

SUMMING UP BY THE ACTING CHAIR

The following remarks by the Acting Chair were made at the conclusion of the Executive Board's discussion of the Global Financial Stability Report on March 30, 2009.

Executive Directors observed that global financial stability has deteriorated further since the issuance of the September 2008 *Global Financial Stability Report (GFSR)*, and broadly supported the staff's recommendations to mend financial systems. Shrinking economic activity has placed pressure on balance sheets of financial institutions as asset values have continued to decline, discouraging lending to households and corporations. The crisis, which originated in the advanced countries, has now spread to emerging market countries. The adverse feedback between economic activity and the financial sector has intensified and become more entrenched. These developments necessitate stronger policy responses and careful consideration of their cross-border implications. Directors stressed the importance of clear messages that integrate the conclusions of the GFSR and *World Economic Outlook* analyses.

With global economic activity contracting, macroeconomic risks have heightened, albeit not uniformly, alongside credit risks. Uncertainty about losses in financial institutions and the value of troubled assets continues to plague the financial systems in most advanced countries, leading to their inability to attract private capital, necessitating, in several cases, government infusions. Financial systems in these economies remain under severe stress. The deteriorating outlook for the household and corporate sectors is taking a toll on balance sheets, including for financial institutions. The retrenchment from foreign markets, particularly from emerging markets, is outpacing the overall deleveraging process, and is expected to yield a deep and long-lasting global credit crunch.

Breaking this downward spiral requires strong political commitment and further enhancement of international cooperation. Encouraging signs have recently been in evidence.

Directors endorsed the report's main findings that further policy actions are needed to: (1) continue to provide liquidity; (2) recapitalize weak, but viable, systemically important financial institutions; and (3) deal with troubled assets on banks' balance sheets. Such actions would assist in smoothing the necessary deleveraging process, reduce uncertainties, and facilitate the continued provision of credit to the real economy. Directors acknowledged that policymakers have already undertaken significant and unprecedented actions in these three areas, but agreed that additional actions are needed reflecting varying country circumstances and policy responses to date. Directors highlighted the difficulty, especially given current high uncertainties, in estimating writedowns and recapitalization needs, calling for balanced and considered assessments.

Directors agreed that the differences in the problems faced by banking systems and the degree to which they have bad assets will help determine the most appropriate approach for a country. It is crucial to choose an approach; ensure that it is adequately funded; implement it in a clear manner; and coordinate with other countries the underlying principles to be applied when valuing the assets and determining the share of losses to be borne by the public sector. Some Directors noted that the Japanese experience of the 1990s suggests that troubled assets are best dealt with a "bad bank" or a stand-alone entity wholly owned by the govern-

ment. Others considered that private/public partnerships, like the one recently proposed by the United States Treasury, could work if properly structured to provide incentives for sufficient private involvement, while maintaining a suitable return for taxpayers and appropriate oversight to ensure that the policy objectives are met. A few Directors suggested that temporary government ownership may be necessary in some instances, but only with the intention of restructuring the financial institution for privatization as rapidly as possible.

Directors emphasized that financial support packages should fully take into account the transfer of financial risks from the private sector to the public sector—both the government and central bank. Combined with longer-term pressures from aging populations, fiscal stimulus and financial support packages could significantly increase public debt, raising in some cases market concerns about fiscal sustainability. Directors therefore stressed the importance of credible, medium-term strategies of fiscal consolidation. In light of fiscal pressures, a few Directors also suggested that private sector participation in bank recapitalization should be further encouraged to the extent feasible.

Directors generally supported the report's recommendation to expand the perimeter of prudential regulation to encompass all systemically important financial institutions, including nonbank financial intermediaries. Some Directors also saw merit in the staff's recommendation to include "financial stability" in the mandates of central banks, regulators, and supervisors, noting that macro-prudential oversight should be better integrated with financial supervision. Directors concurred with staff about the need to strengthen the global financial infrastructure to lower systemic risk from counterparty exposure—such as by credit default swap clearing mechanisms. At the same time, a few Directors stressed that a single global clearing facility would not necessarily be the optimal outcome for credit default swap markets.

Directors expressed concern at the widening impact of the global financial crisis on emerg-

ing market countries, while recognizing the significant differences both across and within regions. Some Directors considered staff analysis for emerging markets too pessimistic, while many Directors viewed it as insufficiently differentiated. Emerging European economies have been hardest hit, reflecting some countries' large domestic and external imbalances and excessive credit growth. External refinancing risks for banks and nonfinancial corporations in some emerging market countries are of particular concern, as are household exposures to foreign currency mortgages. Directors noted that advanced country sovereign borrowing, as well as their debt guarantees to financial entities, might serve to crowd out financing demands from emerging markets, while home country bias in some policy actions could exacerbate the credit crunch in foreign markets.

Directors agreed that, to the extent that domestic central banks are unable to supply the needed foreign exchange for refinancing, advanced country central banks, the IMF, and other international organizations could play a useful role through their various swap lines and other facilities. In particular, Directors stressed the crucial role being played by the IMF and recent Fund efforts to modernize its lending toolkit, including the new Flexible Credit Line, to revamp conditionality, and to expand its lending capacity. They also noted the contributions being made in Europe by the doubling in the European Union's balance of payments assistance facility and the EBRD/EIB/IBRD support to regional banks.

Given the global reach of the crisis and the prevalence of cross-border issues, the effect of national policies can be strengthened if implemented in a coordinated and cooperative fashion among affected countries. Cross-border coordination can ensure a more consistent approach and help avoid regulatory arbitrage, competitive distortions, and financial protectionism. The specific design of policies would appropriately vary from country to country, but policymakers should avoid policies, such as the

favoring of domestic over foreign lending, that could lead to distortions.

Directors saw the staff's analytical work provided in Chapters 2 and 3 as demonstrating the key role that the IMF can play in global financial surveillance, especially identifying systemic risks and detecting potential crises. The tools discussed in those chapters may provide the basis to examine systemic risks more analytically, particularly those arising from financial linkages and networks. Directors agreed on the need to strengthen the monitoring and understanding of direct and indirect financial linkages in part to identify systemically important financial institutions and shed light on the "too-connected-to fail" problem. Recognizing that these techniques require further development before they could provide policy direction, Directors encouraged additional research and data collection, including off-balance-sheet exposures.

Directors underlined the potential contribution of the work in Chapter 3 for the IMF's

surveillance role, particularly its early warning exercise and efforts to strengthen the Fund's oversight of advanced economies and major financial centers. The ability to detect when a financial disturbance becomes a systemic crisis would provide a means of determining when certain policy tools designed to contain the crisis may be best employed. Some Directors also underscored that every measure of systemic risk has limitations to some degree; they noted that the analysis would have been able to pick up early signals of the current episode of systemic distress using market prices, but agreed with staff that it would be difficult to distinguish false from real alarms *ex ante*. Nonetheless, such signals could be used to prompt more direct investigation of the nature of the problem. Directors supported the notion that certain market prices, such as equity options and credit default swap spreads, could be helpful indicators in providing the basis for an assessment of "tail risks"—those risks that often precede or accompany systemic crises.