

PREFACE

The *Global Financial Stability Report* (GFSR) assesses key risks facing the global financial system. In normal times, the report seeks to play a role in preventing crises by highlighting policies that may mitigate systemic risks, thereby contributing to global financial stability and the sustained economic growth of the IMF's member countries.

The current report finds that, despite an improvement in financial stability in advanced economies, risks continue to rotate toward emerging markets. The global financial outlook is clouded by a triad of policy challenges: emerging market vulnerabilities, legacy issues from the crisis in advanced economies, and weak systemic market liquidity. With more vulnerable balance sheets in emerging market companies and banks, firms in these countries are more susceptible to financial stress, economic downturn, and capital outflows. Recent market developments such as slumping commodity prices, China's bursting equity bubble, and pressure on exchange rates underscore these challenges. The prospect of the U.S. Federal Reserve gradually raising interest rates points to an unprecedented adjustment in the global financial system as financial conditions and risk premiums "normalize" from historically low levels alongside rising policy rates and a modest cyclical recovery. The report also examines the factors that influence levels of liquidity in securities markets, as well as the implications of low liquidity. Currently, market liquidity is being supported by benign cyclical conditions. Although it is too early to assess the impact of recent regulatory changes on market liquidity, changes in market structure, such as larger holdings of corporate bonds by mutual funds, appear to have increased the fragility of liquidity. Finally, the report studies the growing level of corporate debt in emerging markets, which quadrupled between 2004 and 2014. The report finds that global drivers have played an increasing role in leverage growth, issuance, and spreads. Moreover, higher leverage has been associated with, on average, rising foreign currency exposures. It also finds that despite weaker balance sheets, firms have managed to issue bonds at better terms as a result of favorable financial conditions.

The analysis in this report has been coordinated by the Monetary and Capital Markets (MCM) Department under the general direction of José Viñals, Financial Counsellor and Director. The project has been directed by Peter Dattels and Dong He, both Deputy Directors, as well as by Gaston Gelos and Matthew Jones, both Division Chiefs. It has benefited from comments and suggestions from the senior staff in the MCM Department.

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This particular edition of the GFSR draws in part on a series of discussions with banks, securities firms, asset management companies, hedge funds, standards setters, financial consultants, pension funds, central banks, national treasuries, and academic researchers.

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