EXECUTIVE SUMMARY

Steadying the Course: Financial Markets Navigate Uncertainty

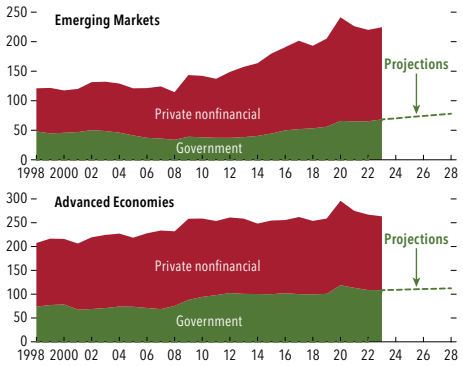
Since the April 2024 *Global Financial Stability Report*, global economic activity has moderated, and inflation has continued to slow. With monetary easing under way among major central banks, financial conditions have remained accommodative, emerging markets have remained resilient, and asset price volatility has stayed relatively low, on net. Near-term financial stability risks, according to the IMF's one-year-ahead growth-at-risk measure, remain contained at around the 40th historical percentile. However, accommodative financial conditions that keep near-term risks at bay also facilitate the buildup of vulnerabilities—such as lofty asset valuations, the global rise in private and government debt (Figure ES.1), and increased use of leverage by nonbank financial institutions—which raises risks to financial stability in the future.

These mounting vulnerabilities could amplify adverse shocks, which have become more probable due to elevated economic and geopolitical uncertainty amid ongoing military conflicts and the uncertain future policies of newly elected governments. In particular, the widening disconnect between uncertainty and market volatility (Figure ES.2) increases the chance of sudden surges in volatility and sharp asset repricing, which could be amplified by the vulnerabilities. As shown in Chapter 1, the market turmoil in early August 2024—when stock market volatility spiked in both Japan and United States (Figure ES.3) and global asset prices declined significantly—provided a glimpse of the violent reactions that can ensue when spikes in volatility interact with the use of leverage by financial institutions to create nonlinear market reactions and hasten sell-offs.

Indeed, Chapter 2 quantitatively demonstrates that further rises in economic uncertainty could increase downside risks to future growth, asset prices, and growth in bank lending. For example, assuming global real economic uncertainty jumps by an amount equivalent to its rise during the global financial crisis, the downside outcome (specifically, the 10th percentile) of one-year-ahead global real GDP growth worsens by 1.2 percentage points (Figure ES.4). This effect is stronger when macrofinancial vulnerabilities are more elevated or when market volatility is more disconnected from uncertainty. Uncertainty can also trigger cross-border spillover effects through trade and financial linkages.

This *Global Financial Stability Report* delves into the financial vulnerabilities and imbalances challenging financial stability, highlighting the urgency for policymakers to address them.

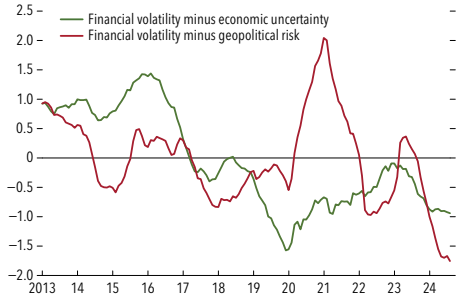
Figure ES.1. Aggregate Debt-to-GDP Ratios
(Historical z-scores)



Sources: Bank for International Settlements; and IMF staff calculations.

Note: Dashed green lines are government debt-to-GDP ratio projects based on the IMF's Global Debt Database.

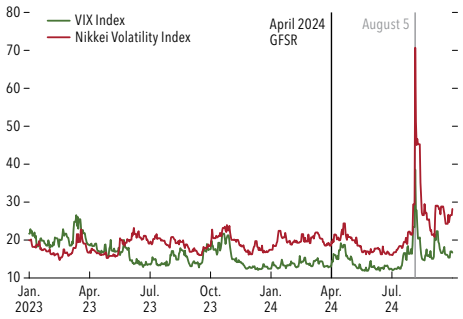
Figure ES.2. Difference of the Standardized Measures of Financial Volatility, Economic Uncertainty, and Geopolitical Risk
(Historical z-scores)



Source: Bloomberg Finance L.P.

Note: "Economic uncertainty" is from Baker, Bloom, and Davis (2016); "financial volatility" is the average of the Chicago Board Options Exchange Volatility Index (VIX), High-Yield Corporate VIX, and Currency VIX; "geopolitical risk" is from Caldara and Iacoviello (2022). Figure shows 12-month moving average values of the differences in z-scores.

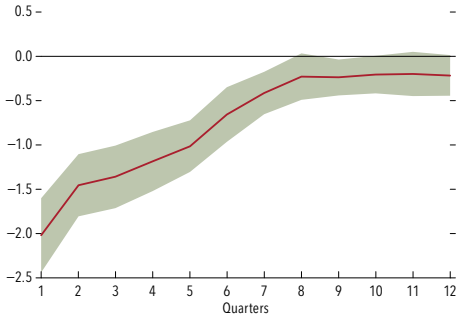
Figure ES.3. Equity Market Volatility in Japan and the United States
(Percent)



Sources: Bloomberg Finance L.P.; and IMF staff calculations.

Note: The Chicago Board Options Exchange Volatility Index, or VIX, is the benchmark measure of US stock market volatility, based on S&P 500 options. Its Japanese counterpart is the Nikkei Stock Average Volatility Index.

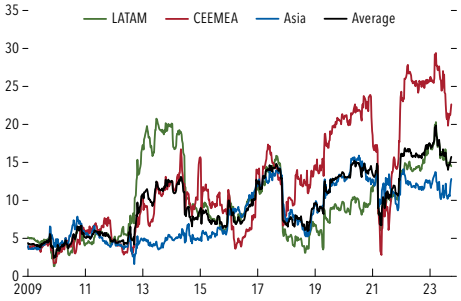
Figure ES.4. Effect of Real Economic Uncertainty on Growth-at-Risk by Horizon
(Percentage points, annualized)



Sources: IMF, Global Debt and International Financial Statistics databases; Organisation for Economic Co-operation and Development, Main Economic Indicators database; and IMF staff calculations.

Note: The figure shows the average effect of a one-standard-deviation increase in a real economic uncertainty index on the 10th percentile of the future real GDP growth distribution for a panel of advanced and emerging market economies. See Chapter 2 for a more detailed description.

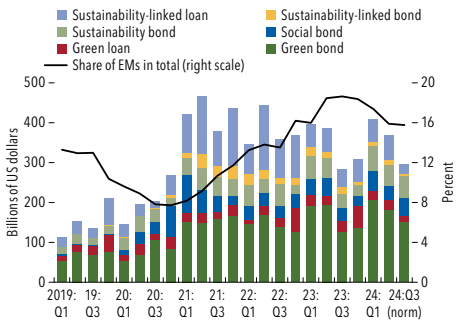
Figure ES.5. Spillover to Emerging Market Term Premiums From US Term Premiums
(Percent)



Sources: Based on Diebold and Yilmaz 2009; Bloomberg Finance L.P.; and IMF staff calculations.

Note: The figure shows the proportion of variation in emerging market term premiums explained by shocks to US term premiums (TPs). CEEMEA = Central and Eastern Europe, the Middle East, and Africa; EMs = emerging markets; LATAM = Latin America.

Figure ES.6. Global Issuance of Sustainable Debt
(Billions of US dollars, left scale; percent, right scale)



Sources: Bloomberg Finance L.P.; Bloomberg NEF; and IMF staff calculations.

Note: The share of EMs shows the four-quarter moving average of total issuance in EMs as a percentage of global issuance, and the Q3 2024 value is based on the latest available information as of August 2024. "24:Q3 (norm)" refers to the normalized value for Q3 2024, based on issuance during July–August 2024.

Vulnerabilities and Imbalances

High levels and rapid growth of sovereign debt remain a global challenge, with many jurisdictions failing to achieve their longer-term debt-stabilizing primary balances. In many advanced economies, increasingly large shares of issuances of government debt will need to be absorbed by price-sensitive buyers amid ongoing quantitative tightening by their central banks, potentially increasing bond market volatility. Emerging markets and frontier economies with weak and worsening fiscal buffers have seen their sovereign bond and credit default swap spreads increase more than those of other jurisdictions, making debt servicing more challenging.

Emerging markets have continued to demonstrate resilience since the April 2024 *Global Financial Stability Report*. Central banks have remained focused on domestic economic and inflation conditions in setting monetary policy, relying on adjustments in exchange rates to mitigate external headwinds. With major advanced economies set to ease monetary policy, pressure on emerging markets could moderate in the near term. Further ahead, however, elevated uncertainty regarding trade policies and geopolitics and a slowing growth outlook in China, a key trading partner for many emerging markets, could make preserving financial stability in emerging markets more challenging. Portfolio flows may become more volatile and access to international funding may be more difficult, especially for frontier economies. Indeed, interest rate spillovers from advanced economies to emerging markets have increased over the past decade, as changes in the 10-year US term premium—risk premiums investors demand to hold longer-term securities—have explained an increasing share of the changes in the term premiums of 10-year emerging market bonds (Figure ES.5).

Global issuance of sustainable debt has rebounded in 2024. However, emerging markets account for just 13 percent of year-to-date issuance (Figure ES.6), and the share of emerging market sustainable debt denominated in local currencies is small. Underinvestment in climate finance could delay mitigation and adaptation efforts and could challenge financial stability in the future.

Even if global interest rates are declining, many firms would find debt servicing a challenge in coming years. Although solid economic activity and healthy corporate balance sheets have kept margins robust for some firms, defaults have steadily risen as weaker firms have struggled. Some midsized companies borrowing at high interest rates in private credit markets are becoming increasingly strained and have resorted to payment-in-kind methods, effectively deferring interest payments and piling on more debt. In addition, trade restrictions and geopolitical events are likely to affect corporations through higher

input costs and a reduced capacity to make interest payments. Despite mounting signs of credit deterioration, corporate bonds have continued to trade within tight spreads by historical standards, leading to pricing misalignments that indicate an increased risk of an abrupt repricing of credit risk.

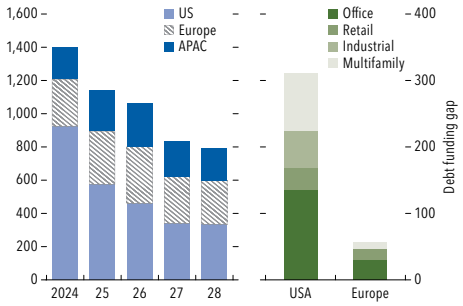
Although stability risks from residential real estate appear contained in most countries, pressures on the commercial real estate (CRE) sector remain acute. Misalignment in prices and fundamentals point to further corrections in the CRE market, especially the embattled office sector. Funding could be withdrawn, pushing down prices and putting more financial institutions under pressure in an adverse feedback loop (Figure ES.7). Both banks with outsized concentrations in CRE and nonbank investors such as real estate investment trusts may experience strains.

The global banking sector has remained resilient, with ample capital and liquidity buffers. Although nonperforming loan ratios have increased for some forms of lending, such as consumer credit cards, automobile loans, and CRE, overall asset quality has not deteriorated significantly. However, net interest margin and bank profitability could be negatively impacted by interest rate cuts, and the temporary sell-off of some banks' stocks in early August highlighted some of the risks ahead, particularly for a relatively large tail of weaker institutions facing challenges related to their business models (Figure ES.8).

The market turmoil in early August serves as another example of how nonbank financial intermediations (NBFIs) can transmit strains through the financial system and amplify stress, as the rapid unwinding of leveraged positions can generate liquidity imbalances that increase volatility. With the growth of open-ended bond funds, hedge funds, and private credit, the use of leverage among several NBFI segments is increasing. Data gaps, which hinder authorities' ability to assess the vulnerabilities associated with nonbank leverage and to identify large and concentrated positions, present a key challenge in addressing these issues.

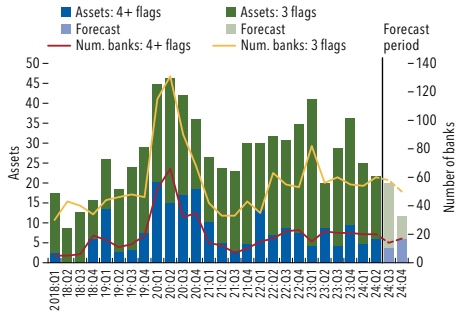
Use of artificial intelligence (AI) in capital market activities may further support the growth of NBFIs. Chapter 3 shows that although adoption of AI in trading and investment activities is still at a relatively early stage, it could accelerate in the coming years: For example, the share of applications related to AI and machine learning in patent filings in asset management has risen impressively in recent years (Figure ES.9). Although adopting these new technologies may bring efficiencies and cost savings to both banks and NBFIs, the latter are generally more agile and subject to fewer constraints in using AI. Indeed, NBFIs are already dominating several asset markets

Figure ES.7. Maturing Commercial Real Estate Debt and Funding Gap
(Billions of US dollars)



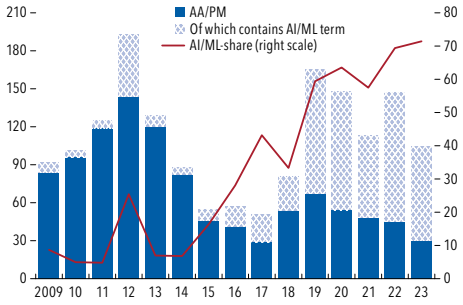
Sources: AEW; EUROPACE AG/Haver Analytics; Trepp; and IMF staff calculations.
Note: APAC = Asia and Pacific.

Figure ES.8. Banks Signaling Vulnerabilities in Three or More Areas of Risk
(Total assets, trillions of US dollars)



Sources: Visible Alpha; and IMF staff calculations.
Note: Forecast period is based on aggregate consensus analysts' forecasts. Num. = number of.

Figure ES.9. Patents in Asset Management Related to Artificial Intelligence
(Number; percent, right scale)



Sources: World Intellectual Property Organization, PATENTSCOPE database; and IMF staff calculations.
Note: Aggregate patents may not be an exhaustive accounting of all patents filed with national authorities and are limited to those available in the PATENTSCOPE database. See Chapter 3 for details. AA = asset allocation; AI = artificial intelligence; ML = machine learning; PM = portfolio management.

amenable to electronic trading. Widespread adoption could also worsen financial fragilities in the future, through potentially higher volatility during market stress, more opacity, and challenges in monitoring how AI is used in capital markets and by whom, reliance on a few key AI service providers increasing operational risks, and growing risks of cyber and market manipulation.

Policy Recommendations

Although near-term financial stability risks appear contained, vulnerabilities are mounting in the financial system. Now is the time for policymakers to act to limit fragilities. For central banks, clear communications that the path of monetary policy should not react excessively to any individual data point would help reduce uncertainty. Where growth and inflation momentum are set to continue, central banks should gradually ease monetary policy toward a more neutral stance. Where inflation remains stubbornly above targets, central banks should push back against overly optimistic investor expectations for monetary policy easing.

With sovereign debt in many countries substantially above prepandemic levels, fiscal adjustments should focus primarily on credibly rebuilding buffers to keep financing costs reasonable, help anchor medium-term inflation expectations, and contain risks of sovereign rating downgrades. For countries with less fiscal space, the credibility of fiscal plans is imperative to prevent cliff effects in ratings that could adversely affect financing conditions. Sovereign borrowers in frontier economies and low-income countries should strengthen efforts to contain risks associated with their debt vulnerability through, among other measures, communications with creditors, multilateral cooperation, and support from the international community.

With the continued growth of NBFIs, from open-ended investment funds to hedge funds and private funds, the risks from increased maturity mismatches and leverage underscore the need for more active regulatory and supervisory engagement. It is crucial to enhance reporting requirements for NBFIs and to strengthen policies that mitigate vulnerabilities and mechanisms of amplification stemming from nonbank leverage. Improving NBFIs' liquidity preparedness, implementing the Financial Stability Board's agreed-upon standards, and enhancing stress testing for nonbanks could reduce systemic risks.

Continued buildup of debt and elevated economic uncertainty underscore the need to strengthen the macroprudential policy framework to contain excessive risk taking in the nonbank financial sector and to ensure that capital and liquidity buffers in banking systems are adequate to support the provision of credit through periods of stress. Policymakers should tighten macroprudential tools to increase resilience against a range of shocks while avoiding a broad tightening of financial conditions.

Continued vigilance is warranted to monitor vulnerabilities of corporations and the CRE sector. To ensure resilience within the banking system and to inform decisions regarding capital adequacy, authorities should conduct stress-testing exercises that incorporate scenarios involving trade restrictions, geopolitical events, and significant declines in CRE prices. Given the increasingly significant role of private credit in financial markets, enhancing reporting requirements to improve monitoring and management of risks is imperative.

The tail of weak banks in the global financial system and the risk of contagion to healthy institutions underscore the need to be ready to address financial instability. It is crucial to ensure that supervisors are equipped to intervene early and that banks are prepared to access central bank liquidity. Further progress on adopting and implementing frameworks for recovery and resolution is critical for addressing weak or failing banks without undermining financial stability or risking public funds. Full, timely, and consistent implementation of international standards remains important in enhancing prudential frameworks.