

THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

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Meeting Paper 3-B

Summary of the IMF Spillover Reports for the Systemic-5

International Monetary Fund

PURPOSE	For information.
ISSUE	Summary of the IMF July 2011 Spillover Reports.
BACKGROUND	This is a summary of the IMF's July 2011 spillover reports, which explore the external effects of policies in 5 systemically important economies (USA, Euro Area, China, Japan and the UK), focusing on concerns raised by key partners.
PROPOSAL	N.A.
DECISION POINT	Note the report.



Detailed papers are available through the following links:

- ♦ China: <http://www.imf.org/external/pubs/ft/scr/2011/cr11193.pdf>
- ♦ Euro Area: <http://www.imf.org/external/pubs/ft/scr/2011/cr11185.pdf>
- ♦ Japan: <http://www.imf.org/external/pubs/ft/scr/2011/cr11183.pdf>
- ♦ UK: <http://www.imf.org/external/pubs/ft/scr/2011/cr11225.pdf>
- ♦ US: <http://www.imf.org/external/pubs/ft/scr/2011/cr11203.pdf>

July 22, 2011

UNITED STATES

SPILOVER REPORT – 2011 ARTICLE IV CONSULTATION

KEY POINTS

Issues. Spillover reports explore the external effects of policies in systemic economies, focusing on concerns raised by key partners. Foreign officials appreciated the boost to world growth from U.S. stimulus but were concerned over unintended consequences. Loose U.S. monetary policies could fuel unsustainable capital flows and commodity prices; high U.S. government deficits create tail risks of a generalized bond shock; and laws and rule changes passed ahead of Basel III could foster financial sector arbitrage

Findings. The main messages flowing from staff analysis are:

- Short-term U.S. spillovers on growth abroad are uniquely large, mainly reflecting the pivotal role of U.S. markets in global asset price discovery.** While U.S. trade is important, outside of close neighbors it is the global bellwether nature of U.S. bond and equity markets that generates the majority of spillovers.
- U.S. macroeconomic stimulus likely supported foreign activity more in 2009 than in 2010.** Facing global turmoil, 2009 initiatives calmed markets. In the less fraught 2010 environment similar policies produced a less favorable response.
- Looking forward:**
 - With QE2 having limited spillovers, its fully anticipated ending will have even less effects. The main monetary exit risk is that expectations of monetary tightening would reverse earlier capital flows to other countries.
 - Spillovers from credible and gradual fiscal consolidation are limited and ambiguously signed, while those from the tail risk of a potential loss of confidence in U.S. debt sustainability are universally large and negative.
 - Robust supervision of U.S.-based (not necessarily U.S.-owned) investment banks can reduce risks of negative global spillovers via dollar funding markets.

□ Overall, U.S. and foreign goals may be better aligned for fiscal and financial policies, given a common interest in limiting globally important tail risks, than for monetary policies, where low interest rates facilitate financial risk-taking.

July 22, 2011

EURO AREA POLICIES

SPILLOVER REPORT FOR THE 2011 ARTICLE IV CONSULTATION WITH MEMBER COUNTRIES

Issues. Spillover reports explore the external effects of policies in systemic economies, focusing on concerns raised by key partners. In the case of the Euro Area (EA), partners appreciated policy efforts to address the sovereign debt crisis, but were concerned over potential spillovers in case debt difficulties in the EA were to deepen, as highlighted by the bouts of heightened co-movement over the past year between stresses in EA program countries and global financial markets.

Findings. The main messages are as follows:

- An intensification of the EA debt crisis, especially if stress were to spread to the core EA, could have major global consequences. This is supported by financial market signals, analysis of a model of global bank interconnectedness, and results from a broader macro-modeling approach. Thus, decisive further policy actions to contain the crisis are critical not only for the EA itself, but also from a global perspective.
- Projected fiscal consolidation efforts in the EA should have modest global demand effects that could be more than offset by credibility gains. Monetary tightening in the area that proceeds at a slightly faster pace than markets presently anticipate would have limited spillovers, but reversal of extraordinary measures would need to be timed with improvements in banking sector health and dissipation of market tensions in EA program countries to help prevent potentially large effects on other economies.
- Envisaged reforms to strengthen banking system resilience, labor and product market reforms to enhance growth potential, and further trade liberalization under the Doha round would have positive, though modest, spillovers.

Authorities' reactions. The EA authorities agreed that any spread of the crisis would have global repercussions, but were confident that policy measures enacted to date and those that were in prospect should help contain the crisis. They also broadly agreed with staff's findings on macroeconomic and structural spillovers, although they were more sanguine on the direct contractionary effects of fiscal tightening, and emphasized that, given the area's high degree of openness to international trade and finance, it was a net recipient of spillovers from the rest of the world during normal times.

June 30, 2011

PEOPLE'S REPUBLIC OF CHINA

SPILOVER REPORT—2011 ARTICLE IV CONSULTATION

KEY POINTS

Issues. Spillover reports explore the external effects of policies in systemic economies, focusing on issues raised by key partners. In the case of China, these partners saw benefits from its growth, especially during the crisis, but were also concerned to varying degrees about spillovers from (1) a potential disruption to China's so far steady growth; (2) the slow pace of currency adjustment; and (3) a further build up in foreign exchange reserves, already the largest in the world, and the closed capital account.

Findings. The main messages flowing from the analysis are as follows:

- China's capacity to both transmit and originate real shocks is rising, implying an important stake for the world in its stability. Insofar as its export-oriented growth model is a source of stresses, economic rebalancing is crucial.
- Currency appreciation is important to that process but alone yields only limited spillovers. Significant positive effects on others' output and trade require a comprehensive transformation that reduces China's household and corporate savings rates and raises depressed factor prices. The latter could also alleviate concerns that China's competitiveness is built on a distorted cost structure, thus easing trade tensions—itsself a risk to the world economy.
- Conversely, *failure* to rebalance the growth model would imply unprecedented increases in export market share, potential overhang in capacity, and adverse spillovers from resulting stresses on corporate and bank balance sheets.
- China's policies can affect global capital flows, although that role is secondary to fundamentals such as emerging market country growth and advanced country liquidity conditions. While China's large purchases of reserve currency assets reduce their yields and push capital to emerging markets, it is unclear what the net effect of its closed capital account is, and what opening it up would do.

June 27, 2011

JAPAN

SPILOVER REPORT FOR THE 2011 ARTICLE IV CONSULTATION¹

KEY ISSUES

¹ The report does not try to capture the full extent and historical significance of Japan's influence on the world economy. Rather, it focuses on key policy-relevant issues raised by partners, and describes the reactions of the Japanese authorities. Technical chapters underlying the analysis can be found in the accompanying Spillover Issues Paper.

Objective. Spillover reports explore the external effects of policies in systemic economies, focusing on concerns raised by key partners. In the case of Japan, these relate primarily to the dynamics of public debt, and the potential effects of delayed fiscal consolidation. More recently, interest centered on the impact of the March 2011 earthquake; particularly in light of Japan's unique role in the global production chain.

Findings. The main messages flowing from the analysis are as follows:

Although the recent earthquake has underscored Japan's role as a supplier of sophisticated technological products, neither fiscal nor monetary policies appear to have led to significant global spillovers in recent years. However, Japan remains an important source of demand in Asia, and the lack of policy space and rising public debt levels in other advanced economies suggests that developments in Japan may have a larger impact than in the past.

While fiscal consolidation in Japan may result in short-run costs for some Asian countries, the long-run effect on all regions would be positive. Speedy implementation of Japan's growth strategy would mitigate any negative short-term spillovers. By contrast, monetary policy spillovers are found to be limited.

Financial spillovers from Japan were found to be smaller than those from other systemic economies, reflecting a financial sector largely focused on the domestic economy. Nevertheless, a delay in fiscal consolidation could lead to strains in JGB markets and losses on bank balance sheets, both of which could affect Japan's trading partners. In particular, a rise in JGB yields could lead to higher interest rates elsewhere, especially in economies where government debt is already high.

The authorities agreed with the key findings of the report, but cautioned that a robust methodology for gauging financial sector spillovers effects was yet to be developed, particularly concerning cross-border confidence effects. They acknowledged that a failure to consolidate fiscal policy could lead to spillover effects, but suggested that Japanese banks would not have a large role in transmitting a shock abroad.

June 29, 2011

UNITED KINGDOM

SPILOVER REPORT FOR THE 2011 ARTICLE IV CONSULTATION

July 11, 2011

KEY POINTS

Issues. Spillover reports explore the external effects of policies in systemic economies, focusing on concerns raised by key partners. In the case of the U.K., these mainly relate to (i) the extent to which the financial sector might be a source or conduit of shocks to the rest of the world, (ii) the impact of U.K. supervision and regulatory policies on efforts to strengthen global financial stability.

Findings. The main messages flowing from staff analysis are:

□ **The size and interconnectedness of the U.K. financial sector make it a powerful originator, transmitter, and potential dampener of global shocks.** The U.K. agglomerates

core international financial functions making it a key node in “funding” liquidity and balance sheet hedging, providing buoyancy to global markets and acting as a key channel transmitting shocks or stabilizing measures.

□ **The stability and efficiency of the U.K. financial sector is therefore a global public good, requiring the highest quality supervision and regulation.** Significant efforts to strengthen supervision will help contain the risks to global stability posed by the sector’s size and complexity. Stronger liquidity, capital and leverage rules should dampen credit cycles and lower systemic risk, as can the U.K.’s macroprudential policies.

□ **International co-operation is critical if the U.K. is to fulfill its potential to support global stability.** U.K. financial stability will be weakened (with adverse spillovers) if EU rules constrain U.K. financial regulations at insufficiently ambitious levels or if they limit the ability to use macro-prudential instruments to address emerging risks. Cooperation (both within and outside the EU) would help limit regulatory arbitrage, while development of cross-border resolution frameworks can limit shock propagation through the U.K. if tail risks materialize. Effective home-host co-ordination would also reduce the risk of fragmented pools of liquidity hampering parent banks’ ability to support branches/subsidiaries in periods of stress.

□ **The U.K. authorities can make a significant contribution to the surveillance of global systemic risks.** The size and role of the U.K. financial sector puts them at an informational advantage, although data gaps and resources pose challenges.