

EXECUTIVE SUMMARY

Financial conditions have tightened since the October 2018 *Global Financial Stability Report* (GFSR) but remain relatively accommodative, notably in the United States. After sharp declines in the fourth quarter of 2018, financial markets rebounded strongly in early 2019 on growing optimism about US-China trade negotiations and as major central banks adopted a more patient and flexible approach to monetary policy normalization. Such a dovish shift in the outlook for monetary policy in advanced economies has helped sustain positive market sentiment despite growing signs of weakening global growth (as discussed in the April 2019 *World Economic Outlook*).

With financial conditions still accommodative, vulnerabilities continue to build. The tightening in financial conditions in the fourth quarter of 2018 was too short-lived to meaningfully slow the buildup of vulnerabilities, leaving medium-term risks to global financial stability broadly unchanged. Financial vulnerabilities are currently elevated in the sovereign, corporate, and nonbank financial sectors in several systemic countries. As the credit cycle matures, corporate sector vulnerabilities—which appear elevated in about 70 percent of systemically important countries (by GDP)—could amplify an economic downturn.

This report presents a new framework for comprehensive assessment of balance sheet vulnerabilities across financial and nonfinancial sectors, and focuses on a number of specific vulnerabilities in advanced and emerging market economies.

- *Corporate sector debt in advanced economies:* Debt-service capacity has improved in most advanced economies, and balance sheets appear strong enough to sustain a *moderate* economic slowdown or a *gradual* tightening of financial conditions. However, overall debt and financial risk taking have increased, and the creditworthiness of some borrowers has deteriorated. As a result, the stock of lower-rated investment-grade (BBB) bonds has quadrupled, and the stock of speculative-grade credits has almost doubled in the United States and the euro area since the crisis. Therefore, a *significant* economic downturn or *sharp* tightening of financial conditions could lead to a notable repricing of credit risk and could strain the debt-service capacity of indebted firms. If monetary and financial conditions remain easy, debt will likely rise further in the absence of policy action, raising the specter of a deeper downturn in the future.
- *The sovereign–financial sector nexus in the euro area:* Fiscal challenges in Italy have rekindled worries about the sovereign–financial sector nexus. Bank capital ratios are now higher in the euro area. But potential losses on nonperforming loans and market-to-market declines in the value of government bonds could result in a significant hit to capital for some banks. Insurance companies could also become entangled in the nexus, given their significant holdings of sovereign, bank, and corporate bonds. There is a risk that strains in the financial sector could yet again be passed on to companies and households, hurting economic growth.
- *China’s financial imbalances and potential spillovers:* Financial vulnerabilities in China remain high, and the authorities face a difficult trade-off between supporting near-term growth, countering adverse external shocks, and containing leverage through regulatory tightening. Small and medium-size banks remain weak, weighing on financing conditions for smaller firms. Yet further monetary and credit easing may increase vulnerabilities, as continued credit growth could slow or impede bank balance sheet repair and exacerbate existing biases in credit allocation. Meanwhile, China’s importance for other emerging markets will continue to increase with its inclusion in benchmark indices; portfolio flows to China are expected to rise by as much as \$150 billion by 2020 as a result of its inclusion in a global bond index.
- *Volatile portfolio flows to emerging markets:* Portfolio flows to emerging markets are increasingly influenced by benchmark-driven investors. The amount of funds benchmarked against widely followed emerging market bond indices has quadrupled in the past 10 years to \$800 billion. Estimates also suggest that 70 percent of country allocations of investment funds are influenced by benchmark indi-

ces. Given that benchmark-driven investors are more sensitive to changes in global financial conditions than other investors, the benefits of index membership may be tempered by financial stability risks for some countries. As these investors become a larger share of portfolio flows, external shocks may propagate to medium-size emerging and frontier market economies faster than in the past.

- *House prices at risk (HaR)*: The recent rapid increase in house prices in many countries has raised concerns about the possibility of a price correction. A new house prices-at-risk framework, presented in Chapter 2 of this report, is used to quantify downside risks to house price growth. Lower house price momentum, overvaluation, excessive credit growth, and tighter financial conditions help predict downside risks to house prices up to three years ahead. In turn, the measure of house prices at risk helps forecast downside risks to GDP growth and predict financial crises. The most recent data point to increased downside risks to house prices over the next one to three years in some countries.

Looking ahead, there is a risk that positive investor sentiment could deteriorate abruptly, leading to a sharp tightening of financial conditions. This will have a larger effect on economies with weaker fundamentals, greater financial vulnerabilities, and less policy space to respond to shocks. Possible triggers include the following:

- A *sharper-than-expected growth slowdown* could lead to tighter financial conditions as risk asset prices fall, reflecting a weaker outlook for corporate earnings, even as policies turn more accommodative.
- An *unexpected shift to a less dovish outlook for monetary policy* in advanced economies could trigger a repricing in markets, especially if investors realize that they have taken too benign a view on the monetary policy stance.
- *Political and policy risks*, such as an escalation of trade tensions or a no-deal Brexit, could affect market sentiment and lead to a spike in risk aversion.

Amid rising downside risks to global growth, policymakers should aim to avoid a sharper economic slowdown, while keeping financial vulnerabilities in check:

- Policymakers should clearly communicate any reassessment of the *monetary policy* stance that reflects either changes in the economic outlook or risks surrounding the outlook. This will help avoid unnecessary swings in financial markets or unduly compressed market volatility.
- In countries with high or rising financial vulnerabilities, policymakers should proactively *deploy prudential tools or expand their macroprudential toolkits* where needed. These countries would benefit from activating or tightening broad-based macroprudential measures, such as countercyclical capital buffers, to increase the financial system's resilience. Efforts should also focus on developing prudential tools to address rising corporate debt from nonbank financial intermediaries and maturity and liquidity mismatches in the nonbank sector. Regulators should also ensure that more comprehensive stress tests (that include macro-financial feedback effects) are conducted for banks and nonbank lenders.
- *Measures to repair public and private balance sheets* should be stepped up. A gradual fiscal adjustment is needed to reduce elevated risks, based on policies that will support medium-term growth. Efforts to tackle nonperforming loans on euro area bank balance sheets should continue. Given concerns about the sovereign–financial sector nexus, consideration could be given to mitigating concentration risk in banks' sovereign exposures.
- Emerging market economies should ensure resilience against *foreign portfolio outflows* by reducing excessive external liabilities, cutting reliance on short-term debt, and maintaining adequate fiscal and foreign exchange reserve buffers. Given the rising importance of benchmark-driven portfolio flows, a close dialogue is needed between index providers, the investment community, and regulators. Building on the progress achieved so far, the Chinese authorities should continue financial sector de-risking and deleveraging policies and put greater emphasis on addressing bank vulnerabilities. Structural reforms such as reducing the emphasis on growth targets and tightening budget constraints for Chinese state-owned enterprises will be critical to reduce credit misallocation.