

Global Financial Stability Report

MARKET UPDATE

Monetary and Capital Markets Department

GFSR MARKET UPDATE

July 28, 2008

Over the last several months, financial markets have made significant adjustments and policymakers have carried out exceptional interventions. Nonetheless, global financial markets continue to be fragile and indicators of systemic risk remain elevated. Credit quality across many loan classes has begun to deteriorate with declining house prices and slowing economic growth. Although banks have succeeded in raising additional capital, balance sheets are under renewed stress and bank equity prices have fallen sharply. This has made raising additional capital more difficult and increased the likelihood of a negative interaction between banking system adjustment and the real economy. At the same time, policy trade-offs between inflation, growth, and financial stability are becoming increasingly difficult. The resilience of emerging markets to the global turmoil is being tested as external financing conditions tighten and policymakers face rising inflation.

Overview of Developments

Credit risks remain elevated and systemic strains in funding markets continue despite official action, while the low level of risk appetite remains unchanged. Financial markets have not returned to the elevated levels of systemic risk seen in the spring, but there is increasing concern over the interaction of the macroeconomic outlook with markets (Figure 1).

High Credit Risks Persist

Although expected losses from U.S. subprime mortgage exposures remain high, they have now largely been acknowledged. The growing concern is that, with delinquencies and foreclosures in the U.S. housing market rising sharply, and house prices continuing to fall, loan deterioration is becoming more widespread. The credit quality of the most recent U.S. mortgage vintages continues to worsen (Figure 2). Charge-offs in the United States are now rising, albeit from a generally low base, across all major credit categories (Figure 3), prompting concerns over future losses at some large U.S. commercial banks, reinforced by the failure of IndyMac.

Uncertainty about future losses and capital needs prompted a sharp decline in the share prices of the government-sponsored-enterprises (GSEs) involved in U.S. housing (Figure 4). The wide investor base in GSE debt (which includes substantial holdings by U.S. banks and foreign investors) and the current reliance of U.S. mortgage lending on agency securitization meant that there would have been systemic consequences had confidence in GSE debt come into question. The policy challenge is now to find a clear and permanent solution while continuing to support U.S. mortgage securitization.

Stemming the decline in the U.S. housing market is necessary for market stabilization as this would help both households and financial institutions to recover. At the moment, a bottom for the housing market is not visible; however, some recent developments in affordability may provide support for house prices to stabilize. House prices are softening in a number of other OECD economies (notably Ireland, Spain, and the United Kingdom (Figure 5)), prompting concerns over future loan losses in the mortgage, construction, and commercial property areas.

Continuing Banking Sector Pressures

Despite writedowns to mortgages and securities that exceed \$400 billion in the aggregate, banks in the United States, Europe, and Asia have generally been successful in raising capital (Figure 6). However, disclosed losses have thus far exceeded capital raised and banks face difficulties in maintaining earnings due to falling credit quality, declining fee income, high funding costs, and exposures to “monoline” and mortgage insurers. Consequently, bank share prices have fallen sharply and measures of credit default risk have risen (Figure 7). Market prices of asset-backed securities and ongoing delinquency experience give us little reason to change the estimates of total mark-to-market losses published in the April GFSR.

As banks deleverage by raising capital and restoring liquidity buffers, interbank rates remain elevated (Figure 8) and long-term funding costs have risen (Figure 9), despite new emergency liquidity facilities offered by some central banks. Spreads on financial institution debt continue to widen reflecting uncertainty over the extent of future credit write-offs, the absorption of off-balance-sheet entities, and future earnings capacity.

Tightening Credit Conditions and Challenges for Monetary Policy

As banks seek to deleverage and economize on capital, assets are being sold and lending conditions tightened, resulting in slower credit growth in the United States and euro area. With inflation risks on the rise, the scope for monetary policy to be supportive of financial stability has become more constrained. In the first quarter of 2008, total U.S. private sector borrowing growth fell to 5.2 percent—a level last seen after the 2001 recession. With continuing pressures on banks to deleverage, this growth might slow further as outlined in the April GFSR (Figure 10). One positive development has been the continuing resilience of investment-grade bond issuance, although high-yield and structured credit markets remain effectively shut.

Emerging Market Risks Rising

Emerging markets (EM) remain relatively resilient to the credit turmoil thus far. However, as the crisis remains protracted, external funding conditions are tightening, and some emerging markets are coming under increased scrutiny, especially regarding their policies to address rising inflationary pressures.

There are now clear signs that investors are becoming more cautious about adding to positions. EM equity markets have marginally underperformed mature market equities since the recent mid-May peak. Outflows from EM equity funds have been concentrated on Asian markets where inflation and downside growth risks are most elevated.

As commodity prices rise, risk appetite wanes, and external financing conditions tighten, markets have become increasingly discriminating with regard to the risks posed by large external imbalances. Risk premia for EM countries with external imbalances (defined as a current account deficit of 5 percent of GDP or more) are returning to their mid-March highs and equity markets are underperforming those of countries with smaller external imbalances (Figure 11).

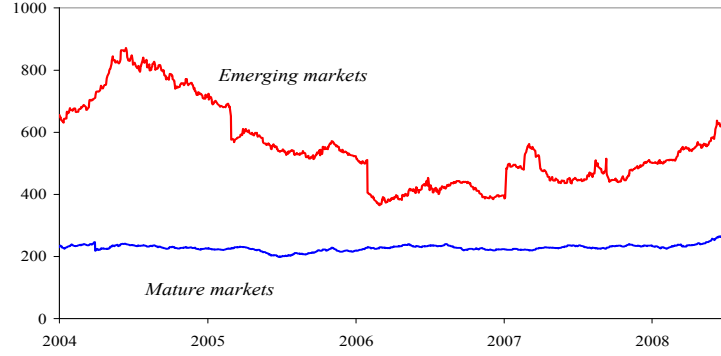
The Policy Response

Thus far, the steps taken by central banks to extend the maturity and the range of collateral and counterparties have succeeded in containing systemic risks. However, in the context of the deleveraging process and uncertainty about asset valuations, credit risks remain elevated, indicating that further raising of capital may be needed in a number of financial institutions. In this phase of the crisis, the nature of resolution strategies and the extent of government support have come into sharper focus.

In view of the systemic importance of GSEs, the U.S. administration took short-term measures to ensure that they have access to liquidity to support their operations. Nevertheless, part of the problem stems from the GSEs' current regulatory framework, which has allowed their balance sheets to expand to their current systemic significance. Further examination of the GSEs' business model and oversight will be needed once conditions have stabilized. The legislation recently taken up by the U.S. Congress includes the establishment of an independent regulator.

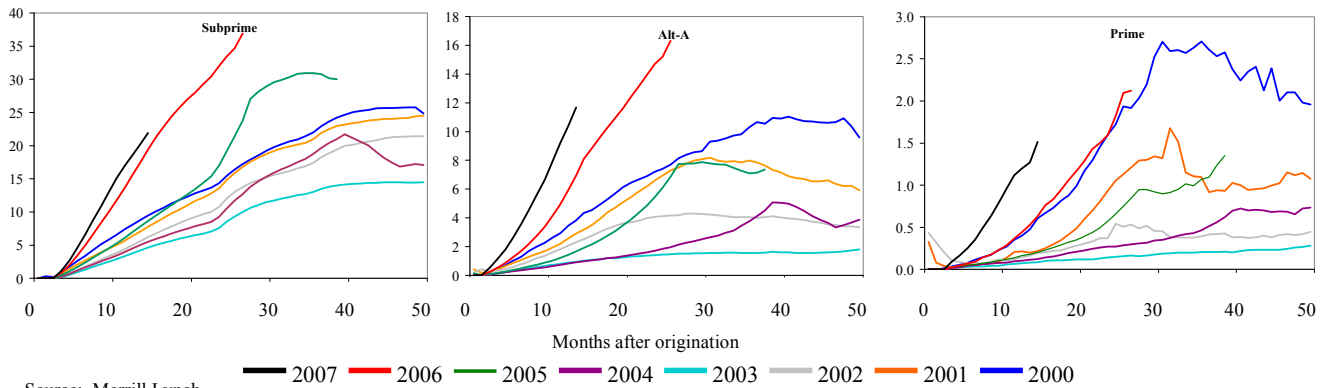
The progression of the crisis has underscored the importance of moving forward with needed reforms as set forth by the IMFC and the Financial Stability Forum. Progress has been made by the relevant institutions and fora on short- and medium-term policies. The IMF has prioritized its own work in key areas of competence within the agenda of policy initiatives, including evaluating and monitoring capital and liquidity, transparency and valuation, and frameworks for crisis management and resolution.

Figure 1. Expected Inflation Rates
(Breakevens, in basis points)



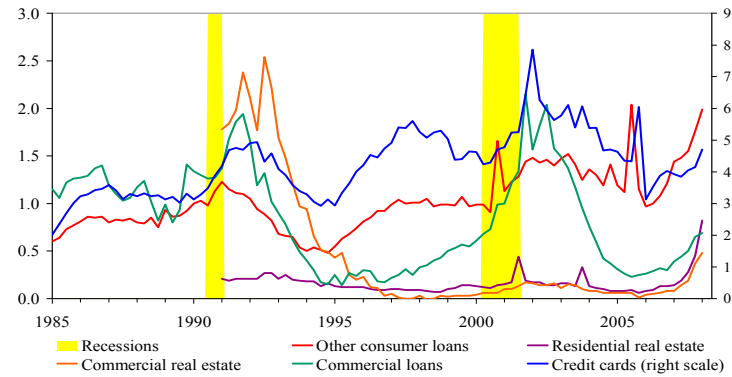
Sources: Barclays Capital; Bloomberg L.P.; and IMF staff estimates.
Note: Emerging markets include Brazil, Colombia, Korea, Mexico, Poland, South Africa, and Turkey.

Figure 2. Mortgage Delinquencies by Vintage Year
(60+ day delinquencies, in percent of balance)



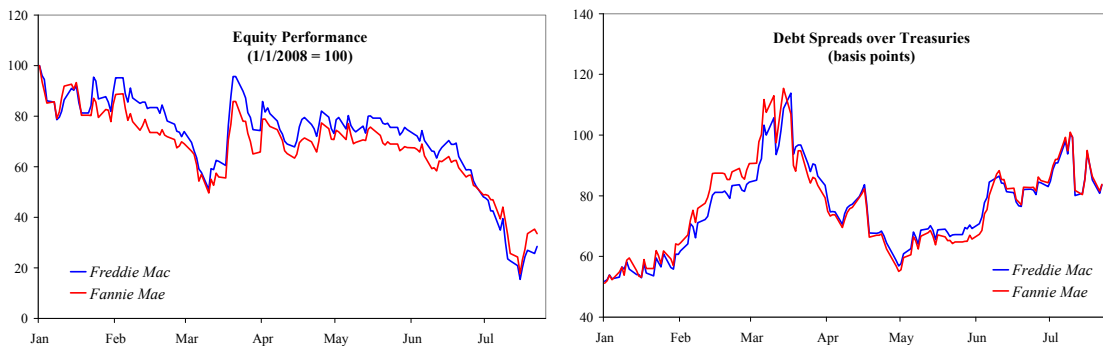
Source: Merrill Lynch.

Figure 3. Loan Chargeoffs
(In percent)



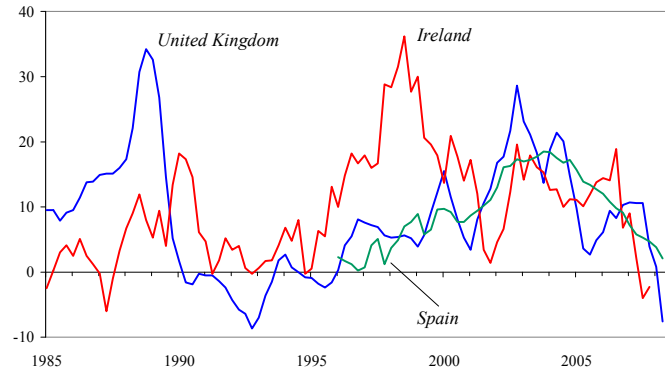
Sources: Barclays Capital; Bloomberg L.P.; National Bureau of Economic Research; and IMF staff estimates.

Figure 4. Government-Sponsored Enterprises



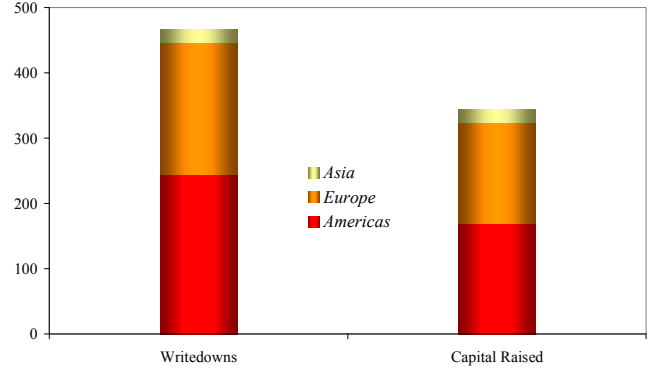
Source: Bloomberg L.P.

Figure 5. European Housing Prices
(Year-on-year percent change)



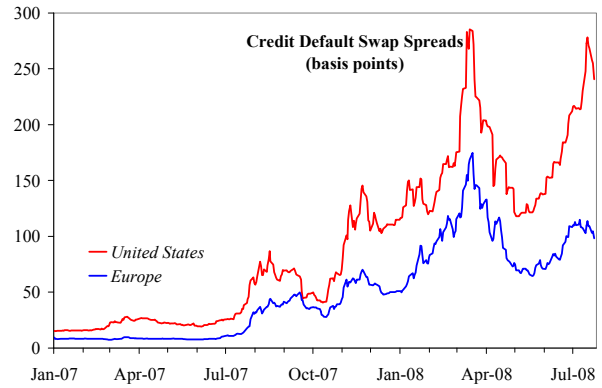
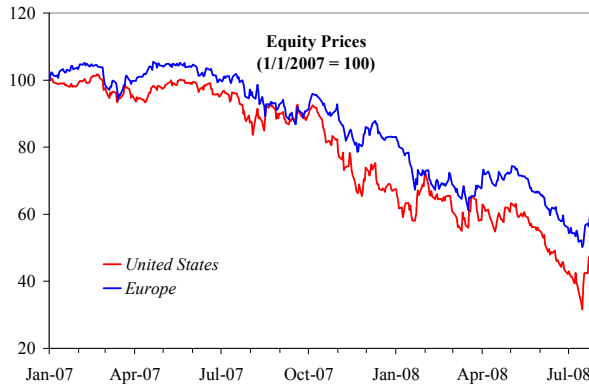
Sources: Ireland and Spain: national authorities; United Kingdom: Halifax, Nationwide, Rightmove; and IMF staff estimates.

Figure 6. Bank Writedowns and Capital Raised
(In billions of U.S. dollars)



Source: Bloomberg L.P.

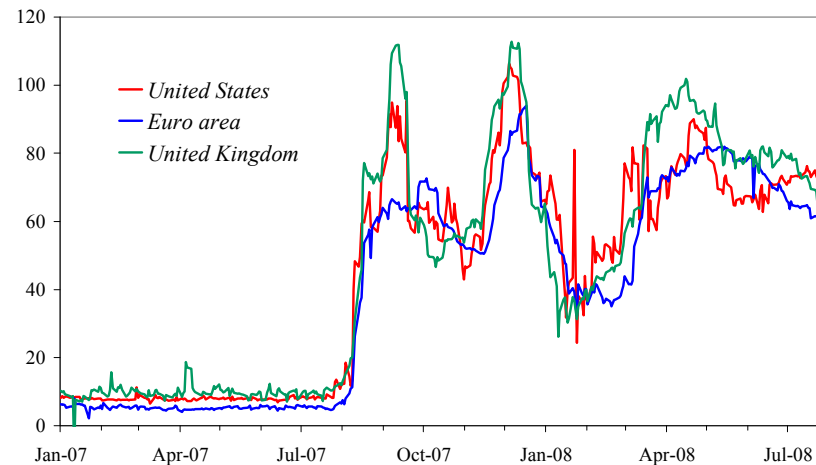
Figure 7. Commercial Banks



Sources: Bloomberg L.P.; Datastream; and IMF staff estimates.

Note: Equity prices reflect sub-indices of the S&P 500 and Eurofirst 300. U.S. credit default swaps represent simple averages of 10 U.S. banks while European spreads from Datastream index.

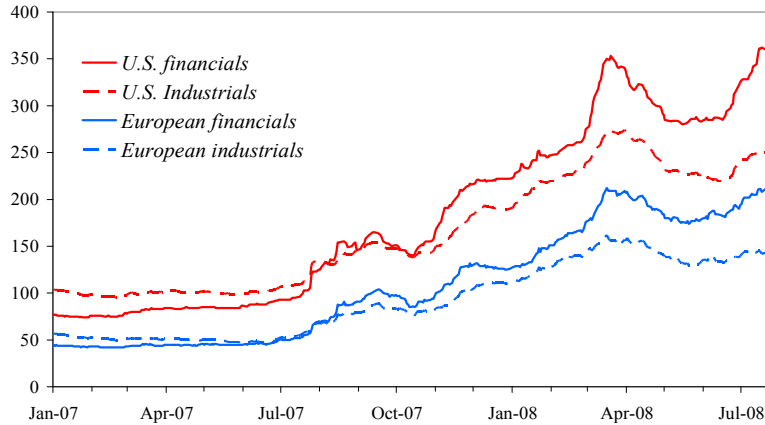
Figure 8. Spread of Libor to Overnight Index Swaps
(3-month, basis points)



Sources: Bloomberg L.P.; and IMF staff estimates.

Figure 9. Financial and Industrial Spreads

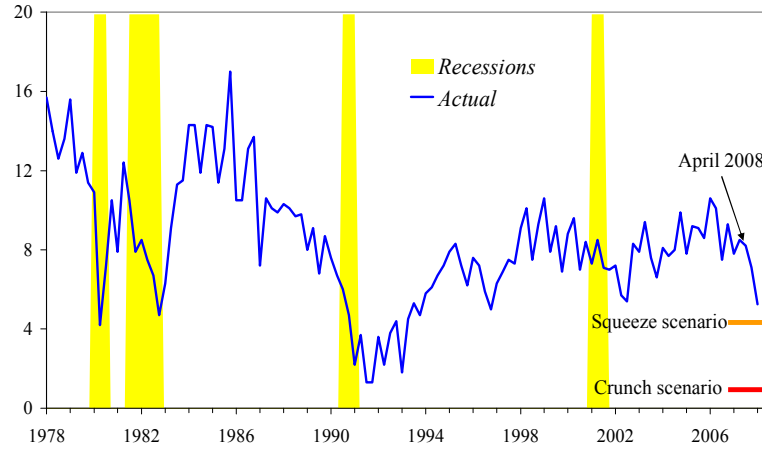
(In basis points)



Source: Merrill Lynch.

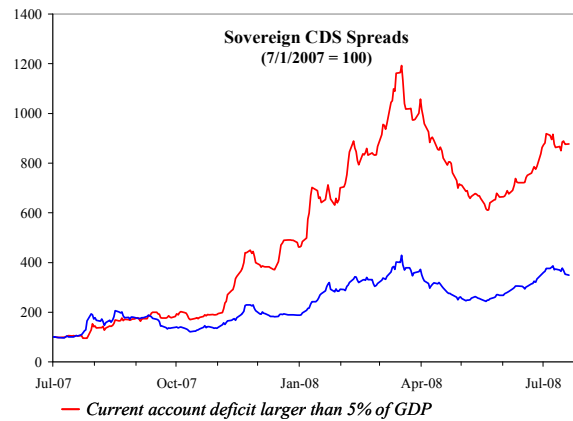
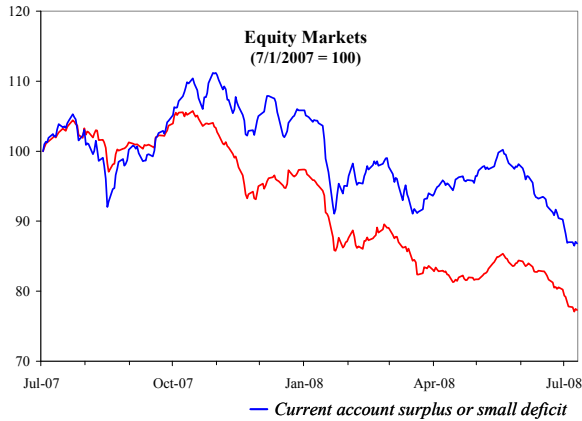
Figure 10. U.S. Private Sector Borrowing

(Actual versus GFSR April 2008 scenarios, percent annualized growth)



Sources: Federal Reserve; National Bureau of Economic Research; and IMF staff estimates.
Note: Yellow bars represent recession periods.

Figure 11. Emerging Markets



Sources: Bloomberg L.P.; Datastream; and IMF staff estimates.