

EXECUTIVE SUMMARY

In the 10 years since the global financial crisis, regulatory frameworks have been enhanced and the banking system has become stronger, but new vulnerabilities have emerged, and the resilience of the global financial system has yet to be tested. Since the last *Global Financial Stability Report* (GFSR), near-term risks to global financial stability have increased somewhat, but financial conditions are still broadly accommodative and supportive of growth in the near term. That said, risks could rise sharply should pressures in emerging market economies mount or if trade tensions escalate. Meanwhile, medium-term risks remain elevated, as easy financial conditions contribute to a further buildup of financial vulnerabilities.

Over the past six months, global financial conditions have marginally tightened and the divergence between advanced and emerging market economies has grown. The global economic expansion continues, providing an opportunity to strengthen balance sheets and rebuild buffers, but growth appears to have peaked in some major economies, as discussed in the October 2018 *World Economic Outlook* (WEO). Yet financial conditions in advanced economies remain accommodative, particularly in the United States, with interest rates still low by historical standards, risk appetite robust, and asset valuations rising in major markets. Financial conditions have remained broadly stable in China, where authorities have eased monetary policy to offset external pressures and the impact of tighter financial regulations. In contrast, financial conditions in most emerging market economies have tightened since mid-April, driven by higher external financing costs, rising idiosyncratic risks, and escalating trade tensions.

As noted in the April GFSR, notwithstanding improved fundamentals over recent years, emerging market economies remain vulnerable to spillovers from monetary policy normalization in advanced economies and could face reduced capital inflows even under a relatively benign baseline scenario. Since then, with rising U.S. interest rates and a stronger dollar, as well as the intensification of trade tensions, a number of emerging market economies have experienced a reversal in portfolio flows. But with buoyant global

risk appetite, market pressures have to date been concentrated in countries with large external imbalances and weak policy frameworks. However, the IMF's capital-flows-at-risk analysis suggests that with a 5 percent probability, emerging market economies (excluding China) could face debt portfolio outflows in the medium term of \$100 billion or more over a period of four quarters (or 0.6 percent of their combined GDP), broadly similar in magnitude to the global financial crisis.

Near-term risks to global financial stability—assessed using the growth-at-risk (GaR) approach—have increased somewhat over the past six months. However, a much sharper tightening of financial conditions in advanced economies would significantly increase short-term risks. An intensification of concerns about the resilience and policy credibility in emerging markets may lead to further capital outflows and possibly rising global risk aversion. A broader escalation of trade actions may undermine investor confidence, harming the economic expansion. Political and policy uncertainty (for example, in the event of a no-deal Brexit or the reemergence of concerns about fiscal policy in some highly indebted euro area countries) could adversely affect market sentiment and lead to a spike in risk aversion. Finally, with inflation firming up, central banks may step up the pace of monetary policy normalization, which could lead to a sudden tightening of global financial conditions. Overall, market participants appear complacent about the risk of a sharp tightening of financial conditions.

Medium-term risks to global financial stability and growth remain elevated. A number of vulnerabilities that have built up over the years could be exposed by a sudden, sharp tightening of financial conditions. In advanced economies, key financial vulnerabilities include high and rising leverage levels in the nonfinancial sector, continued deterioration in underwriting standards, and stretched asset valuations in some major markets. Total nonfinancial sector debt in jurisdictions with systemically important financial sectors has grown from \$113 trillion (more than 200 percent of their combined GDP) in 2008 to \$167 trillion (close to 250

percent of their combined GDP). Banks have increased their capital and liquidity buffers since the crisis, but they remain exposed to highly indebted companies, households, and sovereigns; to their holdings of opaque and illiquid assets; or to their use of foreign currency funding. External borrowing has continued to rise in most emerging market economies. This poses challenges for countries that are facing external financing risks and trade shocks, but that lack adequate reserve buffers or strong domestic investor bases to cushion the impact of external shocks. Given the challenging external environment, policymakers in emerging market economies should be prepared for further capital outflow pressures.

In addition to the analysis of the key risks to global financial stability, this report takes stock of the global regulatory reform agenda over the past decade and looks at whether the global financial ecosystem since the crisis has evolved in the intended direction: that is, toward greater safety.

On the positive side, the broad regulatory agenda set by the international community has helped strengthen the global banking system. Some of the pernicious forms of shadow banking that developed in the run-up to the crisis have been curtailed, and most countries now have a macroprudential authority and some tools with which to oversee and contain risks to the financial system.

However, a number of factors may have led to some fragmentation in funding and market liquidity.

Regulators are increasingly focusing on the liquidity of individual entities within international banking groups. There are benefits to greater ring-fencing of liquidity, particularly in the context of resolution during stress periods, but there is a risk that doing so could fragment liquidity in international banking groups. In capital markets, market liquidity appears to have become more segmented, for example, across different trading platforms. While there is no clear evidence of a broad-based deterioration in market liquidity, careful monitoring of liquidity conditions is warranted.

To further improve the resilience of the global financial system, the financial regulatory reform agenda should be completed, and a rollback of reforms should be avoided. To adequately address potential systemic risks, financial regulation and supervision should be used more proactively. Broad-based macroprudential tools, including countercyclical capital buffers, should be used more actively in countries where financial conditions remain accommodative and where vulnerabilities are high. Furthermore, financial stability requires new macroprudential tools for addressing vulnerabilities outside the banking sector. Finally, regulators and supervisors must remain attentive to new risks, including possible threats to financial stability stemming from cybersecurity, financial technology, and other institutions or activities outside the perimeter of prudential regulation.