EXECUTIVE SUMMARY

Macroeconomic shocks pose new challenges for global markets

A wide range of positive and negative macroeconomic and financial developments have occurred in the past six months. On a net basis, these developments have increased financial stability risks.

On the positive side, as discussed in the April 2015 *World Economic Outlook,* growth in 2015 is expected to be slightly higher than that of 2014, improving in advanced economies enough to offset slower growth in emerging market and developing economies. Sharply lower oil and commodity prices, coupled with lower interest rates from expanded monetary accommodation, are expected to support growth through 2016. Bold monetary policy actions have been taken in both the euro area and Japan to arrest and reverse disinflationary pressures. Quantitative easing provides a strong framework for addressing deflation risks, and some key transmission channels are already working. Spreads on credit have narrowed in the euro area, equity prices have surged, and the euro and yen have depreciated significantly, helping to raise inflation expectations.

At the same time, the U.S. dollar has appreciated substantially, reflecting diverging monetary policies. The dollar has strengthened more against major currencies during the past nine months than it has during any similar period since 1981. The resulting movements in real exchange rates have broadly reflected changes in growth prospects and exposures to lower oil prices, and should help support the global recovery.

However, the financial stability risks around this baseline are rising and rotating. Although the benefits of the improving baseline are widely distributed and accrue over time, the adverse impact of recent shocks is concentrated and is already affecting sectors and economies with preexisting vulnerabilities. Meanwhile, continued financial risk taking and structural changes in credit markets are shifting the locus of financial stability risks from advanced economies to emerging markets, from banks to shadow banks, and from solvency to market liquidity risks.

- Continued financial risk taking and search for yield keep stretching some asset valuations. The low interest rate environment also poses challenges for long-term investors, particularly for weaker life insurance companies in Europe.
- Oil- and commodity-exporting countries and firms have been severely affected by falling asset valuations and rising credit risks. Energy and commodity firms in emerging markets, which account for more than a third of nonfinancial corporate bonds issued in hard currency since 2007, have been particularly hard hit. Strains in the debt-repayment capacity of the oil and gas sector have become more evident for firms in Argentina, Brazil, Nigeria, and South Africa because of low oil prices, as well as for sovereigns reliant on oil revenues such as Nigeria and Venezuela.
- Rapidly depreciating exchange rates have increased pressures on firms that borrowed heavily in foreign currencies and have sparked significant capital outflows for several emerging markets. These developments could add stress to emerging market sovereigns that have increased their combined exposure to foreign currency borrowings and foreign investor holdings of local currency debt.
- Volatility in major exchange rates has increased by more than during any similar period since the global financial crisis. Reduced liquidity in both the foreign exchange and fixed-income markets, as well as the changing composition of the investor bases in these markets, has added frictions to portfolio adjustments. The resulting tensions in global financial markets have increased market and liquidity risks, given that sudden episodes of volatility could become more common and more pronounced.

Existing legacy challenges add to these pressures, leaving overall financial stability risks higher.

Financial stability is not fully grounded in advanced economies, and risks have increased in many emerging markets

Long-term bond yields in many advanced economies have decreased on disinflation concerns and the prospect of continued monetary accommodation. In the euro area, almost one-third of short- and long-term sovereign bonds now carry negative yields. But a prolonged low interest rate environment will pose severe challenges for a number of financial institutions. Weak European mid-sized life insurers face a high and rising risk of distress—stress tests (conducted by the European Insurance and Occupational Pensions Authority) show that 24 percent of insurers may not be able to meet their solvency capital requirements under a prolonged low interest rate scenario. The industry has a portfolio of €4.4 trillion in assets in the European Union, with high and rising interconnectedness with the wider financial system, creating a potential source of spillovers.

High debt levels in the private sector continue to hinder growth and financial stability. Accommodative monetary policies in advanced economies have helped reduce private sector debt ratios by supporting inflation and growth and by increasing asset prices. However, the assumptions for growth and inflation in this report suggest that private sector debt levels in a number of major advanced economies will remain high. This continuing high debt calls for an additional response to address the crisis legacies and unshackle economic potential. Gross corporate debt in France, Italy, Portugal, and Spain is expected to remain above or near 70 percent of GDP by 2020, and gross household debt in Portugal and the United Kingdom is projected to remain high compared with that of other major advanced economies.

At the same time there is a clear upside risk to interest rates in the United States. Two possible scenarios characterize the future normalization of U.S. monetary policy: a smooth well-telegraphed exit, or, despite clear communication, a bumpy ride with a more rapid decompression of term premiums leading to rapidly rising yields and substantially higher volatility. Indeed, declines in structural liquidity in fixed-income markets in both the United States and other economies have amplified asset price responses to shocks, increasing potential spillovers. Technological change, increased regulation, and the shifting composition of market participants have altered the microstructure of fixed-income markets. Illiquidity events now spill over to other asset classes and to emerging markets, as witnessed in the U.S. Treasury market and in policy-induced instability in foreign exchange markets following the removal of the Swiss franc floor. These developments highlight some key vulnerabilities in capital markets and the shadow banking system.

Emerging markets are caught in these global crosscurrents, as they address their own domestic challenges. Lower commodity prices and lower inflationary pressures are benefiting many emerging market economies, providing monetary policy space to combat slowing growth. However, oil- and commodity-exporting countries and countries with high foreign indebtedness face more formidable risks. Although the stronger dollar can help improve competitiveness in emerging market economies in general, and lead to higher growth, the dramatic movements in commodity prices and in the exchange rates of many emerging market economies during the past six months have already had a significant impact on firms' market valuations in these economies. Many companies borrowed heavily in international markets—substituting international borrowings in dollars for local currency borrowing from banks—potentially leading to balance sheet pressures.

In turn, a retrenchment of overinvested industries, real estate sector adjustments, and property price declines—especially in China—could spill over to emerging markets more broadly. The broader impact of a sudden deterioration in corporate health on banking system stability depends on credit exposures. In China, exposures to real estate (excluding mortgages) are almost 20 percent of GDP, and financial stress among real estate firms could lead to direct cross-border spillovers, given the substantial increase in external bond issuance since 2010. In 11 of the 21 emerging market banking systems analyzed in this report, more than half of the bank loan books consists of loans to firms, rendering them more exposed to corporate weakness, particularly in Nigeria, Peru, Turkey, and Ukraine.

In a downside risk scenario, further rapid dollar appreciation and an abrupt rise in U.S. interest rates, coupled with a rise in geopolitical risks, could put added pressure on emerging market currencies and asset markets. After a prolonged period of inflows, foreign investors could abruptly reduce their holdings of local currency debt, thereby adding to turbulence and creating debt rollover challenges. Markets also appear complacent when it comes to geopolitical and political risks. As noted in the April 2015 *World Economic Outlook,* ongoing events in Russia and Ukraine, the Middle East, and parts of Africa could lead to greater tensions and increased disruptions to global trade and financial transactions. Direct financial linkages between Russia and the rest of the world are limited, but the indirect connections with neighboring countries could raise financial stability risks. Stronger institutional frameworks in the euro area have reduced the threat of contagion from Greece, but risks and vulnerabilities remain.

A range of additional policies are required to increase policy traction and ground stability

This report assesses the policy responses of central banks in both advanced and emerging market economies. A key message is that additional policy measures—beyond monetary policies—are required to make a well-grounded exit from the crisis. Policies must address crisis legacies and facilitate sustainable economic risk taking while containing financial excesses across global markets.

To maximize the impact of quantitative easing in the **euro area,** central bank actions must be complemented with measures to restore balance sheet health in the private sector, unclog credit channels, enhance the soundness of nonbank institutions, and promote structural reforms. In particular,

- Unclogging credit channels requires comprehensive actions to tackle the burden of nonperforming loans. Despite improving bank resilience in the wake of the ECB's Comprehensive Assessment and introduction of the Single Supervisory Mechanism, asset quality continues to deteriorate, although at a slowing pace, with total nonperforming loans now standing at more than €900 billion. Banks should be encouraged to develop and use specialized internal and external capacity for handling the stock of nonperforming assets, actively manage their provisions, and write off their nonperforming assets. Further efforts are needed to improve the effectiveness of legal frameworks governing bankruptcy of companies and individuals. Without corrective policy actions, bank lending capacity could be limited to a meager 1 to 3 percent on average a year.
- The challenges facing life insurers should also be tackled promptly. Regulators need to reassess the viability of guarantee-based products and work to bring minimum return guarantees offered to policyholders in line with secular trends in policy rates. Prompt regulatory and supervisory actions are needed to mitigate damaging spillovers from potential difficulties of individual insurers. The introduction of a more harmonized safety net would further increase the industry's resilience.
- Sources of funding need to be diversified away from banks and toward capital markets. Despite the surge in capital market borrowings, they represent only about 36 percent of the system. A deeper and broader capital market would improve access to finance, particularly for smaller firms, and make financial markets more efficient. In the euro area, encouraging the use of capital markets requires harmonization of company law, corporate governance, insolvency regimes, and taxation, in line with the latest Capital Markets Union proposal by the European Commission.

In **Japan** the effectiveness of quantitative easing depends on the policies supporting it. Steadfast implementation of Abenomics' second and third arrows (fiscal and structural reforms) is essential. If these reforms are incomplete, efforts to pull the economy out of deflation are less likely to succeed. The Bank of Japan should consider strengthening the portfolio rebalancing effects of its asset purchases by increasing the share of private assets in purchases and extending the program to longer-maturity government bonds, as necessary, to achieve its 2 percent inflation target. To further stimulate bank lending to the private sector, the authorities should expand special lending facilities; jumpstart the securitization market for small and medium enterprise credits and mortgages; and enhance risk capital provision, including by encouraging more asset-based lending and removing barriers to entry and exit for small and medium enterprises.

In the **United States**, the impact of global market forces requires appropriately balanced policies, including continued clear communication of monetary policies. A smooth market adjustment will be more likely if there is extensive discussion and interpretation of key economic variables given that monetary policy is now data dependent. Yet market expectations can differ from the Federal Reserve's guidance, leading to market tensions and raising market and liquidity risks.

In the United States and other economies with significant nonbank financial systems, addressing illiquidity and potential spillovers by strengthening market structures will help enhance stability. As noted in Chapter 3, the asset management industry needs stronger oversight that combines better microprudential supervision of risks with the adoption of a macroprudential orientation. Policies should seek to address the mismatch between the liquidity promised to mutual fund owners in good times and the cost of illiquidity when redemptions must be met in times of stress. Policies can help to accomplish this objective by reducing asset owners' incentives to run (by aligning funds' redemption terms with the underlying liquidity in the assets invested); enhancing the accuracy of net asset values; increasing liquidity cash buffers in mutual funds; and improving the liquidity and transparency of secondary markets, especially of longer-term debt markets. Market participants in government bond and foreign exchange markets should also have greater incentives to provide secondary market liquidity. Authorities should review current circuit breakers to enhance their functioning. Risk management and control should be reinforced: supervisors should provide coordinated guidance to trading firms, allowing them to set consistent and appropriate risk limits on individual retail investors. Regulators and monetary authorities should consider the correlation between asset classes when evaluating systemic risks in financial markets.

Emerging markets should aim to cushion the impact of global headwinds and safeguard the resilience of their financial systems through enhanced surveillance of vulnerable sectors, particularly in the following areas:

- In China, the overall priority must be to allow an orderly correction of excesses, curtailing the riskiest parts of shadow banking. At the same time, orderly deleveraging requires comprehensive policies that allow credit growth to slow gradually and, where necessary, the mechanisms to be provided for orderly corporate debt restructuring, and the exit of nonviable firms.
- Across emerging markets more generally, the large portion of debt denominated in foreign currencies means that micro- and macroprudential measures have important roles to play in limiting the risks from shocks. Regulators need to conduct bank stress tests related to foreign currency and commodity price risks and more closely and regularly monitor corporate leverage and foreign currency exposures, including derivatives positions.
- To ensure markets function properly, authorities need to prepare for lapses of liquidity in local currency bond markets. Country authorities might potentially use cash balances when needed, or lower the supply of long-term debt to the market to help curtail bond spread increases. Bilateral and multilateral swap line agreements, by providing foreign currency funding in times of stress, can enhance confidence and help reduce excess volatility in currency markets. Multilateral resources such as IMF facilities could also provide additional buffers.

The international financial regulatory reform agenda has strengthened regulatory frameworks, and is helping to make financial institutions and the global financial system more robust. Global standard setters and national regulators now need to provide further clarity about regulatory standards—and thus improve certainty for banks adapting their business models—by finalizing the calibration of recent requirements, including the leverage ratio, the net stable funding ratio, and total loss-absorbing capital requirements. Promptly putting in place regulations to transform shadow banking into a stable source of market-based finance is also a must.

At the same time, micro- and macroprudential policies for nonbanks should be strengthened. Existing regulatory frameworks may need to be reassessed to enable the authorities to better understand the less closely regulated corners of the financial sector that could cause problems for the banking system and the broader economy, and act as needed to mitigate identified vulnerabilities.

Changes in international banking models have reduced risks in host financial systems

On a more positive note, Chapter 2, which examines changes in international banking since the global financial crisis, finds that these changes are likely to promote more stable bank lending in host countries. It also finds a need for more international cooperation for dealing with regional or global shocks to maximize the benefits of cross-border banking while mitigating risks.

International banks, especially those in Europe, have reduced their cross-border lending, while local loans by branches and subsidiaries of foreign banks abroad have remained steady. Local and regional banks have stepped in to offset, at least partially, euro area banks' reduction in exposure to some regions. As a result, intraregional linkages have deepened, in particular in Asia. Regulatory changes and weaknesses in bank balance sheets have contributed significantly in the past to the observed cutback in cross-border lending, whereas accommodative monetary policies may have slowed the cutback.

The relative shift from cross-border lending to more local lending by affiliates should improve the financial stability of host countries. Cross-border lending flows are more sensitive to global shocks than are local lending and international portfolio flows. Cross-border lending also tends to amplify the effect of adverse domestic shocks on credit. In contrast, lending by foreign subsidiaries is more resilient than lending by domestic banks during domestic crises when the parent bank is well capitalized and less dependent on nondeposit funding sources. However, restrictions on cross-border lending may jeopardize other benefits not examined in the chapter.

Oversight of asset managers must be proportional to the risks they pose to the financial system

Chapter 3 finds that the asset management industry needs to strengthen its oversight framework in two key areas: better microprudential supervision of risks and adoption of some macroprudential concerns as a standard part of its orientation. Asset management firms can provide credit to the real economy even when banks are distressed, and they have certain advantages over banks from a financial stability perspective. However, the sector's growth and the structural changes in financial systems have heightened stability concerns. Although the risks posed by leveraged hedge and money market funds are already widely recognized, opinions about less leveraged "plain-vanilla" investment products are divided.

However, even plain-vanilla products may pose financial stability risks through two channels: (1) incentive problems between end investors and portfolio managers (which potentially can lead to herding, among other things) and (2) run risk stemming from the presence of liquidity mismatches. The empirical analysis finds evidence of many of these risk-generating mechanisms, although their importance varies across asset markets. Without providing a verdict on whether large asset managers should be designated as systemically important, the analysis indicates that a fund's investment focus is relatively more important than its size when it comes to its contribution to systemic risk.

These findings suggest that securities regulators should shift to a more hands-on supervisory model, supported by global standards on supervision and better data and risk indicators. The roles and adequacy of existing risk-management tools should be reexamined to take into account the asset management industry's role in systemic risk and the diversity of its products.