and in light of the responses by staff? Is it going to be reflected in the text of the GFSR? Is it going to be addressed somehow differently? But, obviously, there is a need to take it into account, as soon as possible, and I think many European Directors made it clear today.

Mr. Saho made the following statement:

I did not have the opportunity in the earlier session on the WEO to join colleagues in mentioning the Acting Chair's very strong contribution to the Fund and I now beg your indulgence to do so. This chair appreciates your work. The chair also thanks Mr. Viñals and other staff for a good GFSR. The report captures appropriately the seriousness of the risks to global financial stability without sounding alarmist.

We welcome that the GFSR this time has clearly pointed out that political responses are going to be an important aspect of improving or worsening outcomes. It would seem that the political process in some countries needs to rise to the momentous challenges of these times in order to

address the risk in a constructive manner so we can restore confidence in the global financial system.

Some very painful political decisions have to be sold to the electorate of some countries, so the challenges cannot be underestimated. For instance, how does one sell the proposition to the citizens of core Europe that to address sovereign risk fiscal transfers to some countries in the periphery may be a part of the solution?

It would not be easy to sell to the people that perhaps in finding a solution to the problems we have, everyone may end up being worse off.

Some other countries are also equally challenged. We agree with the analysis that the time to act is now. Of course, the politicians know this better than us. But, nonetheless, I think our message should be communicated in a constructive way, without adding to negative market sentiment, and I think it is unfortunate that some of the issues that we are to discuss today are already out in the public domain, but I think we should add to the voices that are trying to spur leaders into further and stronger action. And in this regard, we agree with Mr. Bakker and Mr. Gibbs that more specific recommendations would be useful.

The Acting Chair (Mr. Lipsky) agreed with Mr. Palei that it would be necessary to take stock before deciding how address communication issues, including those related to the unauthorized disclosure of information contained in the GFSR.

Mr. Kiekens made the following statement:

I very much want to support the independence of staff analysis, both in Article IV consultations and bilateral surveillance, and in multilateral surveillance. What we see today with these leaks and the high profile debate and discussion that we had publicly after the Jackson Hole speech and the leak now in The Financial Times, we have not seen such dramatic problems with Article IV consultations for a specific reason.

The staff report in an Article IV consultation is written after extensive consultations with the authorities. Here, traditionally and for reasons we can understand, the staff produces its paper, without this intense consultation, and then once it is circulated, with a various degree of leaks, there is the opportunity for the authorities, through the Board and bilaterally, to discuss.

But, with the risks involved, which we see now, and I wonder whether we do not need to reflect on our procedures, particularly for technical analysis. The technical analysis and methodology that we have seen developed and which is the heart of this technical discussion between our authorities and the staff, could have been done probably before the release of the papers to the Board, rather than after, probably in line with what happens in Article IV consultations, because the authorities discuss with the staff technical analysis before the Article IV consultation is released to the Board. So let us reflect on that as well.

The Acting Chair (Mr. Lipsky) agreed with Mr. Kiekens that it was important to reflect on the unauthorized disclosure of sensitive GFSR material.

Mr. Fayolle agreed with the suggestions made by Mr. Kiekens.

Mr. Kiekens noted that the wide circulation of the draft GFSR could increase the risk of unauthorized disclosure of its content.

The following summing up was issued:

Executive Directors broadly agreed with the staff's analysis and expressed concern regarding the deterioration in global financial stability, following signs of an economic slowdown and renewed market anxieties about the euro area periphery and the U.S. fiscal and debt challenges. They noted that weaker growth could have a negative impact on both public and private sector balance sheets, with rising financing costs that could aggravate the fiscal position in many advanced economies. Directors observed that emerging market economies are generally in a stronger position, but also face difficult policy challenges, including those related to possible overheating. Directors underscored the importance of strong, coherent policy responses to address rising contagion risks and strengthen financial systems.

Directors noted that the financial crisis has entered a new difficult phase. In this context, they were concerned that political differences within the euro area may have delayed a lasting solution to the sovereign debt crisis. They also noted that difficulties in reaching a political consensus on medium-term fiscal adjustment in some other countries, including the United States, could undermine market confidence. Directors stressed, therefore, that a timely resolution of these difficulties would be critical to limiting risks to financial stability and addressing the fundamental challenges.

Directors observed that the adverse feedback loop between sovereign risk and bank balance sheets has intensified. They noted that risks of a funding disruption would rise if banks were unable to strengthen their balance sheets or sovereigns could not agree on credible medium-term fiscal plans in a timely manner. Directors concurred with the need to address vulnerabilities in the banking sector, including a further strengthening of bank capital buffers where necessary, to minimize risks to the real economy. Directors warned that lack of decisive action in this regard, as well as on the fiscal front, could trigger a negative spiral of rising funding costs and deteriorating debt dynamics.

Directors noted the staff's analysis of the potential impact of sovereign stress on bank balance sheets in Europe. A number of Directors welcomed this analysis as important to an understanding of contagion risks, but a number of others expressed concerns about the underlying methodological and data choices and the challenges in communicating it to the public. Many Directors saw scope for further work in this area.

Directors agreed that significant measures would be needed to restore the financial system to health. In the United States, policymakers still need to address the legacy of the financial crisis as it persists in household balance sheets. In the euro area, Directors called for swift implementation of the decisions taken at the Euro Area Summit in July 2011.

Directors noted that low policy interest rates, while necessary in many countries under current conditions, could pose long-term financial stability risks. The “search for yield” could push some market segments into excessive leverage, exposing them to higher risk. Directors concurred that a prompt completion of balance sheet repair in financial institutions could help contain these risks. A few Directors noted, however, that such risks could be overstated.

Directors shared the view that, while the recent surge of capital inflows to emerging markets has had beneficial effects, these inflows have fueled liquidity and credit expansion that could be destabilizing in case of a global growth slowdown, a rapid increase in funding costs, or a sudden reversal of the flows. Directors agreed that a variety of measures, combining macroeconomic and macroprudential tools, could help limit the buildup of financial vulnerabilities, and stressed the importance of closely monitoring credit growth.

Overall, Directors agreed that the key near-term policy challenges should center around implementing coherent solutions to reduce sovereign

risks, introducing credible efforts to rebuild the strength of the financial system in advanced economies, and controlling the risks of overheating and asset bubbles in emerging market economies. They also stressed that the international financial reform agenda needs to be completed as soon as possible. A few Directors were mindful of the possible adverse impact on bank lending and growth of an accelerated compliance with Basel III capital standards. A number of Directors noted that following up on the implementation of the previous advice and more specific policy recommendations by staff would help focus the discussion and more clearly define policy options.

Directors welcomed the analysis in Chapter 2 of the forces driving global asset allocation by long-term investors. They noted that public and private pension funds, insurance companies, and asset managers, have altered their behavior since the crisis by focusing more on market, liquidity, and sovereign risks. They agreed that the generalized move to safer, more liquid securities may limit the stabilizing role that long-horizon investors can play in global markets.

Directors observed that the main factors underlying the long-term trend toward emerging market assets are strong domestic economic growth prospects and lower perceived country risk. They noted the risk of a reversal of these flows, especially in the current times of heightened global risk aversion, but agreed that the longer-term trend favoring emerging markets is likely to continue. To mitigate the chances of a sudden reversal, Directors called on policymakers in emerging markets to focus their attention on maintaining strong and stable growth, and financial system resiliency.

Directors welcomed the analysis in Chapter 3, which takes a step forward in the design and operation of macroprudential policy frameworks. In particular, they appreciated the discussion of the macro-financial linkages and concurred that understanding the sources of shocks would help the design of policy instruments. Directors concluded that establishing macroprudential frameworks would require careful consideration, taking into account country-specific circumstances.

The Acting Chair (Mr. Lipsky) made the following statement:

This was my last time chairing the Board, and I want to thank all of you for the contributions you have made. It has been a terrific experience. We have been through an awful lot of interesting things, including today's meeting. And we will be through a lot more.

It is probably worth mentioning, it is interesting, Ms. Lundsager alluded to it, that my arrival coincided with the formation of the Monetary and Capital Markets Department, and was also virtually simultaneous with Mr. Caruana as the first Director, succeeded by Mr. Viñals. It is gratifying to look back. We still have controversies, but I think people take the GFSR and our work in this area extremely serious as a benchmark publication, something everybody looks to for expertise and opinions on developments in international financial markets. Frankly, that was not the case five years ago. It is obviously necessary, it is obviously crucial, for our ability to fulfill our responsibilities of safeguarding economic and financial stability and economic progress. So, we have the additional challenge of forging an ongoing productive relationship with the FSB, which also did not exist when I arrived. It is gratifying to look back and see how far we have come.

Next time around, I think tomorrow, I believe, you will be chaired by the new First Deputy Managing Director. The changes are going to be very modest, only three letters in the surname need to be changed, and there are additional similarities, by the way. I am the first senior management officer of the IMF to have attended Wesleyan University in Middletown, Connecticut, and Mr. Lipton is the second. I do admit he went to Harvard afterwards, instead of Stanford, but we will overlook that youthful lapse in judgment. If you have ever spent winter in Cambridge or winter in Palo Alto, you will recognize the errors in his ways. I would say there are no hurricanes in Palo Alto. I was the first senior officer, outside of the first set of Deputy Managing Directors, to have been an IMF staffer, like Mr. Lipton. I was also the first to have a private sector career and Mr. Lipton is the second.

The similarities are manifest and lest you get confused, remember, I am the one with a mustache.

APPROVAL: August 23, 2012

JIANHAI LIN  
Secretary

## Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

## **Chapter 1: Overcoming Political Risks and Crisis Legacies**

### **European Sovereign and Banking Markets**

1. *We invite staff to elaborate more on the exercise assumptions and the rationale behind some methodological choices, in particular the use of 5-year CDS spreads as a proxy for the change in the market value of exposure and the end of 2009 as the cut-off date.*  
**AND**
2. *We wonder how sensitive the results are to changes in the cut-off date, the sources of data, and the measures of sovereign risk used. Further, the benchmark instrument of 5-year bonds looks dubious.*
  - CDS spreads were used to estimate the impact of the increase in sovereign credit risk on the banking sector. This credit risk is best measured by CDS spreads or, equivalently, bond spreads. For the final version of the GFSR we have revised the estimation using weighted-average maturity-CDS spreads for both sovereign and interbank exposures. For sovereign exposures this method gives a very similar result to the original calculation which used 5-year CDS spreads. The results on changes in the value of interbank claims are lower. The cut-off date (end-2009) is chosen so that the spillovers are calculated over the whole period of sovereign stress. If yields were to be used, the calculation would be lower. But such a calculation would include changes in risk-free rates as well as increases in credit stress. Moreover, the adoption of a broader approach that takes into account the effects of a low risk-free rate would need to include other impacts, including the predominantly negative impact on bank profitability of lower long-term yields.
3. *The data sets used in particular the reliance on unconsolidated BIS data on exposures...lead to a significant upward bias in the results.*
  - The analysis can be approached using either locational or consolidated data. The former would include banks operating in a certain country, including branches and subsidiaries of foreign banks, and the latter would reflect the ownership of banks. For the final version of the chapter, we have moved the exercise to a consolidated basis to help the presentation of the results.
4. *The framework applies the sovereign shock in a selective way. It focuses solely on losses associated with exposures to high-spread countries, but disregards gains made on exposures to sovereigns treated as 'safe havens,' which would bring substantial relief to a number of banks.*



- The aim of the exercise is to assess the spillover from high-spread governments—those which have faced the highest sovereign risks—to the banking system. Therefore, it does not perform a mark-to-market analysis of all assets. Nevertheless, it is interesting to note that if the methodology is extended to the sovereign bonds issued by the other countries in the euro area the estimated spillover would actually be greater.
  - Moreover, if offsets pertaining to the flight to safety are included, other related losses, such as those on bank equities, corporate bonds and loan portfolios, should also be taken into account, which would make the exercise more akin to a full-fledged stress test. This is not the aim of the GFSR exercise, which has a narrower focus—it estimates spillovers from high-spread euro area sovereigns (Greece, Ireland, Portugal, Belgium, Italy and Spain) to the EU banking sector.
5. ***The framework does not take into account losses which have already been recognized in the form of mark-to-market trading losses during the period between end-2009 and now. In the same vein, it does not take into account the provisions that have already been made by EU banks on sovereign debt exposures. Ignoring provisions and mark-to-market trading losses that have already been made/recognized introduces an element of double-counting in the exercise.***
- The aim of the exercise is to measure the spillovers from high-spread euro area sovereigns to banks. These spillovers can include recognized and unrecognized losses. We note in the final text that to some degree losses have been recognized. We also note that there is uncertainty about the scale of losses that have been recognized by banks, particularly in their regulatory capital, and we include policy recommendations to encourage greater consistency across jurisdictions. As mentioned above, the estimation starts at end-2009 in order to capture the full period of sovereign stress, and so does not double-count.
6. ***The mark-to-market losses stemming from claims on banks in the high-spread countries and the impact on bank funding markets are overestimated, especially since the analysis derives from total interbank claims which represent a much broader range of liabilities than actual wholesale interbank funding.***
- The mark-to-market impact on interbank funding includes holdings of debt issued by other banks, as well as interbank loans. As sovereign risks have spilled over to banks, exposures to the affected banks have become more risky, amplifying the overall spillover. As mentioned above, the calculation of the mark-to-market impact on interbank exposures has been updated to reflect the maturity of these interbank exposures. Of course, this only includes the first-round impact of spillovers in interbank markets. Including second-round affects, such as increases in the credit risk of exposures to other European banks that are impacted by spillovers, would have raised the magnitude of estimated spillovers further.

## U.S. Mortgage Market

**7. *We would welcome staff indications on the volume of mortgages “under water” and the cumulative size of write-downs.***

- As of Q1 2011, 27.7 percent of all residential properties with a mortgage were in negative or near-negative equity, down only slightly from 27.9 percent in the fourth quarter of 2010. According to the latest U.S. Article IV report, the cumulative size of residential mortgage-related loan charge-offs from Q2 2008 through Q3 2010 stood at just under \$500 billion. Efforts to mitigate foreclosures have thus far had limited success, in part as a result of the inability to address borrowers’ high-debt profiles and/or their large negative equity positions.

## Emerging Market Corporate Debt Issuance

**8. *We note the staff assessment that emerging market credit risk is being “exported” to international investors as domestic regulators have tightened prudential regulations. We would welcome staff comments on the share of such debt issuance in international markets and if such exposures justify a systemic concern.***

- Emerging market corporate debt is viewed favorably by investors on the basis of a number of factors, including lower leverage, higher risk-adjusted returns and lower expected default. This is highlighted in page 51 of the report. Cumulative EM external corporate debt issuance totaled around \$350 billion between Q1 2010 and Q2 2011 and compared to a combined issuance of about \$2.9 trillion for U.S., U.K. and euro-area corporates. On an absolute basis, EM issuance is a relatively small proportion of global issuance and does not constitute a systemic concern by itself. However, EM corporate external debt issuance was around \$380 billion for the previous three years combined (2007-2009), indicating that firms had significantly increased their reliance on external wholesale funding over a relatively short period.

## Chapter 2: Long-Term Investors and Their Asset Allocation: Where Are They Now?

**9. *Additionally, staff mentions that “because balance sheet repair has been incomplete, the ‘search for yield’ is pushing some segments to become more leveraged” (paragraph 3, Executive Summary, page 7). This did not seem consistent with the finding in Chapter Two, (paragraph 55, page 44) which says “the low interest rate investment in advanced economies...has not yet pushed investors into riskier investments to enhance yield.” The staff’s clarification is welcome.***

- The staff points out that Chapter 2 only looks at “real-money” long-term institutional investors, not the leveraged short-term investors that Chapter 1 looks at. As the investment behavior of these groups of investors tends to be different, there is no inconsistency between the statements in Chapter 1 and Chapter 2.

**10. *What are the policy implications are if pension funds would prefer to hold FX-denominated assets instead of domestic currency, when their liabilities are in domestic currency?***

- Investors will in general benefit from a well-diversified portfolio. Assets that may by themselves involve considerable risk could still lower overall portfolio risk when added to achieve a well-diversified portfolio. For investors in any individual country, a well-diversified portfolio includes foreign assets. In fact, it can be shown that from a theoretical point of view, the optimally diversified portfolio includes a market-weighted combination of world assets.
- For any individual investor, a mismatch between the currency denomination of assets and liabilities creates exchange rate risk. However, such risk can be hedged with the appropriate instruments. Alternatively, if the portfolio is structured to have low turnover and with a long-term view, currency risk tends to be low relative to the risks involved in the allocation decision and some pension funds consciously decide not to hedge it.
- In practice, the IMF Survey on Global Asset Allocation shows that more than three quarters of bonds and half of equities held by pension funds is still held in the country of domicile (Table 2.14). This suggests remaining “home bias” and considerable scope for further diversification. This need not lead to an increase in foreign exchange risk, as most pension funds increasingly use a variety of instruments to hedge risks (Table 2.20).
- For the case of Iceland, since domestic assets constitute a very small portion of the “world” portfolio, a well-diversified portfolio would in fact consist mostly of foreign assets.
- From a policy point of view, regulators should focus on the quality of risk management by pension funds. Such risk management could include mitigation of exchange rate risk in the portfolio with the help of appropriate instruments.

**11. *Would the [chapter’s empirical analysis] imply that a rise in interest rates in advanced economies would not lead to large capital flow reversals in emerging markets, everything else being equal? Moreover, we wonder whether there is some inconsistency with the findings in Chapter 4 of the April 2011 WEO report that net flows to emerging markets rise during periods of low global interest rates and risk aversion and fall afterward. The staff’s comments would be appreciated.***

- The chapter finds that flows into and out of bond and equity investments of long-term unleveraged institutional investors do not respond significantly to interest-rate differentials between countries.

- This implies that, all else being equal (in particular, without a change in emerging market growth prospects, country risk, or global risk), a rise in advanced-economy interest rates would not lead to disinvestment out of emerging market bond and equity funds by these investors.
- However, as the chapter notes, this does not imply that changes in interest rates do not affect general capital flows, which include a number of items not covered by the chapter, including, in particular: (i) investments other than bonds and equities; and (ii) investments by short-term leveraged investors. These investments might still be affected by interest-rate differentials, and may well dominate the flows of long-term investors, especially in the short term and during periods of market turmoil.
- These differences in focus are also likely the cause for the somewhat different conclusions of Chapter 2 of the GFSR and Chapter 4 of the April 2011 WEO.

**12. *We would be interested in staff views on the role of mandated stock selling within portfolios, as driven by rating agency changes. The role of rating agencies has perhaps led to a broad consensus on risk (both in the lead up to the crisis and at the present time).***

- As noted in Chapter 3 of the October 2010 GFSR, staff advised policymakers to continue their efforts to reduce their own reliance on credit ratings and wherever possible remove or replace references to ratings in laws and regulations.
- We also suggested that they should discourage the mechanistic use of ratings in private contracts, including investment manager internal limits and investment policies. However, they should recognize that smaller and less sophisticated investors and institutions that do not have the economies of scale to do their own credit assessments will inevitably continue to use ratings extensively.
- The messages of this GFSR chapter are that real-money institutional investors need to increase their ability to examine and monitor at credit risk—and they are doing this—as they realize that even assets they thought were risk-free are not. Part of good risk management processes is to have a disciplined method of determining when to sell an asset that is not performing as expected. This process should not be based on one criterion, such as a rating, but take into account all the risks and returns of the asset and its usefulness in the portfolio context.

**13. *How well will investors' increased sensitivity to risk hold up?***

- Both the anecdotal and empirical evidence suggest strongly that the increased risk consciousness of investors is of a permanent nature.

- In the regressions in the chapter, there was a clear structural break at the time of the crisis that saw real-money investors move away from risk assets, most likely as a result of the new assessment of risk. There is no evidence in the data that that effect is fading.
- In interviews conducted by staff as background for the chapter, virtually all institutional investors indicated that they thought the risk consciousness of real-money investors had changed fundamentally as a result of the crisis.
- While the evidence is fairly compelling, history suggests that investors become complacent about certain types of risks over time, and while this latest crisis was quite large and recent, we would expect some investors' risk sensitivity will wane over the long run.

***14. Strengthening the resilience of the financial system through higher capital buffers and more effective financial sector regulation is crucial. (...) However, some regulations designed to strengthen the resilience of the system may have unintended consequences. The staff concludes that initiatives like Solvency II for European insurance companies may push these institutions away from the traditional role of taking on longer-term risky assets (GFSR, Chapter 2). We would appreciate staff's comments on possible ways of balancing these trade-offs.***

- The staff generally supports efforts to make the financial system safer. Regulation can play an important role in those efforts.
- The chapter points to possible negative effects on the asset allocation of insurance companies of the regulations contained in Solvency II—that is, that there is less incentive to invest in longer-term assets and less incentive to invest in equity. The chapter suggests that this may lessen an important investor base for the supply of longer-term risky capital.
- The chapter notes that one way to balance these trade-offs is to consider how sovereign investors might benefit from taking on the role of providing longer-term risky capital. Investments by sovereign wealth funds in particular are typically made with a focus on the long term, without regard to the business cycle. In this way, excess reserves and sovereign wealth fund's investment strategies could help play the role of “deep pockets” maintaining their investments during downturns, perhaps even supporting the market by buying underpriced securities during periods of stress.
- Another way to balance these trade-offs is to ensure careful implementation of the Solvency II regulations so as to give insurance companies ample time to adjust their asset allocations. Given the large amount of funds involved, this would mitigate the risk of disruptions to asset markets if insurance companies change their asset allocations quickly.

**15. *The staff's assertion on global foreign exchange reserve holdings having exceeded that needed for balance of payments and monetary purposes needs to be interpreted cautiously. We share the view of Mr. Garcia-Silva, Mr. Hendrick and Mr. Maciel that there is no conclusive agreement on how the "optimum level of official reserves" should be determined. Further, Box 1.4 in the WEO on "External Liabilities and Crisis Tipping Points" found evidence that higher reserves mitigate crisis risk over and above their effects on the net debt position, suggesting that so-called excess reserves continued to have a precautionary function. The staff's comments on these somewhat diverging statements would be appreciated.***

- The chapter does not aim to take a stand on the optimal level of international reserves.
- It notes, however, that international reserves have grown very fast in the past decade and that one specific metric (from the staff paper on Assessing Reserve Adequacy discussed by the Board on March 4, 2011) suggests that in many countries, they exceed the level needed for balance of payments purposes. To the extent that this is true, such additional reserves could be invested more aggressively than traditional reserves.
- In this context, some reserve management authorities have already taken the step of creating an "investment tranche" of reserves with a less conservative investment mandate.
- While these reserves may be invested in slightly less liquid assets than traditional reserves, it is likely that they could still be available in times of crisis to bolster confidence or otherwise mitigate crisis risk. They could thus still have a precautionary function.

**16. *The finding that interest rate differentials do not significantly affect real money investor flows is somewhat unexpected. To shed more light on this result, could staff provide some more information on the impact of interest differentials on investment flows of other investors and on possible differences of the impact of short term and long term interest rate differentials.***

- Chapter 2 only looks at investment flows of long-term, real-money investors. It concludes that interest rate differentials do not significantly affect investments flows of these investors.
- The baseline analysis in the chapter used short-term interest rate differentials, but found no difference in results for long-term rate differentials, which also do not significantly affect real-money investor flows.
- Investment flows of leveraged investors may still be affected by interest rate differentials. There are a number of reasons for this, which include:

- By definition, leveraged investors borrow funds to invest. The interest rate is therefore a direct cost component for these investors (as opposed to an opportunity cost, in the case of unleveraged investors). This may make them more sensitive to changes in interest rates.
- Leveraged investors in general are expected to trade more frequently and more substantially than real money investors, because leverage generally increases risk since a smaller amount of initial investment controls a larger position. Their tendency to trade more frequently makes their investments more sensitive to all underlying fundamentals, including interest rates.
- The chapter did not conduct an empirical analysis of the determinants of leveraged investors' flows.
- On the relative size of leveraged and real-money flows, we can note the following:
  - It is estimated that the total assets under management of hedge funds amount to about \$2.5 trillion. With leverage about 3, assets that are under the control of hedge funds are in the range of \$7–\$10 trillion. Some banks may also have (leveraged) proprietary trading activities, but these have declined in recent years. In all, investable assets of leveraged investors are a fraction of the assets of real-money investors, which are likely about 10 times larger.
  - However, as leveraged investors may be inclined to trade more frequently, trading flows from leveraged investors may still be quite important. For this reason, in some situations or markets, they may dominate the trades of real-money investors. This may be true in particular in sharply declining markets, when leveraged investors may be subject to margin call and/or forced sales to generate liquidity.

### **Chapter 3: Towards Operationalizing Macroprudential Policies: When to Act?**

#### **General: Policy Coordination**

**17. *We broadly agree with the staff's practical guidelines for operationalizing macro prudential policies but further work is needed, in particular with regard to cross-border implications. Whereas the Fund has tackled these implications within the discussions on capital account policies, it has not so far developed a view on these same concerns related to macro prudential policies. However, for small open economies, capital account policies and macro prudential policies are close relatives, and thus policymakers face similar tradeoffs when deciding how to implement them as complements to standard macroeconomic tools. The staff's views on how to properly coordinate macro prudential policies across countries would be welcome.***

- We agree that cross-border cooperation (including between national agencies) is key to effective macroprudential policy making in general.
- Based on the analysis of the chapter, which showed that one popular macroprudential tool could be applied as effectively (but calibrated accordingly) in different exchange rate regimes, we suggest that cross-border coordination would be easier when a common set of tools can be used. We are suggesting that efforts by such standard setters, like the Basel Committee, are on firmer ground when they promote such common tools.
- Beyond this insight, countries should refer to the Basel Committee of Banking Supervision (BCBS) paper on “Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems,” for guidance on how to implement the countercyclical capital buffer on internationally active banks.
- See Jácome and others (forthcoming Staff Discussion Note) on effective mechanisms at cross-institutional coordination and governance arrangements within a country.

### Use of the Structural Model

**18. *We welcome staff work toward developing operational analysis and tools for the use of macroprudential policies (Chapter 3). The indicators of buildup of financial stress, including thresholds of credit to GDP growth and other variables, are useful in identifying rising risks of financial crises while differentiating them from episodes of rapid credit growth driven by improved fundamentals. In this regard, we wonder whether expectations about the behavior of market participants in response to asset price rises and credit growth could be included in the model. Such expectations might contain useful information about future pro-cyclical behavior, or shift in sentiment toward risk taking. The staff's comments would be appreciated. Overall, even if we continue to believe that crises cannot be predicted, these tools should help policy makers become aware of looming risks and better inform policy response. We encourage staff to work closely with country authorities to build relevant indicators of financial stress and, where feasible, help develop country-specific models.***

- We agree that indicators tracking expectations about the behavior of market participants in response to asset price rises and credit growth could be useful leading indicators.
- In some sense, the high-frequency market-based indicators do track such expectations. However, these indicators can only inform policymakers that risks are about to materialize. Hence, these are useful, as was emphasized in the chapter, at informing policymakers that risks are looming so that they can prepare to release buffers built up in advance.



- The simulation experiments can technically be re-designed by modifying the expectations-structure of all agents and adding shocks to them. One could also attempt to capture the incentives that agents have for trend following or other behaviors. In both cases this would, however, make the experiments much more complex and it will be more difficult to gain insights from them. Nonetheless, these are natural next steps.

**19. *The use of a structural model in Chapter 3 to illustrate systemic risk build-up and provide advice on operationalizing macro-prudential policy is an interesting and helpful exercise. These kinds of models will be important if we are to understand the costs and benefits of different policy choices. However, the assumptions underlying the model influence the results. Considerable work remains before we can be reasonably sure that we can describe the relevant complex macro-financial feedback loops, intra financial dynamics and other relevant features of systemic risk in relatively simple, stylized models. Could staff elaborate more on how the selected model approach and specific assumptions influence the advices?***

- The structural model allowed us to understand very complex real-financial linkages in a simple way. By putting together the various pieces, it imposes a structure on how we think of these relationships.
- The set of practical guidelines provided in the chapter is based on both the structural model and the series of empirical exercises. The model was merely used as guidance and should not be used for deriving precise forecasts.
- Changing the basic assumptions about the model does not change the set of practical guidelines. The model was calibrated to mimic an average of several open economies thought to be representative of the issues we are trying to look at. In particular, several countries' averaged data are used to judge the starting point for the steady state, the sensitivity of the responses to, say, exchange rate changes, and the normal cyclicity of demand components. Other parameters are chosen to mirror what we see in financial markets—specifically about bank behavior.
- As is elaborated in the chapter, changing the assumptions about the degree of trade-openness (for instance, the sensitivity of the exchange rate to import and exports) does not change the basic set of predictions of the model. Again, the chapter does find that the presence of managed exchange rate regimes together with foreign-currency loans amplifies movements following all shock scenarios.

## **Empirical Models**

**20. *What is the basis for choosing the growth versus the gap measure of credit-to-GDP when both perform equally well in the panel regression? Why do the results on the***

***“gap” measure differ from BCBS (Drehmann, Borio and co-authors). For example, is it mostly due to the inclusion of a greater number of emerging markets in the panel? How does the timeframe considered compare? Are the evaluation criteria different?***

- The panel regression does not take into account the preference of policy makers in issuing signals. If policy makers are trying to avoid missing crisis (reducing Type I error), then the “growth” measure performs better than the gap. If they are trying to avoid issuing too many false-signals (Type II error), then the “gap” measure is better.
- In the analysis of noise-to-signal ratios (which puts together Type I and Type II errors), we find that the number of countries with 100 percent Type I error (that is, the number of countries where crises were missed using a given measure) is much higher for the “gap” measure. This means that taken together (that is trying to predict accurately and avoid false signals), the growth measure is better overall.
- Our results on the “gap” differ from existing work due to two reasons: sample of countries and difference in the preference of policymakers. First, inclusion of emerging and low-income countries greatly increases the sample-size of the tests. We show that in this larger sample, the “gap” is not a clear winner. We do note that the “gap” measure performs very well if the sample is reduced to advanced countries only. Second, the BCBS assumes that policymakers would clearly prefer to lower Type II errors (false positive signals). In this chapter, we are also focusing on Type I errors (missing crises) and we find that the “gap” measure misses too many crises.



# International Monetary Fund

August 31, 2011



## Overcoming Political Risks and Crisis Legacies

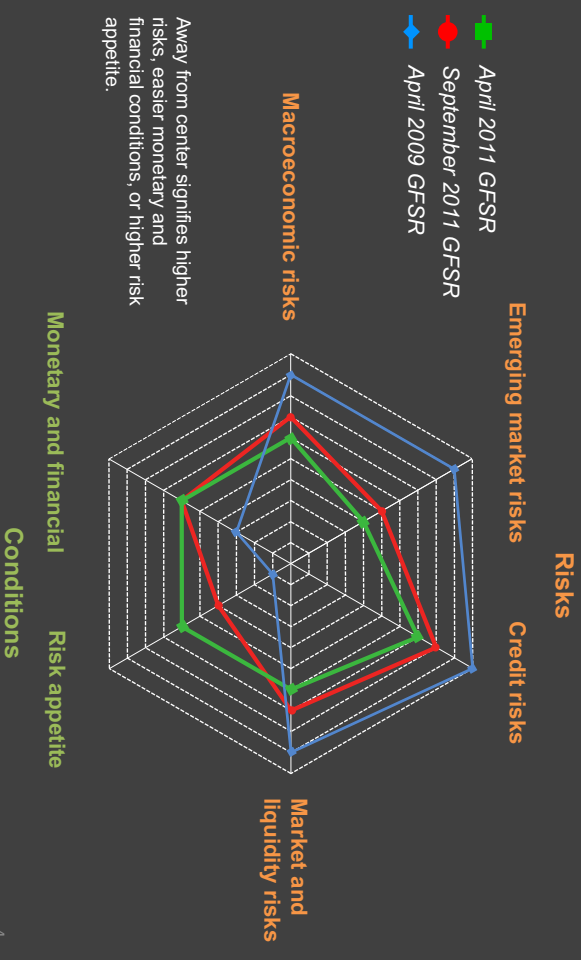
- Confidence crisis**
  - Sources: weak growth, weak politics
  - How different from Lehman?
- Sovereign strains**
  - Becoming more widespread
  - After U.S., who's next?
- Spillovers to banks**
  - How strong?
  - Will credit dry up?
- The credit cycle**
  - Where are we? AE vs. EM
  - The unpleasant side-effects of low rates. How serious?
- Policy priorities**
  - Time is running out... but not yet too late

2

## Confidence Crisis

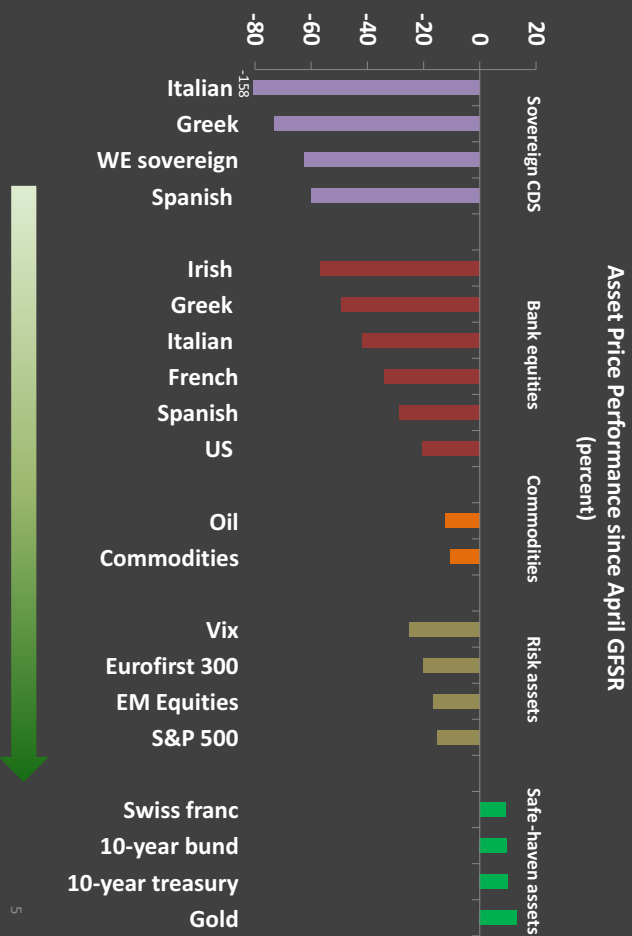
3

## Stability risks have risen across all risk metrics ...



4

## ... prompting a flight to safe assets

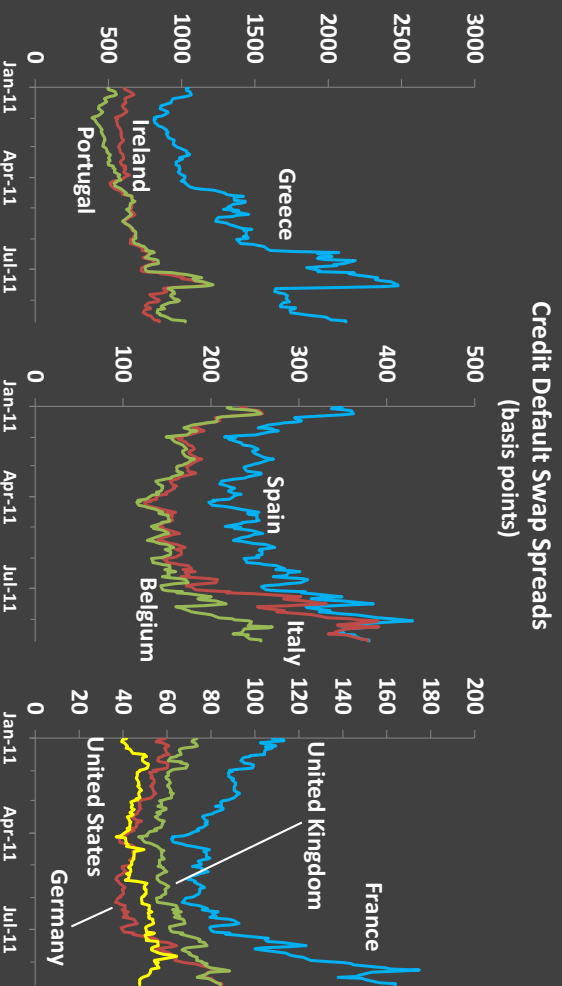


## Sovereign Stress

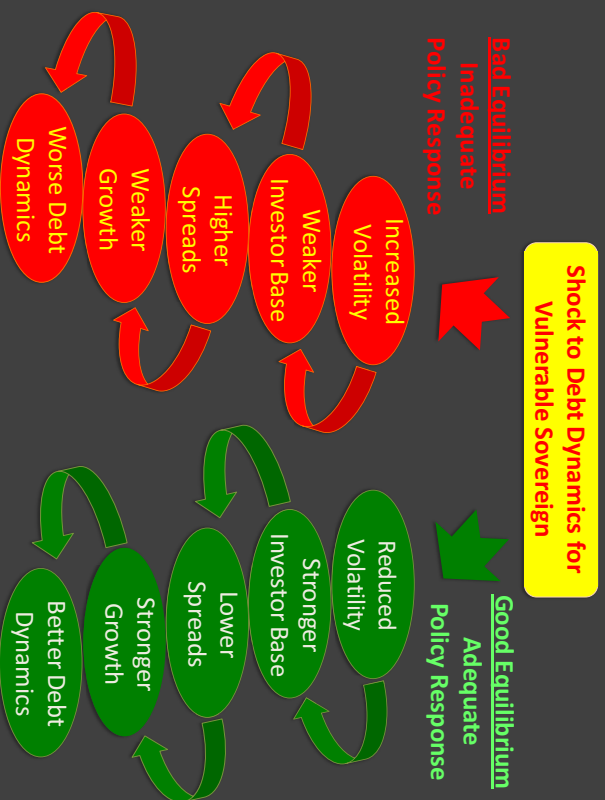
## What's different from "Lehman"?



## Sovereign strains becoming more widespread ...

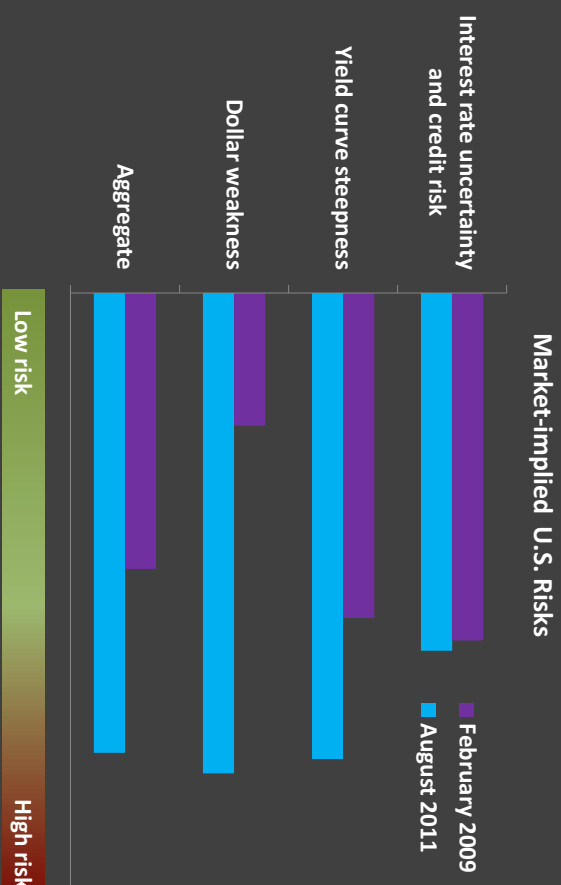


... threatening a shift towards a bad equilibrium



9

U.S. sovereign risks are also rising

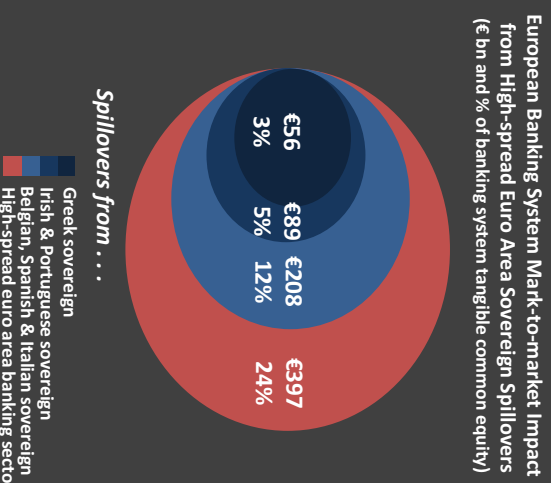
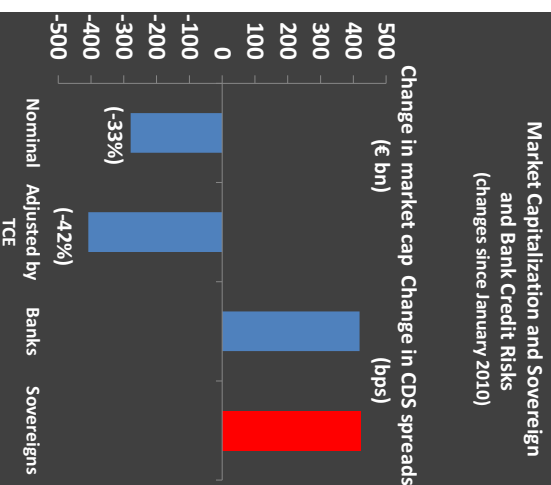


10

Banking

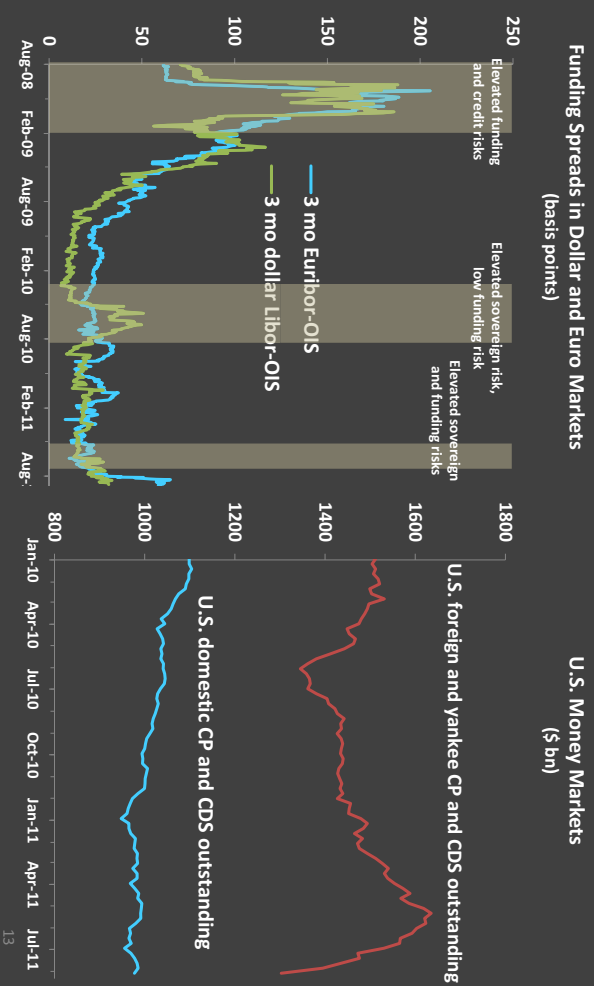
11

Euro area sovereign risks have spilled over to the EU banking system ...



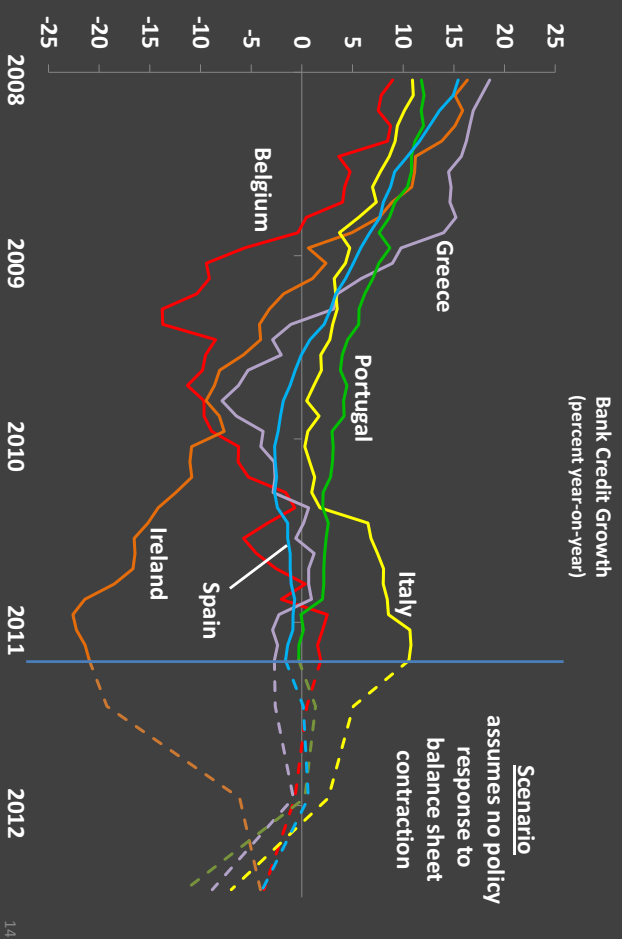
12

## ... with adverse effects on interbank funding ...



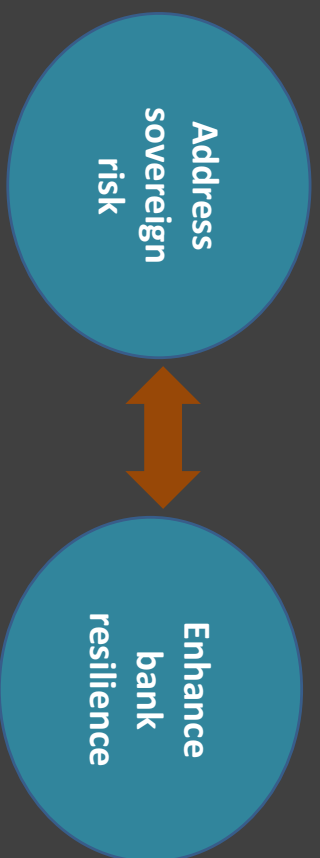
13

## ... threatening the real economy

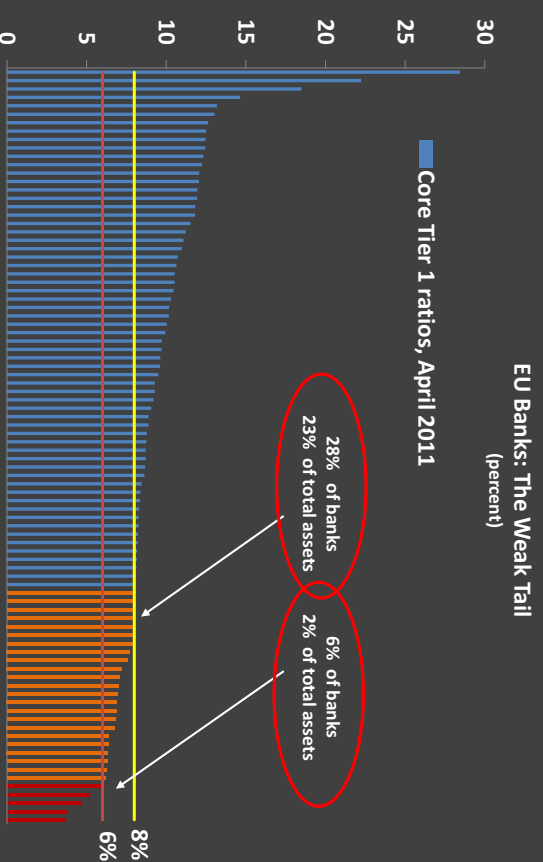


14

## How to cut the Gordian knot between sovereigns and banks?



## Some banks still need to increase capital ratios



15

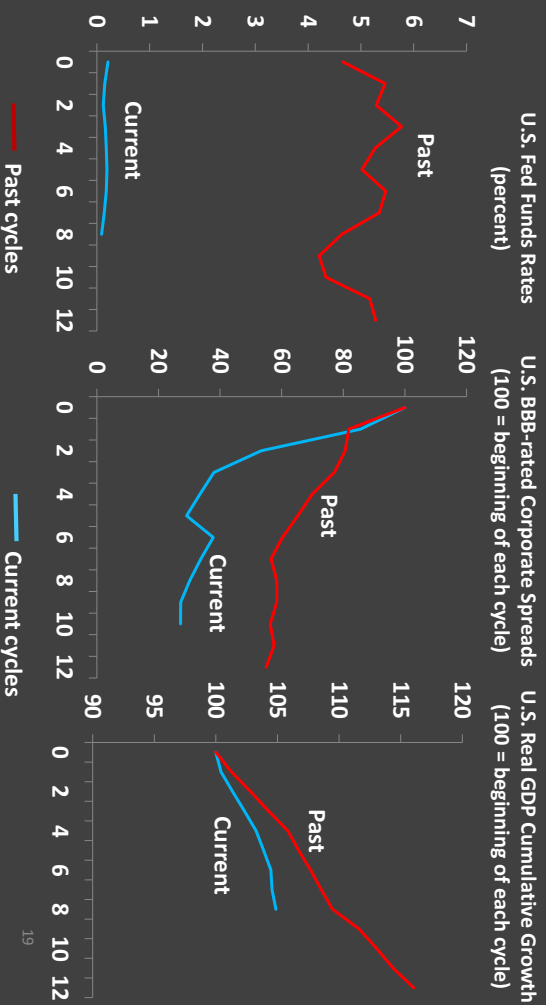
16

## Credit Cycle and Search for Yield

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### Low policy rates encourage a “search for yield” ...

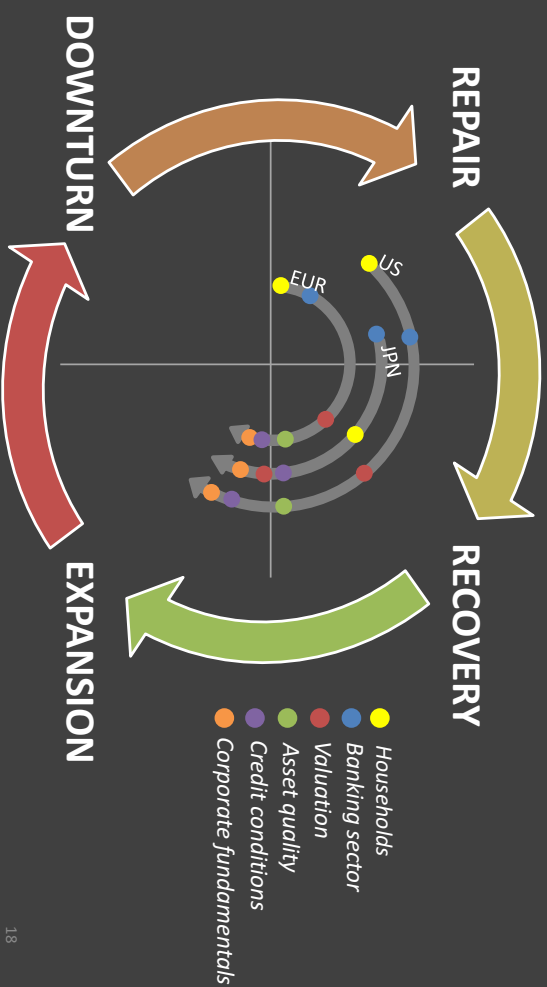
Fed Funds Rates, BBB-rated Corporate Credit Spreads, and U.S. Real GDP Cumulative Growth



19

Advanced economies are stuck between repair and expansion phase of the credit cycle

Phases of the Credit Cycle

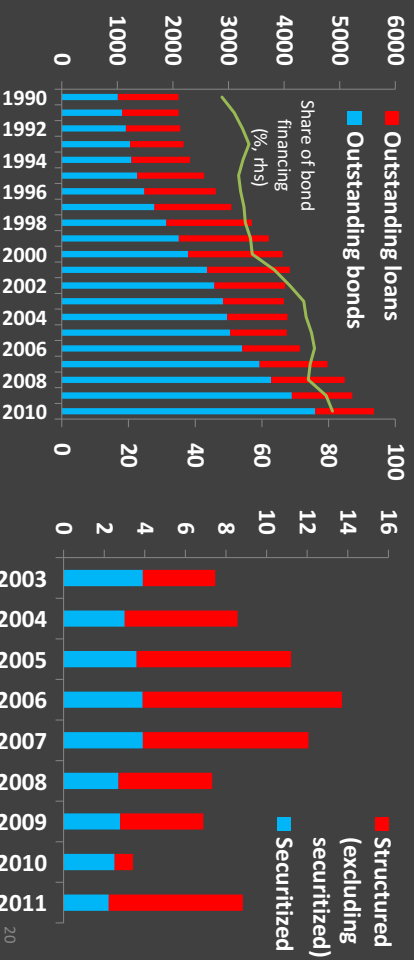


18

... accompanied by a shift to capital-markets-based financing and expansion of the shadow banking system

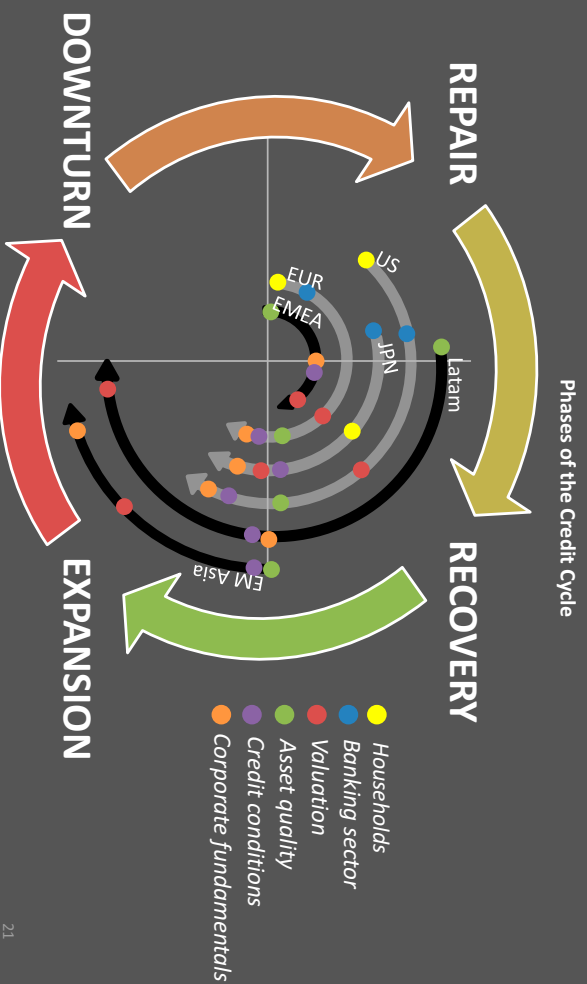
U.S. Corporate Financing (\$ bn)

Global Securitization and Structured Products Issuance (\$ tn)



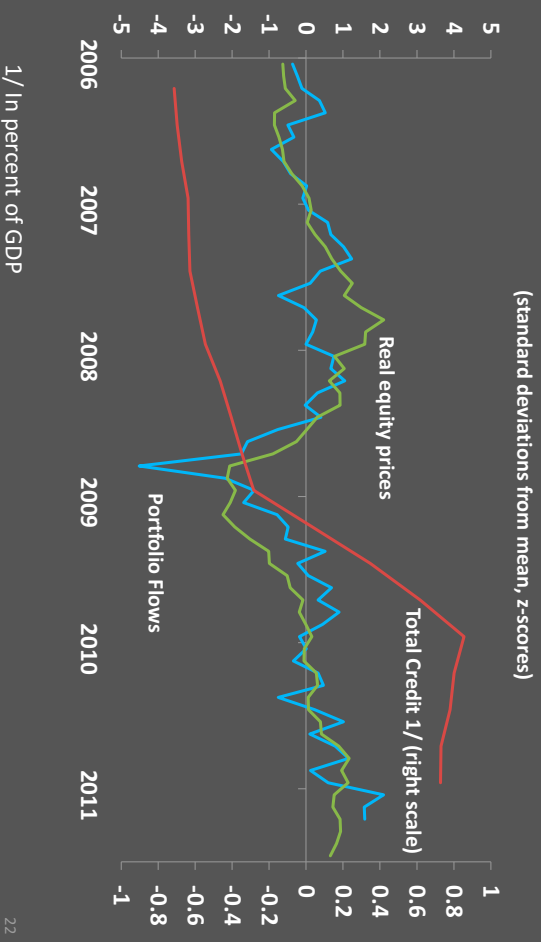
20

## Emerging economies are further along in the credit cycle



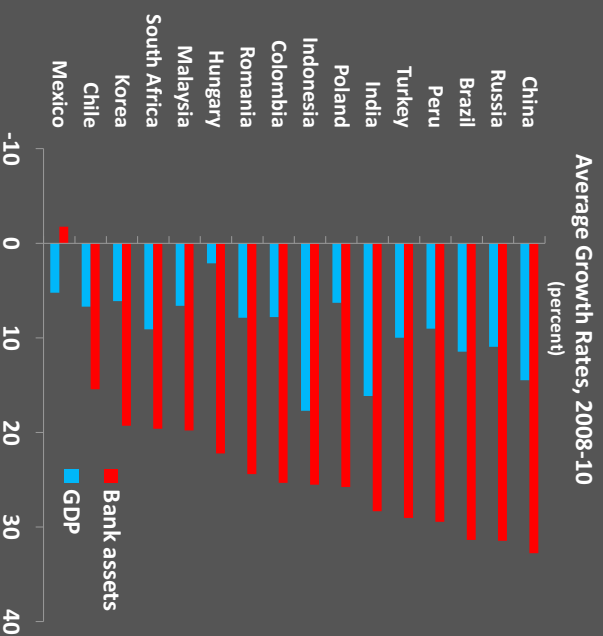
21

## Emerging markets are in the expansion phase



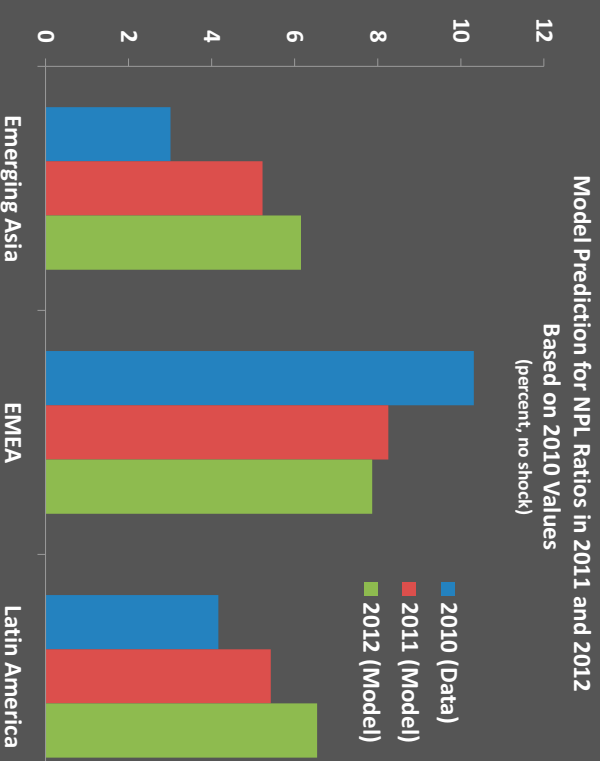
22

## ... and in many economies credit is running well ahead of GDP



23

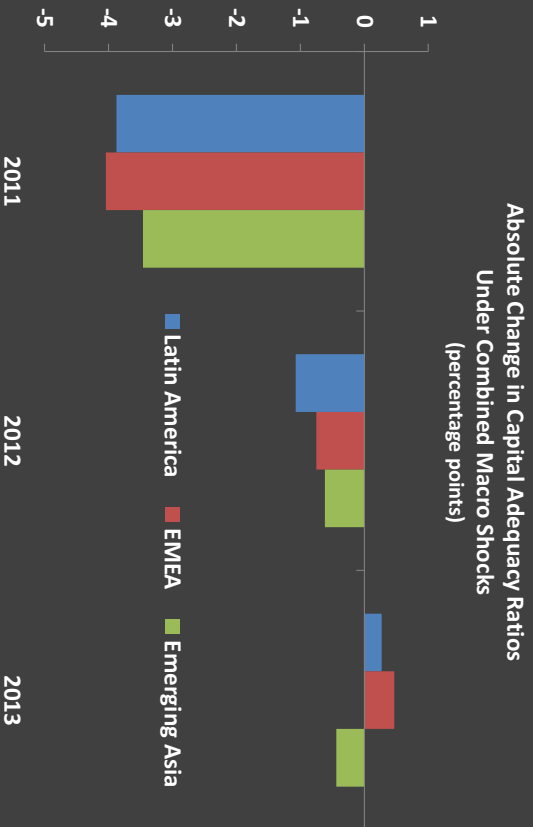
## Rapid credit growth *now* can lead to rising nonperforming loans *later*



24



## An external shock would test the resilience of emerging market banks



25

## Policy Priorities

26

153

Advanced Economies → avoid *near-term* crisis



27

Emerging Economies → avoid *future* crisis



28

## Global Regulatory Reform

Complete	Basel III SIFIs Shadow Banking Macro-prudential
Implement	Nationally and Internationally

29

## New, Dangerous, Political Phase of the Crisis

Risks to global  
financial stability have  
increased notably

back into the  
"danger zone"

Time is running out...  
we need to act

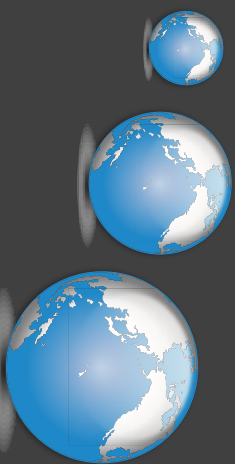
now,  
bold,  
global,  
coordinated

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## International Monetary Fund

August 31, 2011



**Global Financial  
Stability Report**  
*José Viñals*  
*Financial Counsellor*