

## Near-Term Risks Are Lower

The global financial system continues to strengthen in response to extraordinary policy support, regulatory enhancements, and the cyclical upturn in growth. The health of banks in many advanced economies continues to improve, as progress has been made in resolving some weaker banks, while a majority of systemic institutions are adjusting business models and restoring profitability. The upswing in global economic activity, discussed in the October 2017 *World Economic Outlook* (WEO), has boosted market confidence while reducing near-term threats to financial stability.

But beyond these recent improvements, the environment of continuing monetary accommodation—necessary to support activity and boost inflation—is also leading to rising asset valuations and higher leverage. Financial stability risks are shifting from the banking system toward nonbank and market sectors of the financial system. These developments and risks call for delicately balancing the eventual normalization of monetary policies, while avoiding a further buildup of financial risks outside the banking sector and addressing remaining legacy problems.

## The Two Sides of Monetary Policy Normalization

The baseline path for the global economy, envisaged by central banks and financial markets, foresees continued support from accommodative monetary policies, as inflation rates are expected to recover only slowly. Thus, the gradual process of normalizing monetary policies is likely to take several years. Too fast a pace of normalization would remove needed support for sustained recovery and desired increases in core inflation across major economies. Unconventional monetary policies and quantitative easing have forced substantial portfolio adjustments in the private sector and across borders, making the adjustment of financial markets much less predictable than in previous cycles. Abrupt or ill-timed shifts could cause unwanted turbulence in financial markets and reverberate across borders and markets. Yet the prolonged monetary support envisaged for the major

economies may lead to the buildup of further financial excesses. As the search for yield intensifies, vulnerabilities are shifting to the nonbank sector, and market risks are rising. There is too much money chasing too few yielding assets: less than 5 percent (\$1.8 trillion) of the current stock of global investment-grade fixed-income assets yields over 4 percent, compared with 80 percent (\$15.8 trillion) before the crisis. Asset valuations are becoming stretched in some markets as investors are pushed out of their natural risk habitats, and accept higher credit and liquidity risk to boost returns.

At the same time, indebtedness among the major global economies is increasing. Leverage in the non-financial sector is now higher than before the global financial crisis in the Group of Twenty economies as a whole. While this has helped facilitate the economic recovery, it has left the nonfinancial sector more vulnerable to changes in interest rates. The rise in leverage has led to a rise in private sector debt service ratios in several of the major economies, despite the low level of interest rates. This is stretching the debt servicing capacity of weaker borrowers in some countries and sectors. Debt servicing pressures and debt levels in the private nonfinancial sector are already high in several major economies (Australia, Canada, China, Korea), increasing their sensitivity to tighter financial conditions and weaker economic activity.

The key challenge confronting policymakers is to ensure that the buildup of financial vulnerabilities is contained while monetary policy remains supportive of the global recovery. Otherwise, rising debt loads and overstretched asset valuations could undermine market confidence in the future, with repercussions that could put global growth at risk. This report examines such a downside scenario, in which a repricing of risks leads to sharp increases in credit costs, falling asset prices, and a pullback from emerging markets. The economic impact of this tightening of global financial conditions would be significant (about one-third as severe as the global financial crisis) and more broad-based (global output would fall 1.7 percent relative to the WEO baseline with varying cross-country effects). Monetary normalization would go into

reverse in the United States and would stall elsewhere. Emerging market economies would be disproportionately affected, resulting in an estimated \$100 billion reduction in portfolio flows over four quarters. Bank capital would take the biggest hit where leverage is highest and where banks are most exposed to the housing and corporate sectors.

### Deleveraging in China: Challenges Ahead

Steady growth in China and financial policy tightening in recent quarters have eased concerns about a near-term slowdown and negative spillovers to the global economy. However, the size, complexity, and pace of growth in China's financial system point to elevated financial stability risks. Banking sector assets, at 310 percent of GDP, have risen from 240 percent of GDP at the end of 2012. Furthermore, the growing use of short-term wholesale funding and “shadow credit” to firms has increased vulnerabilities at banks. Authorities face a delicate balance between tightening financial sector policies and slowing economic growth. Reducing the growth of shadow credit even modestly would weigh on the profitability and broader provision of credit by small and medium-sized banks.

### Global Banks' Health Is Improving

The health of global systemically important banks (GSIBs) continues to improve. Balance sheets are stronger because of improved capital and liquidity buffers, amid tighter regulation and heightened market scrutiny. Considerable progress has been made in addressing legacy issues and restructuring challenges. At the same time, while many banks have strengthened their profitability by reorienting business models, several continue to grapple with legacy issues and business model challenges. Banks representing about \$17 trillion in assets, or about one-third of the GSIB total, may continue to generate unsustainable returns, even in 2019. As problems in even a single GSIB could generate systemic stress, supervisory actions should remain focused on business model risks and sustainable profitability. Life insurers have also been adapting their business strategies in the low-yield environment following the global financial crisis. They have done this by reducing legacy exposures, steering the product mix away from high guaranteed returns, and seeking higher yields in investment portfolios. Meanwhile, supervisors need to monitor rising exposure to market and credit risks.

### Policymakers Must Take Proactive Measures

Policymakers must take advantage of the improving global outlook and avoid complacency by addressing rising medium-term vulnerabilities.

- Policymakers and regulators should fully address crisis legacy problems and require banks and insurance companies to strengthen their balance sheets in advanced economies. This includes putting a resolution framework for international banks into operation, focusing on risks from weak bank business models to ensure sustainable profitability, and finalizing Basel III. Regulatory frameworks for life insurers should be enhanced to increase reporting transparency and incentives to build resilience. A global and coordinated policy response is needed for resilience to cyberattacks (see Box 1.2).
- Major central banks should ensure a smooth normalization of monetary policy through well-communicated plans on unwinding their holdings of securities and guidance on prospective changes to policy frameworks. Providing clear paths for policy changes will help anchor market expectations and ward off undue market dislocations or volatility.
- Financial authorities should deploy macroprudential measures, and consider extending the boundary of such tools, to curb rising leverage and contain growing risks to stability. For instance, borrower-based measures should be introduced and/or tightened to slow fast-growing overvalued segments, and bank stress tests must assume more stressed asset valuations. Capital requirements should be increased for banks that are more exposed to vulnerable borrowers to act as a cushion for already accumulated exposures and incentivize banks to grant new loans to less risky sectors.
- Regulation of the nonbank financial sector should be strengthened to limit risk migration and excessive capital market financing. Transition to risk-based supervision should be accelerated, and harmonized regulation of insurance companies—with emphasis on capital—should be introduced. Tighter microprudential requirements should be implemented in highly leveraged segments.
- Debt overhangs—especially among the largest borrowers as potential originators of shocks—must be addressed. Discouraging further debt buildup through measures that encourage business investment and discourage debt financing will help curb financial risk taking.

- Emerging market economies should continue to take advantage of supportive external conditions to enhance their resilience, including by continuing to strengthen external positions where needed, and reduce corporate leverage where it is high. This would put these economies in a better position to withstand a reduction in capital inflows as a result of monetary normalization in advanced economies or waning global risk appetite. Similarly, frontier market and low-income-country borrowers should develop the institutional capacity to deal with risks from the issuance of marketable securities, including formulating comprehensive medium-term debt management strategies. This will enable them to take advantage of broader financial market development and access, while containing the associated risks.
- In China, the authorities have taken welcome steps to address risks in the financial system, but there is still work to do. Vulnerabilities will be difficult to address without slower credit growth. Recent policies to improve the risk management and transparency of the banking system and reduce the buildup of maturity and liquidity transformation risks in banks' shadow credit activities are essential and must continue. However, policies should also target balance sheet vulnerabilities at weak banks. The government's commitment to reducing corporate leverage is welcome and should remain a priority as part of a broader effort to insulate the economy against slower credit growth.
- Although significant progress has been made in developing the postcrisis policy response, progress remains uneven across the various sectors, with several design and implementation issues remaining outstanding. Ensuring that the reform measures are completed and implemented is essential to minimize the likelihood of another disruptive crisis. Completing the reform agenda will also allow policymakers to conduct a comprehensive evaluation of the impact of the reforms and fine-tune the agreed measures. This will allow them to address any material unintended effects their cumulative implementation might have on the provision of key financial services. This is critical to provide continued assurance that reforms have delivered on their objectives and to stave off emerging pressures to roll back these measures, which would only make the financial system more vulnerable.
- Finally, implementation of structural reforms and supportive fiscal policies (as examined in Scenario

Box 1 of the October 2017 *World Economic Outlook*) would lift global growth and generate positive economic spillovers, reinforcing financial policy efforts.

## Household Debt and Economic Growth

Chapter 2 examines the short- and medium-term implications for economic growth and financial stability of the past decades' rise in household debt. The chapter documents large differences in household debt-to-GDP ratios across countries but a common increasing trajectory that was moderated but not reversed by the global financial crisis. In advanced economies, with notable exceptions, household debt to GDP increased gradually, from 35 percent in 1980 to about 65 percent in 2016, and has kept growing since the global financial crisis, albeit more slowly. In emerging market economies, the same ratio is still much lower, but increased relatively faster over a shorter period, from 5 percent in 1995 to about 20 percent in 2016. Moreover, the rise has been largely unabated in recent years. The chapter finds a trade-off between a short-term boost to growth from higher household debt and a medium-term risk to macroeconomic and financial stability that may result in lower growth, consumption, and employment and a greater risk of banking crises. This trade-off is stronger when household debt is higher and can be attenuated by a combination of good policies, institutions, and regulations. These include appropriate macroprudential and financial sector policies, better financial supervision, less dependence on external financing, flexible exchange rates, and lower income inequality.

## Financial Conditions Can Predict Growth

The global financial crisis showed policymakers that financial conditions offer valuable information about risks to future growth and provide a basis for targeted preemptive action. Chapter 3 develops a new macroeconomic measure of financial stability by linking financial conditions to the *probability distribution* of future GDP growth and applies it to a set of 21 major advanced and emerging market economies. The chapter shows that changes in financial conditions shift the whole distribution of future GDP growth. Wider risk spreads, rising asset price volatility, and waning global risk appetite are significant predictors of increased downside risks to growth in the near term, and higher leverage and credit growth provide

relevant signals of such risks in the medium term. Today's prevailing low funding costs and financial market volatility support a sanguine view of risks to the global economy in the near term. But increasing leverage signals potential risks down the road, and a scenario of a rapid decompression in spreads and volatility could significantly worsen the risk outlook for global growth. A retrospective real-time analysis

of the global financial crisis shows that forecasting models augmented with financial conditions would have assigned a considerably higher likelihood to the economic contraction that followed than those based on recent growth alone. This confirms that the analytical approach developed in the chapter can be a significant addition to policymakers' macro-financial surveillance toolkit.