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IMF warns eurozone on capital flight

By Claire Jones in Tokyo and Michael Steen in Frankfurt

The International Monetary Fund has warned that unless the eurozone resolves its capital crisis, European banks' balance sheets will contract severely, further damaging growth and pushing unemployment beyond already record highs in the region.

In its global financial stability report, the IMF concluded that capital flight from the eurozone's periphery to the bloc's core, driven by fears of a break-up of the currency union, had sparked "extreme fragmentation" of the euro area's funding markets. The fund said this was causing renewed pressure for banks to shrink their balance sheets, particularly those in countries with fiscal woes.

Delays in resolving the crisis meant that unless eurozone officials beefed up their policy response, European banks would dump \$2.8tn worth of assets – more than 7 per cent of their balance sheets – by the end of next year. Banks in the periphery would shed just short of 10 per cent of their assets.

The deleveraging would weigh on growth and add to increasingly high unemployment levels in the region. Businesses would suffer as bond markets proved unable to plug the gap left by banks.

"The expected amount of bank deleveraging is now higher [than forecast in April] because of lower expected earnings, higher losses linked to worsening economic conditions and greater funding pressures on banks," the fund said. The estimates are based on assumptions about the behaviour of the region's 58 largest banks.

The IMF acknowledged that the European Central Bank's pledge to buy government debt if countries agreed to reform programmes had lowered sovereign bond yields but said it was too early to tell whether the scheme would relieve deleveraging pressures.

"Although many core euro area banks are able to issue debt, and issuance has picked up in recent weeks, broader funding market conditions are still challenging for weaker periphery banks," the IMF said.

The report said that if there were additional measures "at the national level" alongside the ECB's actions, banks were likely to offload \$2.3tn of assets, or 6 per cent of their balance sheet, by the end of next year.

The additional measures that the IMF recommended included the ability for policy makers to inject capital directly into banks via the European Financial Stability Facility and European Stability Mechanism, the region's two bailout vehicles. The fund also advised eurozone officials to speed up their response to the crisis.

Testifying at the European parliament in Brussels, Mario Draghi, president of the ECB, said capital flight and the financial fragmentation of the 17-member euro area underscored the need for structural reforms.

"You can't have a union when you have certain countries that are permanent creditors and a set of countries that are permanent debtors," he said. "So part of this rebalancing will be achieved by regaining competitiveness."

Mr Draghi insisted that the ECB's bond-buying plan – dubbed outright monetary transactions or OMT – was designed to tackle the growing disparity in market interest rates paid by companies in countries such as Spain compared with those in Germany. OMT has yet to be used as Spain, the most likely candidate, has not applied to the eurozone's rescue fund as a necessary first step to triggering the bond-buying.

"The greatest contribution to growth in the euro area is to overcome the present state of financial and banking financial fragmentation in the euro area," Mr Draghi said. "The OMT is designed to overcome one reason of financial fragmentation."

The IMF said the risks to global financial stability had risen since spring, with the eurozone crisis still the chief concern despite policy makers' efforts to allay fears of a break-up of the single currency.

Countries in emerging Europe would suffer most if risks emanating from the eurozone emerged because of their direct exposures to the region. Asia and Latin America appeared more resilient, though economies such as Brazil, China and India were exposed to risks from rising property prices and high credit expansion levels.

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