EXECUTIVE SUMMARY

Overall Assessment: Where Do We Stand?

As the world continues to navigate the global pandemic, financial stability risks have been contained so far, reflecting ongoing monetary and fiscal policy support and the rebound of the global economy this year. While financial conditions have eased further in advanced economies, on net, the sense of optimism that had propelled markets in the first half of the year faded somewhat over the summer. Investors have become increasingly concerned about the economic outlook amid rising virus infections and greater uncertainty about the strength of the recovery, particularly in emerging markets. In late September, concerns that inflationary pressures may be more persistent than initially anticipated have pushed nominal yields higher, in some countries entirely reversing their earlier moves. Despite some improvements since the April 2021 Global Financial Stability Report, financial vulnerabilities continue to be elevated in a number of sectors, masked in part by massive policy stimulus. Policymakers are confronted with a challenging trade-off: maintaining near-term support for the global economy while preventing unintended consequences and medium-term financial stability risks. A prolonged period of extremely easy financial conditions, while needed to sustain the economic recovery, may result in overly stretched asset valuations and could fuel financial vulnerabilities. Some warning signs—for example, increased financial risk-taking and rising fragilities in the nonbank financial institutions sector—point to a deterioration in the underlying financial stability foundations. If left unchecked, these vulnerabilities may evolve into structural legacy problems, putting medium-term growth at risk and testing the resilience of the global financial system.

Progress since the April 2021 Global Financial Stability Report

Financial conditions have eased further, on net, in advanced economies, buoyed by expectations of continued accommodative monetary policy and rising risk asset valuations. By contrast, financial conditions have changed little, on balance, in emerging markets, as monetary policy tightening in response to inflation pressure in some countries has offset gains in risk asset prices (Figure 1).

Corporate balance sheets have strengthened overall. A feared substantial pickup in bankruptcies has not...
materialized, thanks to targeted fiscal support and unprecedented monetary policy support. Revenues have risen, with profitability surpassing pre-pandemic levels in several economies (Figure 2). Credit quality in speculative-grade bond markets has continued to strengthen, with default rates expected to remain low.

Household financial positions have improved and appear to be stronger than they were during the global financial crisis. Households have benefited from lower interest rates and support for income and interest costs, including debt payment moratoria in some countries. Debt service ratios have fallen in many countries, reducing the risk of defaults on mortgage and other consumer loans (Figure 3).

In emerging and frontier market economies, the outlook for portfolio flows has improved, boosted by the ongoing economic recovery and robust global risk sentiment, even though local currency debt flows have not recovered from the first-quarter weakness. Hard currency issuance has rebounded strongly, with many lower-rated issuers returning to capital markets (Figure 4).

With a solid global capital position, the global banking sector has continued to play a crucial role in supporting the flow of credit to the economy. With the exception of a weak tail in some countries, banks have remained resilient, reflecting years of capital buildup following the global financial crisis reforms and continued unprecedented monetary and fiscal policy support.

The global financial sector—and the investment fund sector in particular—can play a crucial role in catalyzing private investment to accelerate the transition to a low-carbon economy and mitigate climate change (Chapter 3).

With investor awareness of catastrophic events rising in the wake of the pandemic, flows into sustainable funds, and into climate funds in particular, have surged since early 2020 (Figure 5). Inflows support climate stewardship and issuance of securities by “green” firms. Sustainable investors may also offer financial stability benefits as they tend to be less sensitive to short-term returns. However, the sustainable fund sector remains small ($3.6 trillion in assets under management at the end of 2020, of which only $130 billion is in climate funds).

However, Risks Remain amid Still-Elevated Financial Vulnerabilities

After declining notably through the summer, global long-term yields have risen in late September, in some countries entirely reversing their earlier moves, on concerns that price pressures may be more persistent than initially anticipated (Figure 6).
While investors still expect recent price pressures to moderate and then gradually subside, concerns about inflation risks have intensified recently in financial markets (Figure 7). In addition to the recent rise in energy and commodity prices, investors have highlighted the possibility that supply chain disruptions and shortages of labor and materials may be more persistent than currently anticipated, feeding into wage dynamics and eventually unmooring inflation expectations.

Asset valuations appear to be stretched in some market segments. Despite recent market turbulence, equity prices have risen further, on net, since the April 2021 GFSR, boosted by accommodative monetary policy and strong earnings. However, equity price misalignments (relative to fundamentals-based values) have remained elevated in most markets (Figure 8). Credit spreads have narrowed to below pre-pandemic levels. House prices have risen rapidly in many countries, reflecting, among other factors, the improved outlook, policy support, and shifting household preferences.

Emerging and frontier markets continue to face large financing needs. Local currency government bond yields have increased in many countries on the back of domestic factors (higher inflation and fiscal concerns). The late-September increase in the US Treasury yields may exert additional pressure going forward, leading to higher funding costs for many countries. Inflation pressure has led many central banks to adopt a tighter monetary policy stance. The outlook for capital flows has improved, boosted by the ongoing recovery and robust global risk appetite. Monetary conditions are still broadly accommodative, with deeply negative real rates. But there is a risk that real rates may rise significantly in coming years (Figure 9). A sudden change in the monetary policy stance of advanced economies may result in a sharp tightening of financial conditions, adversely affecting capital flows and exacerbating pressures in countries facing debt sustainability concerns.

Despite improvements during the recovery, financial vulnerabilities remain elevated in several sectors. Among nonfinancial firms, the recovery remains uneven across countries, sectors, and firm sizes. Solvency risks continue to be elevated in sectors hit hardest by the pandemic (for example, transportation and services) and in small firms (Figure 10). In China, credit conditions have tightened, particularly for firms with weak credit ratings and in provinces with weaker public finances.

Vulnerabilities in investment funds unmasked by the “dash for cash” in March 2020 remain and risks are rising at some other nonbank financial institutions as they reach for yield to meet nominal return targets. For example, life insurance companies still face elevated asset-liability duration mismatches in many jurisdictions. Seeking to enhance their
In the current environment of persistently low interest rates and ample liquidity, greater use of financial leverage to boost returns could prompt volatility in financial markets.

In the banking sector, loan underwriting standards remain restrictive in many countries. According to bank loan officer surveys, this posture is expected to persist, with risks to the credit outlook as the main constraint to loan growth. A slowdown in international bank lending may pose additional downside risks to many emerging market economies (Figure 11).

The crypto ecosystem continues its rapid growth (Figure 12), presenting new opportunities and challenges (Chapter 2). Crypto asset exchanges pose several operational and financial integrity risks through their cross-border operations. Investor protection risks loom large for crypto assets and decentralized finance. For example, stablecoins have generally poor disclosures and can be subject to runs if their reserves come into question. In emerging markets, the advent of crypto assets may be accelerating dollarization and eroding the effectiveness of existing exchange restrictions and capital control management measures. Increased trading of crypto assets by emerging market users can potentially lead to destabilizing capital flows. Emerging market and developing economies faced with these risks should prioritize strengthening macro policies and consider the benefits of issuing central bank digital currencies. And globally, policymakers should work together through the G20 Cross Border Payments Roadmap to make cross-border payments faster, cheaper, more transparent, and inclusive.

Policy Recommendations

While policy support continues to be key to sustaining the ongoing recovery, it should be tailored to country circumstances given the mixed pace of the economic recovery across countries. Central banks should provide clear guidance about their future policy stance to prevent an abrupt tightening of financial conditions. If price pressures turn out to be more persistent than currently expected, monetary authorities should act decisively to prevent an unmooring of inflation expectations. Fiscal policy should continue to support vulnerable firms and individuals. Given policy space, fiscal measures should be targeted and tailored to country characteristics and needs.

In light of the possible need for prolonged policy support to ensure a sustainable and inclusive recovery, policymakers should act decisively to address the potential unintended consequences of unprecedented measures taken during return on investment, US and European life insurers have increased their share of lower-quality bonds. In the current environment of persistently low interest rates and ample liquidity, greater use of financial leverage to boost returns
the pandemic. Policymakers should tighten selected macroprudential tools to tackle pockets of elevated vulnerabilities while avoiding a broad tightening of financial conditions. Due to possible lags between the activation and impact of such tools, they should take early action. If such tools are not available—for example, in the nonbank financial intermediary sector—policymakers should urgently develop them. Given the challenges to designing and operationalizing macroprudential tools within existing frameworks, policymakers should also consider building buffers elsewhere to protect the financial system. In particular, policymakers should urgently address vulnerabilities in investment funds through enhanced prudential supervision and regulation to raise ex ante resilience against liquidity risks. Critically, the global nature of the investment fund business makes it imperative that further reform be achieved on an internationally coordinated basis through the Financial Stability Board.

Emerging and frontier markets remain exposed to the risk of a sudden tightening in external financing conditions. They should, while leveraging the historic general special drawing rights allocation, rebuild buffers as appropriate and implement structural reforms to insulate themselves from the damage from capital flow reversals and abrupt increases in funding costs.

Policymakers in emerging markets must also address the challenges posed by digital dollarization. They should reverse or avert dollarization by strengthening the credibility of monetary policy, safeguarding central bank independence, and maintaining a sound fiscal position. Effective legal and regulatory measures will be necessary to disincentivize foreign currency use. Adequate frameworks for crypto asset service providers must be established, with coordination among national regulators. More generally, countries must reconsider capital flow restrictions in a more digital world, and cross-border collaboration and cooperation are needed to address the technological, legal, regulatory, and supervisory challenges (see Chapter 2).

To foster the growth of the sustainable fund sector and mitigate potential financial stability risks stemming from the transition to a green economy, policymakers should urgently strengthen the global climate information architecture (data, disclosures, sustainable finance classifications). Once this architecture is in place, they could also consider tools to channel savings toward transition-enhancing funds (such as financial incentives for investment in climate funds). Finally, they should conduct scenario analysis and stress testing of the investment fund sector to mitigate potential financial stability risks from the transition.