FOREWORD

Starting with this report, Chapter 1 of the *Global Financial Stability Report* (GFSR) will regularly provide a quantitative assessment of the degree to which future GDP growth faces downside risks from financial vulnerabilities, using a Growth-at-Risk (GaR) framework. The GaR approach links financial conditions to the distribution of future GDP growth outcomes and provides a framework for assessing the trade-off between supporting growth in the short term and putting financial stability and future growth at risk over the medium term. Our current assessment through the prism of GaR is that, over the past six months, short-term downside risks to global financial stability have increased somewhat, reflecting somewhat tighter financial conditions amid investors' concerns about newly announced trade measures. Even so, still-accommodative financial conditions continue to be supportive of economic growth. Taking a longer view, downside risks, as measured by GaR, remain large: easy financial conditions continue to fuel financial vulnerabilities, leaving the global economy exposed to the risk of a sharp tightening in financial conditions. Policymakers thus face the twin challenges of continuing to support growth in the short term by keeping monetary policy accommodative as well as reining in rising financial stability risks in the medium term by deploying micro- and macroprudential policy tools.

Managing the gradual process of monetary policy normalization will be tricky against this backdrop of elevated medium-term risks, and will require careful communication from central banks and policymakers to reduce the risks from a sharp tightening of financial conditions. The spike in volatility in global equity markets in early February has brought into focus the risk of abrupt, adverse feedback loops in a period of asset price adjustments. The recently increased trade tensions have led to investors' jitters, and a wider escalation of protectionist measures could ultimately take a toll on the global economy and on global financial stability. Many markets still have stretched valuations, and may experience bouts of volatility in the period ahead, in the context of continued monetary policy normalization in some advanced countries. Investors and policymakers should be cognizant of the risks associated with rising interest rates after years of very easy financial conditions and take active steps to reduce these risks. Asset price spillovers have important implications for the housing market. As explained in Chapter 3, house price correlations across countries and across major cities have been trending up during the past 30 years, suggesting that spillovers via the housing sector may play a prominent role in a future crisis.

A variety of indicators point to vulnerabilities from financial leverage, a deterioration in underwriting standards, and ever more pronounced reaching for yield behavior by investors in corporate and sovereign debt markets around the world. Chapter 2 presents an innovative gauge of the riskiness of credit allocation. The new metric computes the difference in vulnerability between the firms with the largest and smallest expansions in debt. This indicator exhibits strong forecasting power for downside risks to GDP growth, and is currently at medium to elevated levels in several countries. A host of more conventional metrics of corporate debt vulnerability around the world, including a deterioration in nonprice terms and underwriting standards in debt deals, suggest that market risks are rising, as easy financial conditions support high issuance and strong global capital flows. In low-income countries, the share of private and non–Paris Club creditors is increasing, and greater use of collateralized debt exposes borrowing countries to potentially costly debt restructurings in the future.

Over the past year, crypto assets trading has emerged as a new potential vulnerability. Price volatility of crypto assets has been much higher than that of commodities, currencies, or stocks. Financial stability risks could arise from leveraged positions taken by investors in this new asset class, infrastructure weaknesses of cryptocurrency exchanges, and fraud, in addition to elevated volatility. Regulators around the world are responding to the growing use of crypto assets through various measures, including enforcement actions, indirect interventions via the banking system, and outright bans. While crypto assets may generate new vulnerabilities, they also create opportunities and, indeed, a number of central banks around the world are considering the issuance of central bank digital currency.

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