

Financial Stability Has Improved

Financial stability has continued to improve since the October 2016 *Global Financial Stability Report* (GFSR). Economic activity has gained momentum, as outlined in the April 2017 *World Economic Outlook* (WEO), amid broadly accommodative monetary and financial conditions, spurring hopes for reflation. Longer-term interest rates have risen, helping to boost earnings of banks and insurance companies. Gains in many asset prices reflect a more optimistic outlook. Equity markets in the United States hit record highs in March on investors' hopes for tax reform, infrastructure spending, and regulatory rollbacks. Markets outside the United States have also risen steadily over the past six months, driven in part by stronger growth expectations and higher commodity prices. At the same time, risk premiums and volatility have declined.

How strong is the case for such optimism? To realize stronger growth and sustain the improvements in financial conditions, policymakers will need to implement the right mix of policies, including to (1) invigorate economic risk taking, especially in the United States, through policies that boost potential output, increase corporate investment, and avoid raising financial stability risks; (2) address domestic and external imbalances to enhance resilience in emerging market economies; and (3) respond more proactively to long-standing structural issues in European banking systems.

Policy Uncertainty Is a Key Downside Risk

New threats to financial stability are emerging from elevated political and policy uncertainty around the globe. In the United States, if the anticipated tax reforms and deregulation deliver paths for growth and debt that are less benign than expected, risk premiums and volatility could rise sharply, undermining financial stability. A shift toward protectionism in advanced economies could reduce global growth and trade, impede capital flows, and dampen market sentiment. In Europe, political tensions combined with a

lack of progress on structural challenges in banking systems and high debt levels could reignite financial stability concerns. The potential for a broad rollback of financial regulations—or a loss of global cooperation—could undermine hard-won gains in financial stability. So far, markets have taken a relatively benign view of these downside risks, suggesting the potential for a swift repricing of risks in the event of policy disappointment.

Are U.S. Companies Strong Enough to Accelerate the Expansion Safely?

Policy proposals under discussion by the new U.S. administration in the areas of tax reform and deregulation could have a significant impact on the corporate sector. Healthy corporate balance sheets are a prerequisite for these policy proposals to gain traction and stimulate economic risk taking. Many nonfinancial firms do have the balance sheet capacity to expand investment, and reductions in corporate tax burdens could have a positive impact on their cash flow. But reforms could also spur increased financial risk taking and, in some sectors, could raise leverage from already-elevated levels. The sectors that have invested the most have the highest leverage, and financing additional investment with debt will increase their vulnerabilities. Under a scenario of rising global risk premiums, higher leverage could have negative stability consequences. In such a scenario, the assets of firms with particularly low debt service capacity could rise to nearly \$4 trillion, or almost a quarter of corporate assets considered.

Emerging Market Economies Face Trying Times in Global Markets

Emerging market economies have continued to enhance their resilience by lowering corporate leverage and reducing external vulnerabilities. Their growth is expected to continue improving, driven by gains for commodity exporters and prospects for positive growth

spillovers from advanced economies. But overall financial stability risks remain elevated because global political and policy uncertainties are opening new channels for negative spillovers. A sudden reversal of market sentiment or a global shift toward inward-looking protectionist policies could reignite capital outflows and hurt growth prospects, testing the resilience of these economies.

Countries with strong international financial and trade links in particular could be challenged by tighter global financial conditions or adverse trade measures. These risks could exacerbate existing vulnerabilities in the corporate sector and could increase the debt at risk of the weakest firms by \$130–\$230 billion. A sharp turn away from the current supportive external environment could reinforce risks in countries whose weakest banks are challenged to maintain asset quality and adequately provision for bad loans after long credit booms.

China faces mounting risks to financial stability as credit continues to rise rapidly. China's bank assets are now more than triple its GDP, and other nonbank financial institutions also have heightened credit exposure. Many financial institutions continue to be overly dependent on wholesale financing, with sizable asset-liability mismatches and elevated liquidity and credit risks. Recent turbulence in money markets illustrates the vulnerabilities that remain in China's increasingly large, opaque, and interconnected system.

European Banking Systems Must Address Structural Challenges

Considerable progress has been made in the European banking sector over the past few years, and optimism about a cyclical upturn in advanced economies has helped boost European banks' equity prices. However, as assessed in the October 2016 GFSR, a cyclical recovery will likely be insufficient on its own to restore the profitability of persistently weak banks. Although many banks face profitability challenges, this is particularly true for domestic banks, which are most exposed to their home economies: almost three-quarters of these banks had weak returns in 2016 (defined as return on equity of less than 8 percent). This report examines the system-wide structural features that are compounding profitability challenges. One structural challenge is overbanking, which varies by nature and degree from country to country. Some examples

include banking systems with assets that are large relative to the economy, with a long weak tail of banks, or with too many banks with a regional focus or a narrow mandate. These features can result in limited lending opportunities or a high number of branches relative to the assets in the banking system, adding to costs and reducing operational efficiencies. Although measures are being taken to address profitability concerns, more progress needs to be made in reducing overbanking in the countries with the biggest challenges.

System-wide headwinds are a problem not only within countries but can also affect the profitability of large, systemically important banks in Europe. These institutions find it difficult to keep up with their global competitors, and in some cases this may be partly due to profitability problems in their home countries. Until these structural impediments are addressed, a simple restructuring of their business models is unlikely to yield sufficient profitability. Left unresolved, a combination of weak profits, lack of access to private capital, and large bad debt burdens impedes recovery and could reignite systemic risks.

It Is Crucial to Get the Policy Mix Right

Securing and building on improvements in stability and market expectations will require concerted and careful efforts by policymakers at the national and global levels. Policymakers should adjust the policy mix to deliver a stronger path for long-term and inclusive growth while avoiding politically expedient but ultimately counterproductive inward-looking policies. In the United States, policymakers should vigilantly monitor increased leverage and deteriorating credit quality. Regulators should preemptively address excessive financial risk taking. Prudential and supervisory actions should be taken if policy stimulus leads to an increase in debt-financed investment and rising corporate vulnerabilities. Tax reforms that reduce incentives for debt financing could help attenuate risks of a further buildup in leverage, and possibly even encourage firms to lower existing tax-advantaged leverage.

In Europe, further actions should be taken to address bank profitability and legacy challenges. Banks have the primary responsibility for developing sustainable earnings by tackling business model problems through consolidation, branch rationalization, and investment in technology to increase medium-term efficiency. Encouragingly, supervisors are increasingly

emphasizing the examination of bank business models in their supervisory frameworks. To determine weak links in banking systems with significant asset quality challenges, consideration could be given to targeted asset quality reviews for banks that have not undergone such an exercise. Regulators should then take action to resolve unviable institutions to remove excess capacity. Authorities should also focus on removing system-wide impediments to profitability, including addressing nonperforming loans and developing frameworks that accelerate recovery.

Emerging market economies should address domestic vulnerabilities to enhance their resilience to external shocks. They should seek to preserve financial stability by taking further steps to strengthen supervision and bank governance while maintaining a robust macroprudential toolkit. Bank regulators should closely monitor vulnerabilities in countries with wide net foreign-currency positions or foreign-currency maturity gaps. Policymakers should focus on strengthening the health of corporates and the banking system by proactively monitoring and reducing vulnerabilities and improving restructuring mechanisms. In China, although the authorities have recognized the urgent need to deleverage the financial system and have undertaken substantive corrective measures, supervisory attention should concentrate on banks' emerging risks, especially fast asset growth among smaller banks, increasing reliance on wholesale funding, and risks from interconnections between shadow products and interbank markets. But staving off further bouts of market instability—and ultimately, macro instability—will require measures to address the policy tension between maintaining a high level of growth and the need for deleveraging.

The postcrisis reform agenda has strengthened oversight of the financial system, raised capital and liquidity buffers of individual institutions, and improved cooperation among regulators. Caution is needed when considering any future regulatory rollback. While regulation is never costless, neither is its removal; weakening regulatory standards comes at the cost of higher financial stability risks. Decisions to opt out of mutually established regulations in an uncoordinated or unilateral manner could result in financial fragmentation and could threaten to reignite a race to the bottom in regulatory standards. Completing the regulatory reform agenda is vital to ensure that weaknesses are addressed and to reduce uncertainty. Although there is scope to

consider the impact and unintended consequences of reforms, such a review should not unravel the broad improvements achieved in buttressing the resilience of the global financial system.

This report also includes two thematic chapters analyzing the long-term implications of low growth and low interest rates for financial intermediation, and the ability of country authorities to influence domestic financial conditions in a financially integrated world.

A Long Period of Low Growth and Low Interest Rates Would Challenge Financial Intermediation

Advanced economies have experienced a prolonged episode of low interest rates and low growth since the global financial crisis. From a longer-term perspective, real interest rates have been on a steady decline over the past three decades. Despite recent signs of an increase in longer-term yields, particularly in the United States, Japan's experience suggests that an imminent and permanent exit from low rates is not necessarily guaranteed, especially in view of the prevalence of slow-moving structural factors, such as demographic aging in many advanced economies. Chapter 2 analyzes the potential long-term impact of a scenario of sustained low growth and low real and nominal rates for the business models of banks, insurers, and pension funds and for the products offered by the financial sector. It finds that yield curves would likely flatten, lowering bank earnings—particularly of smaller, deposit-funded, and less diversified institutions—and presenting long-lasting challenges for life insurers and defined-benefit pension funds. If bank deposit rates cannot drop (significantly) below zero, bank profits would be squeezed even further. Smaller, deposit-funded, and less diversified banks would be hurt most. As banks reach for yield, new financial stability challenges would arise in their home and host markets.

More generally, a “low-for-long” interest rate environment, driven by population aging, rising longevity, and stagnation in productivity, could fundamentally change the nature of financial intermediation. For example, credit demand would likely be lower in this scenario, whereas household demand for transaction services would likely rise. Consequently, bank business models in advanced economies may evolve toward fees-based and utility banking services. Demographic

changes would also increase demand for health and long-term-care insurance, and low asset returns would accelerate the transition to defined-contribution private pension plans. Demand would weaken for guaranteed-return, long-term savings products offered by insurers, and it would strengthen for passive index funds offered by asset managers. Policies could help ease the adjustment to such an environment. In general, prudential frameworks would need to provide incentives to ensure longer-term stability instead of falling prey to demands for deregulation to ease short-term pain.

Policymakers Challenged to Effectively Steer Domestic Financial Conditions amid Increased International Financial Integration

Chapter 3 shows that countries can retain influence over their domestic financial conditions in a globally integrated financial system. Although greater financial integration can complicate the management of domestic financial conditions, it need not result in a loss of control. The chapter develops financial conditions

indices that make it possible to compare a large set of advanced and emerging market economies. It finds that global financial conditions account for 20 to 40 percent of the variation in countries' domestic financial conditions, with notable differences among economies. The importance of this global factor does not, however, seem to have increased much over the past two decades.

Despite the significant role of global financial shocks, countries seem to be able to influence their own financial conditions to achieve domestic objectives—specifically, through monetary policy. But because domestic financial conditions react strongly and rapidly to global financial shocks, countries may find it difficult to implement timely policy responses. Emerging market economies, which are more sensitive to global financial conditions, should prepare for tighter external financial conditions. Governments can promote domestic financial deepening to enhance resilience to global financial shocks. In particular, developing a local investor base, as well as fostering greater equity- and bond-market depth and liquidity, can help dampen the impact of such shocks.