EXECUTIVE SUMMARY

Financial stability has improved in advanced economies

Financial stability has improved in advanced economies since the April 2015 *Global Financial Stability Report*. This progress reflects a strengthening macrofinancial environment in advanced economies as the recovery has broadened, confidence in monetary policies has firmed, and deflation risks have abated somewhat in the euro area.

The Federal Reserve is poised to raise interest rates as the preconditions for liftoff are nearly in place. This increase should help slow the further buildup of excesses in financial risk taking. Partly due to confidence in the European Central Bank's (ECB's) policies, credit conditions are improving and credit demand is picking up. Corporate sectors are showing tentative signs of improvement that could spawn increased investment and economic risk taking, including in the United States and Japan, albeit from low levels.

Risks continue to rotate toward emerging markets, amid greater market liquidity risks

Despite these improvements in advanced economies, emerging market vulnerabilities remain elevated, risk appetite has fallen, and market liquidity risks are higher. Although many emerging market economies have enhanced their policy frameworks and resilience to external shocks, several key economies face substantial domestic imbalances and lower growth, as noted in the October 2015 *World Economic Outlook* (WEO). Many emerging market economies relied on rapid credit creation to sidestep the worst impacts of the global crisis. This increased borrowing has resulted in sharply higher leverage of the private sector in many economies, particularly in cyclical sectors, accompanied by rising foreign currency exposures increasingly driven by global factors. This confluence of borrowing and foreign currency exposure has increased the sensitivity of these economies to a tightening of global financial conditions (see Chapter 3).

As emerging market economies approach the late stage of the credit cycle, banks have thinner capital cushions, while nonperforming loans are set to rise as corporate earnings and asset quality deteriorate. In China, banks have only recently begun to address the growing asset quality challenges associated with rising weaknesses in key areas of the corporate sector. These developments in emerging market banking systems stand in contrast to those in advanced economies, where banks have spent the past few years deleveraging and repairing balance sheets, raising capital, and strengthening funding arrangements.

Against a challenging backdrop of falling commodity prices and weaker growth, several emerging market sovereigns are at greater risk of losing investment-grade ratings in the medium term. Pressures on sovereign ratings could intensify if contingent liabilities of state-owned enterprises—with a large and rising share of emerging market corporate bond issuance—have to be assumed by the sovereign, for example, from firms in the oil, gas, and utility sectors.

Policymakers confront a triad of challenges

The baseline outlook for financial stability, consistent with the October 2015 WEO, is characterized by continuing cyclical recovery, but with weak prospects for medium-term growth in both advanced economies and emerging markets. In advanced economies, improvements in private balance sheets and continued accommodative monetary and financial conditions have spurred a cyclical recovery, but the handover to higher levels of self-sustaining growth is incomplete. Emerging markets face substantial challenges in adjusting to the new global market realities from a position of higher vulnerability.

Successful normalization of financial and monetary conditions would bring macrofinancial benefits and considerably reduce downside risks. This report analyzes the prospects for normalization according to three scenarios: the baseline, an upside scenario of successful normalization, and a downside scenario characterized by disruptions in global asset markets. Against this backdrop, the global financial outlook is clouded by a triad of broad policy challenges in evidence over the past several months:

- *Emerging market vulnerabilities*—As examined in the WEO, growth in emerging markets and developing economies is projected to decline for the fifth year in a row. Many emerging markets have increased their resilience to external shocks with increased exchange rate flexibility, higher foreign exchange reserves, increased reliance on FDI flows and domestic-currency external financing, and generally stronger policy frameworks. But balance sheets have become stretched thinner in many emerging market companies and banks. These firms have become more susceptible to financial stress, economic downturn, and capital outflows. Deteriorating corporate health runs the risk of deepening the sovereign-corporate and the corporate-bank nexus in some key emerging markets. China in particular faces a delicate balance of transitioning to more consumption-driven growth without activity slowing too much, while reducing financial vulnerabilities and moving toward a more market-based system—a challenging set of objectives. Recent market developments, including slumping commodity prices, China's bursting equity and margin-lending bubble, falling emerging market equities, and pressure on exchange rates, underscore these challenges.
- *Legacy issues from the crisis in advanced economies*—High public and private debt in advanced economies and remaining gaps in the euro area architecture need to be addressed to consolidate financial stability, and avoid political tensions and headwinds to confidence and growth. In the euro area, addressing remaining sovereign and banking vulnerabilities is still a challenge.
- *Weak systemic market liquidity*—This poses a challenge in adjusting to new equilibria in markets and the wider economy. Extraordinarily accommodative policies have contributed to a compression of risk premiums across a range of markets including sovereign bonds and corporate credit, as well as a compression of liquidity and equity risk premiums. While recent market developments have unwound some of this compression, risk premiums could still rise further. Now that the Federal Reserve looks set to begin the gradual process of tightening monetary policy, the global financial system faces an unprecedented adjustment as risk premiums "normalize" from historically low levels alongside rising policy rates and a modest cyclical recovery. Abnormal market conditions will need to adjust smoothly to the new environment. But there are risks from a rapid decompression, particularly given what appears to be more brittle market structures and market fragilities concentrated in credit intermediation channels, which could come to the fore as financial conditions normalize (see Chapter 2). Indeed, recent episodes of high market volatility and liquidity dislocations across advanced and emerging market asset classes highlight this challenge.

Strong policy actions are needed to ensure "successful normalization"

The relatively weak baseline for both financial stability and the economic outlook leaves risks tilted to the downside. Thus, ensuring successful normalization of financial and monetary conditions and a smooth handover to higher growth requires further policy efforts to tackle pressing challenges. These should include the following:

- Continued effort by the Federal Reserve to provide clear and consistent communication, enabling the smooth absorption of rising U.S. rates, which is essential for global financial health.
- In the euro area, more progress in strengthening the financial architecture of the common currency to bolster market and business confidence. Addressing the overhang of private debt and bank nonperforming loans in the euro area would support bank finance and corporate health, and boost investment.
- Rebalancing and gradual deleveraging in China, which will require great care and strong commitments to market-based reforms and further strengthening of the financial system.
- More broadly, addressing both cyclical and structural challenges in emerging markets, which will be critical to underpin improved prospects and resilience. Authorities in emerging markets should regularly monitor corporate foreign currency exposures, including derivatives positions, and use micro- and macroprudential tools to discourage the buildup of excessive leverage and foreign indebtedness.
- Safeguarding against market illiquidity and strengthening market structures, which are priorities, especially in advanced economies' markets.
- Ensuring the soundness and health of banks and the long-term savings complex (for example, insurers and pension funds), which is critical, as highlighted in the April 2015 GFSR.

With bold and upgraded financial policy actions detailed in the report, policymakers can help deliver a stronger path for growth and financial stability, while avoiding downside risks. Such an upside scenario would benefit the world economy and raise global output 0.4 percent above the baseline by 2018. Further growth-enhancing structural reforms, detailed in the WEO, could bring additional support to growth and stability, beyond the benefits detailed here.

Possible shocks or policy missteps could lead to a global asset market disruption

Without the implementation of policies to ensure successful normalization, potential adverse shocks or policy missteps could trigger an abrupt rise in market risk premiums and a rapid erosion of policy confidence. Shocks may originate in advanced or emerging markets and, combined with unaddressed system vulnerabilities, could lead to a global asset market disruption and a sudden drying up of market liquidity in many asset classes. Under these conditions, a significant—even if temporary—mispricing of assets may ensue, with negative repercussions on financial stability (see Chapter 2).

In such an adverse scenario, substantially tighter financial conditions could stall the cyclical recovery and weaken confidence in medium-term growth prospects. Low nominal growth would put pressure on debt-laden sovereign and private balance sheets, raising credit risks. Emerging markets would face higher global risk premiums and substantial capital outflows, putting particular pressure on economies with domestic imbalances. Corporate default rates would rise, particularly in China, raising financial system strains, with implications for growth. These events would lead to a reappearance of risks on sovereign balance sheets, especially in Europe's vulnerable economies, and the emergence of an adverse feedback loop between corporate and sovereign risks in emerging markets. As a result, aggregate global output could be as much as 2.4 percent lower by 2017, relative to the baseline. This implies lower but still positive global growth.