A Bumpy Road Ahead for the Global Financial System

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Versions in عربي (Arabic), 中文 (Chinese), Español (Spanish), Français (French), Português (Portuguese), Русский (Russian)

The current economic environment remains favorable, but short-term risks to global financial stability have increased in the past six months, as a result of a spike in stock-market volatility in February and continuing investor concerns about rising geopolitical and trade tensions. Looking ahead, the odds of a downturn remain elevated, and there's even a small chance of a global economic contraction over the medium-term.

Policy makers should take advantage of this favorable environment to take steps that will reduce the risks. For emerging-market economies, this means strengthening economic fundamentals and buffers against external shocks; for advanced economies, it means deploying and developing their regulatory and financial policy tools and following through on plans to strengthen financial institutions.

The global financial stability assessment contained in the latest *Global Financial Stability Report* (GFSR) is based on the new "Growth-at-Risk" approach that links financial conditions to the distribution of future economic growth. Given current financial conditions, risks to financial stability and growth are high over the medium-term. This reflects the fact that recent years of low interest rates—needed to support economic growth—have provided an environment in which vulnerabilities have been building. These vulnerabilities could exacerbate the next economic downturn and could also make the road ahead bumpy.

How could today's financial vulnerabilities make the road bumpy? Larger imbalances mean that any shock to the economic or financial system would trigger a more painful adjustment. For example, a faster-than-anticipated increase in US inflation could cause the Federal Reserve and other central banks to withdraw monetary accommodation more quickly than is currently expected, and that could shake financial markets. Another risk is a wider escalation of protectionist measures, which would take a toll on financial markets as well as growth. In either case, a sudden decline in asset prices could expose vulnerabilities in the financial system.

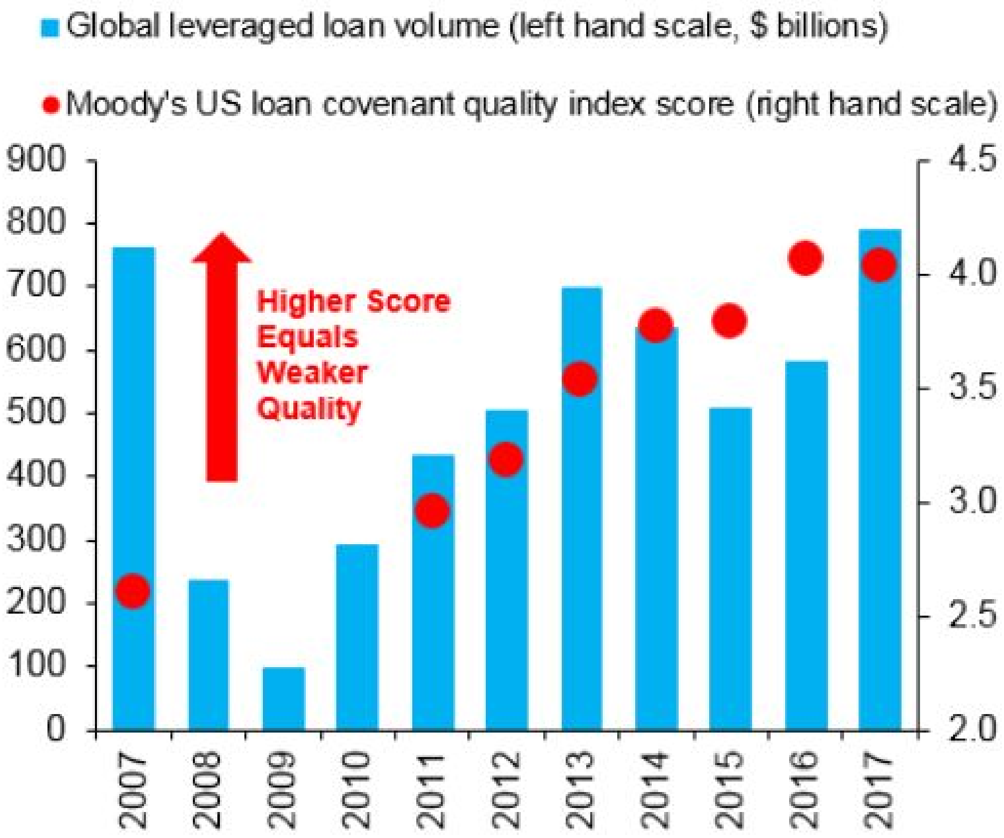
The report identifies three areas of vulnerability: weakening credit quality; external debt-related vulnerabilities in emerging markets and low-income countries; and dollar liquidity mismatches among banks outside the United States. Let's consider each in turn.

> **Weaker credit quality.** Increasingly, less creditworthy companies are able to borrow in financial markets. Global issuance of so-called leveraged loans—made to riskier companies and those with high debt loads—rose to a record $788 billion last year.

There are similar trends in corporate bond markets, where lower rated US and euro-area companies account for a growing proportion of bonds.

Leveraged lending

Global leveraged loan issuance is at record highs, and investor protections, known as covenants, are weakening.



Sources: Moody's, Standard & Poor's Leveraged Commentary and Data, and IMF staff estimates

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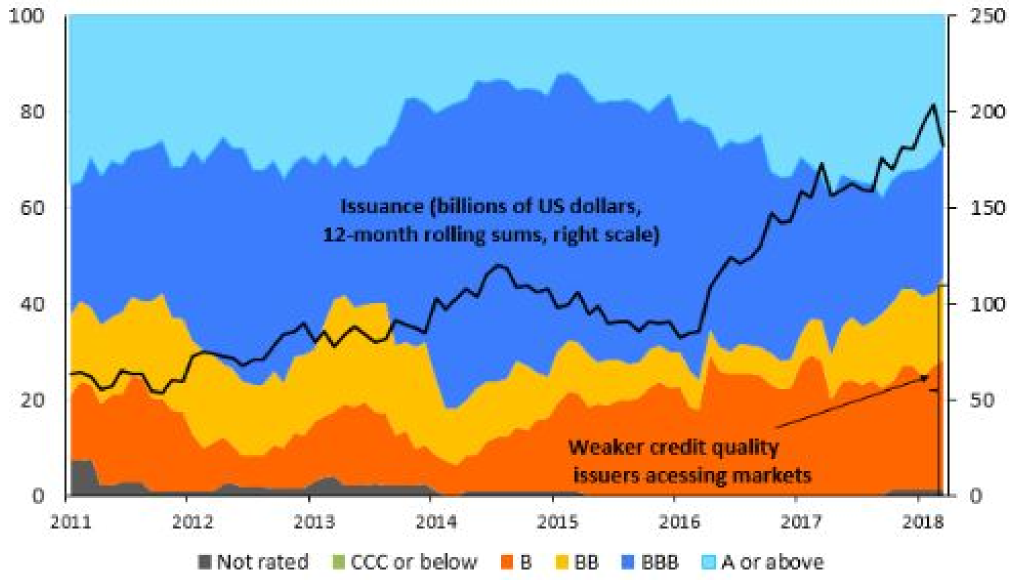
External debt in emerging-market and low-income countries. Foreign capital flows have remained robust in recent years, with more emerging and low-income economies benefitting from favorable external financing conditions. But as the global liquidity tide recedes, flows to emerging markets could decline by as much as $60 billion a year, equal to about a quarter of annual totals in 2010-17. In such a scenario, less creditworthy borrowers may experience relatively larger outflows. Low-income countries may be affected, because more than 40 percent of them are at a high risk of debt distress.

Changing credit mix

Low interest rates have given weaker issuers access to international credit markets.



Sources: Bloomberg Finance L.P., Bond Radar, and IMF staff estimates.

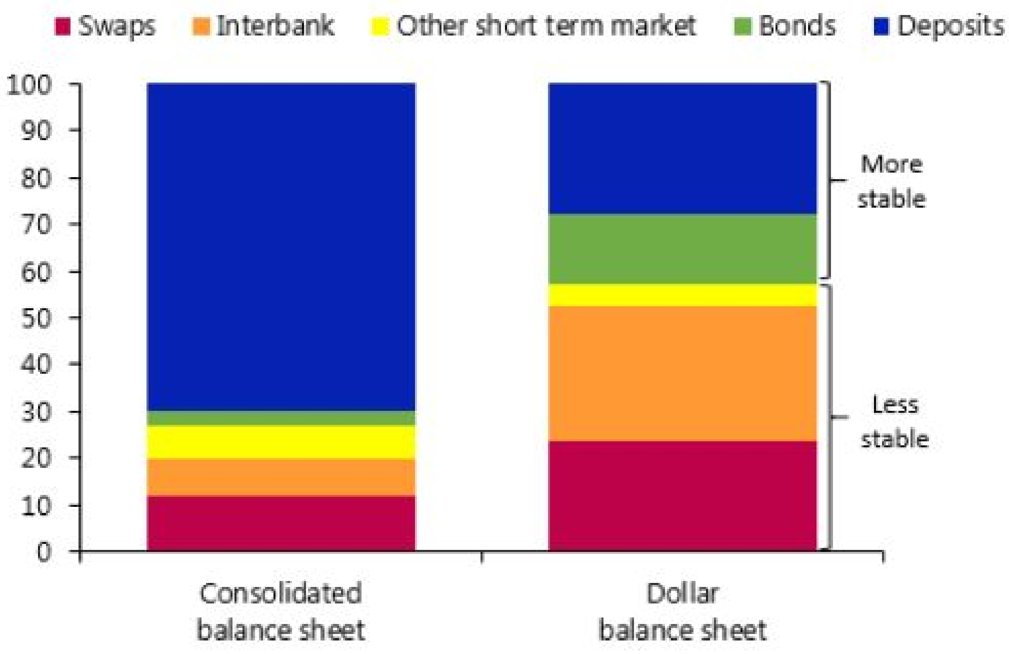
INTERNATIONAL MONETARY FUND

US dollar liquidity mismatches among non-US banks. Overall, banks are more resilient than before the global financial crisis. But internationally active non-US banks rely on short-term or wholesale sources for about 70 percent of their dollar funding. Moreover, these dollar liabilities are not always evenly matched with dollar assets in terms of size or maturity. This could leave banks exposed to dollar funding problems in the event of a sudden tightening in financial conditions and strains in markets.

Dollar mismatches

Non-US banks tend to rely on short-term wholesale dollar funding.

(funding mix of non-US banks, in percent of total, as of fourth quarter 2016)



Sources: Bank for International Settlements; bank financial statements; Bank of Japan; Federal Financial Institutions Examination Council; S&P Global Market Intelligence; and IMF staff estimates and analysis.

INTERNATIONAL MONETARY FUND

Separately, the GFSR looked at the rise of crypto assets. Some of the technologies behind these assets could make financial market infrastructures, such as payment systems, more efficient. But they have also been afflicted by fraud, security breaches, and operational failures—and have been associated with illicit activities. While the limited size of crypto assets suggests they currently pose little risk to financial stability, risks could grow if their use became more widespread without appropriate safeguards.

Policy options

Policymakers should take advantage of today's favorable environment to adopt safeguards against looming financial risks.

- Central banks should continue to gradually withdraw monetary accommodation, where appropriate, while communicating their decisions clearly.

- Regulators should address financial vulnerabilities by deploying and developing regulatory and financial policy tools.
- Policymakers should ensure that the post-crisis regulatory reform agenda is completed — and they should resist calls for rolling back reforms.
- Emerging markets and low-income countries should build reserves and fiscal buffers against external risks.

The global economic recovery has so far been resilient to the pronounced swings in financial markets—but investors and policy makers shouldn't take too much comfort from that fact. They should remain attuned to the risks associated with rising interest rates, elevated market volatility, and increasing protectionism. The road ahead may well be bumpy.

For an explanation of the new "Growth at Risk" model, click here .

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