IMF report warns of global financial risks

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While the global financial system appears to be relatively stable at present, it could face serious risks in the future arising from a collapse of investor confidence or a tightening of credit. This warning is contained in the latest quarterly *Financial Global Stability* report released by the International Monetary Fund last week.

The past few months, it explained, had seen a “sharp erosion of investor confidence, heightened risk aversion, and growing concerns about the strength and durability of the global recovery and the pace and quality of corporate earnings” which had repercussions “in all of the major equity, credit and foreign exchange markets.”

In the world’s key financial markets, it said, the “most immediate concern is that investor trust and confidence may erode to the point where investors withdraw en masse from financial and economic risk-taking.”

Deterioration in credit conditions had created a record number of “fallen angels”, that is, companies whose outstanding bonds have been downgraded from investment grade to junk status.

The decline in the value of the dollar, coupled with the “continuous stream” of accounting irregularities in the United States, had raised concerns about how much further the major currencies would be realigned and the “sustainability of capital flows needed to finance the US current account deficit.”

The report noted that as of early last month the global financial system remained “resilient” despite major price movements and significant financial losses for investors and suggested that there was “little evidence now” of the type of shifts in liquidity and credit that could give rise to “systemic problems”.

But a reading of the report makes clear that “stability” could be a short-term affair. It warned that financial risks could emanate from both mature and so-called “emerging financial markets.”

A major source of instability continues to be the technology, media and telecommunications (TMT) sector which has sustained some the heaviest financial losses.

“The implosion of the TMT sector in 2000 and that sector’s continued weakness raise the concern that further equity price corrections could cascade across markets and thereby trigger liquidity and/or credit events,” the report noted. Such a process could trigger the withdrawal of funds from financial markets, leading to “further sharp corrections in already weak corporate securities markets, a continued loss of resilience and flexibility by global financial institutions, and a greater withdrawal of lending even to low-risk borrowers.”

If such a scenario were to develop it could create conditions in which “fear feeds upon fear” and “panic selling” occurs.

Another source of financial risk is the possibility that the accumulated losses incurred by major financial institutions could impair the capital positions either of key institutions or a number of smaller ones.

“This is a particular concern in Europe, where TMT and energy companies have been hard hit and face significantly higher funding costs, where insurance and reinsurance companies have fared poorly recently, and where bank stocks overall have been devalued about as sharply as the overall European markets.”

The report identifies a third source of risk in the “possibility of a rapid slowdown of net capital flows into the United States.” By the end of 2001 these inflows had reached the level of $400 billion a year. Throughout the 1990s, it noted, capital inflows into US markets were associated with sharp increases in asset prices and a persistent increase in the value of the dollar. But to the extent that inflows decline “some of the dynamics associated with the inflows will necessarily be reversed.”

Highlighting the dependence of the US on capital inflows, the report pointed out that it now draws in some 70 percent of net savings (comprising current account surpluses) available from the rest of the world.

That dependence was further underscored by other figures released last week which showed that in the second quarter of this year the balance of payments deficit widened to a record $130 billion, beating the previous record of $112.5 billion set in the first quarter of this year.

The significance of foreign capital inflows for US financial markets can be seen from the following figures: At the end of 2001 foreign investors held about $1.7 trillion in US equities, $1.2 trillion in corporate debt and another $1.2 trillion in treasury debt, representing 12 percent, 24 percent and 42 percent of the outstanding amounts, respectively.

The report points out that even a 10 percent reduction in these holdings, resulting from such factors as fears of a further fall in equity values or a rapid decline in the value of the US dollar could adversely affect conditions in financial markets.

Summing up the overall outlook the report said that while major global financial institutions remained “resilient,” there were “considerable downside risks” in the immediate future.

These include: the possibility of further equity declines and a “worse case scenario of panic selling by both institutional and retail investors”; a further weakening of the balance sheets and profit outlook of banks and insurers, particularly in Europe and; an accelerating slowdown in net capital inflows to the US with the associated potential for “substantial exchange rate movements.”