FOREWORD

Markets sold off sharply late last year, broadly across asset classes, amid growing signs of a slowing global economy and rising concerns about US-China trade tensions. Against a backdrop of rising downside risks, policymakers across the globe took steps to prevent a sharper deceleration of the economy. Such a forceful response supported market sentiment and triggered a sharp rebound in risk assets. Despite this recent improvement, financial markets remain susceptible to a sudden tightening in financial conditions. Potential triggers include a sharp repricing of risk, an intensification of trade tensions, a further slowdown in global economic activity, or political shocks.

An abrupt deterioration in financial conditions could unmask financial fragilities that have built during the period of very low interest rates. In this issue of the *Global Financial Stability Report* we are introducing a more structured, systematic approach aimed at monitoring financial vulnerabilities. Using data back to 2000 for 29 systemically important economies that account for a significant share of the global economy, we assess the level of vulnerability across regions and sectors (banks, nonbank financial institutions, sovereigns, firms, and households).

This new framework detects elevated financial vulnerability in several sectors around the world, including sovereigns, firms, and nonbank financial institutions. These vulnerabilities could turn into powerful amplification mechanisms if adverse shocks materialize. For example, the level of corporate debt has been rising around the world, and there is a weak tail of companies with high leverage and weak earnings prospects. There are growing signs that this credit cycle may be maturing, and risks of an economic slowdown are rising. The most highly indebted companies could be vulnerable to such a shock. While fundamentals in emerging markets are stronger and policy frameworks generally more resilient than in the past, some countries have low reserves, high leverage, or high foreign currency exposures that could make them more vulnerable to capital flow pressures. Furthermore, in Europe, fiscal challenges in some countries have reignited worries about the sovereign-bank nexus as a potentially powerful amplification mechanism in economies with more indebted sovereigns. Finally, housing markets in many advanced and emerging markets are at risk.

In sum, these rising financial vulnerabilities point to elevated medium-term risks to financial stability. Policymakers should act now to reduce these vulnerabilities while they can. Countercyclical capital buffers should be activated in countries with rising vulnerabilities, and macroprudential tools should be developed to contain corporate vulnerabilities. Monetary policies should remain data dependent and well communicated to avoid market overreaction and prevent further growth deceleration.

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