EXECUTIVE SUMMARY

Risks to global financial stability have increased since the October 2015 *Global Financial Stability Report*. In advanced economies, the outlook has deteriorated because of heightened uncertainty and setbacks to growth and confidence. Disruptions to global asset markets have added to these pressures. Declines in oil and commodity prices have kept risks elevated in emerging market economies, while greater uncertainty about China's growth transition has increased spillovers to global markets. These developments tightened financial conditions, reduced risk appetite, raised credit risks, and stymied balance sheet repair, undermining financial stability.

Many market prices dropped dramatically during the turmoil in January and February, moving asset valuations to levels below those consistent with macroeconomic fundamentals that suggest a steady but slowly improving growth path (see the April 2016 *World Economic Outlook*). Instead, heightened market volatility and risk aversion may have reflected rising economic, financial, and political risks as well as weakened confidence in policies. The recovery in asset prices since February has reversed much of these losses and lowered volatility. Market sentiment has been supported by higher oil and commodity prices, stronger data out of the United States, and supportive actions by central banks. But the net impact of the turmoil has been a shock to confidence, with negative repercussions for financial stability.

The main message of this report is that additional measures are needed to deliver a more balanced and potent policy mix for improving the growth and inflation outlook and securing financial stability. In the absence of such measures, market turmoil may recur. In such circumstances, rising risk premiums may tighten financial conditions further, creating a pernicious feedback loop of fragile confidence, weaker growth, lower inflation, and rising debt burdens. Disruptions to global asset markets could increase the risks of tipping into a more serious and prolonged slowdown marked by financial and economic stagnation. In a situation of financial stagnation, financial institutions responsible for the allocation of capital and mobilization of savings might struggle with impaired balance sheets for an extended period of time. Financial soundness could become eroded to such an extent that both economic growth and financial stability are adversely affected in the medium term. In such a scenario, world output could fall by 3.9 percent relative to the baseline by 2021.

Policymakers need to build on the current economic recovery and deliver a stronger path for growth and financial stability by tackling a triad of global challenges—legacy challenges in advanced economies, elevated vulnerabilities in emerging markets, and greater systemic market liquidity risks. Progress along this path will enable the world's economies to make a decisive break toward a strong and healthy financial system and a sustained recovery. In such a scenario, world output could expand by 1.7 percent relative to the baseline by 2018.

Advanced economies must deal with crisis legacy issues. Banks in advanced economies have become safer in recent years, with stronger capital and liquidity buffers and progress in repairing balance sheets. Despite these gains, banks came under market pressure at the start of the year, reflecting concerns about the profitability of banks' business models in a weak economic environment. Approximately 15 percent of banks in advanced economies (by assets) face significant challenges in attaining sustainable profitability without reform. In the euro area, market pressures also highlighted long-standing legacy issues, indicating that a more complete solution to European banks' problems cannot be further postponed. Elevated nonperforming loans urgently need to be tackled using a comprehensive strategy, and excess capacity in the euro area banking system will have to be addressed over time. In the United States, mortgage markets—which were at the epicenter of the 2008–09 crisis—continue to benefit from significant government support. Authorities should reinvigorate efforts to reduce the dominance of Fannie Mae and Freddie Mac and continue with reforms of these institutions.

Chapter 3 shows that across advanced economies, the contribution of the insurance sector—particularly life insurers—to systemic risk has increased, although not yet to the level of the banking sector. This increase is largely a result of growing common exposures to aggregate risk, partly because insurers' interest rate sensitivity has risen and partly because of higher correlations across asset classes. In the event of an adverse shock, therefore, insurers are unlikely to fulfill their role as financial intermediaries at a time when other parts of the financial system are also struggling to do so.

These findings suggest that a more macroprudential approach to supervision and regulation of insurance companies should be taken. Measures could include regular macroprudential stress testing or the adoption of countercyclical capital buffers. Steps that would complement a push for stronger macroprudential policies include the international adoption of capital and transparency standards for the sector. In addition, the different behavior of smaller and weaker insurers warrants attention by supervisors.

Emerging markets need to bolster their resilience to global headwinds. Emerging market economies are faced with a difficult combination of slower growth, weaker commodity prices, and tighter credit conditions, amid more volatile portfolio flows. This mixture has kept financial and economic risks elevated. So far, many economies have shown remarkable resilience to this more difficult domestic and external environment, as policymakers have made judicious use of buffers in strengthened policy frameworks.

Commodity-related firms are cutting capital expenditures sharply as high private debt burdens reinforce risks to credit and banks. Commodity-exporting countries and those in the Middle East and the Caucasus are particularly exposed to strains across the real economy and the financial sector. The nexus between state-owned enterprises (SOEs) and sovereigns has intensified, and could increase fiscal and financial stability risks in countries with repayment pressures. More broadly, debt belonging to nonfinancial corporations with reduced ability to repay have risen to $650 billion, or 12 percent of total corporate debt of listed firms considered in this report. Bank capital buffers are generally adequate, but will likely be tested by weaker earnings and the downturn in the credit cycle.

Emerging market economies generally have the tools to boost their resilience and counter the effects of lower commodity prices and the slowdown in growth and capital flows. Authorities in emerging market economies should continue to use their buffers and policy space, where available, to smooth adjustment and strengthen sovereign and bank balance sheets. This includes using external buffers, fiscal and monetary policy, and macroprudential and supervisory frameworks, among other tools. Countries with insufficient buffers and limited policy space should act early by adjusting macroeconomic policies to address their vulnerabilities, including by seeking external support.

China's economic rebalancing is gaining traction. The country has made notable progress in rebalancing its economy toward new sources of growth and addressing some financial sector risks. In addition, stricter regulation of shadow banking activities has helped steer the composition of financing toward bank loans and bond issuance. Nevertheless, China's rebalancing is inherently complex, and commitment to a more ambitious and comprehensive policy agenda is urgently needed to stay ahead of rising vulnerabilities. Slowing growth has eroded corporate sector health, with falling profitability undermining the debt-servicing capacity of firms holding some 14 percent of the debt of listed companies, adding to balance sheet stresses across the system. A comprehensive plan to address the corporate debt overhang would assist a steady deleveraging process. Corporate deleveraging should be accompanied by a strengthening of banks and social safety nets, especially for displaced workers in overcapacity sectors. A comprehensive restructuring program to deal with bad assets and strengthen banks should be developed swiftly, along with a sound legal and institutional framework for facilitating bankruptcy and debt-workout processes.

Chapter 2 finds that spillovers of emerging market shocks to equity prices and exchange rates have risen substantially, and now explain more than a third of the variation in asset returns. This underscores the importance for policymakers in both advanced economies and emerging markets of taking account of economic and policy developments in emerging market economies when assessing domestic macro-financial conditions. Financial integration, more than economic size and trade integration, is key to an emerging market economy's role as receiver and emitter of financial spillovers. The level of integration explains, for example, why purely financial contagion from China remains less significant even as the impact of Chinese growth shocks is increasingly important for equity returns in both emerging market and advanced economies. As China's role in the global financial system continues to grow, clear and timely communication of its policy decisions and transparency about its policy goals and strategies consistent with their achievement will be ever more important. Given the evident relevance of corporate leverage and mutual fund flows in amplifying spillovers of shocks, shaping macroprudential surveillance and policies to contain systemic risks arising from these channels will be vital.

The resilience of market liquidity should be enhanced. As discussed in previous reports, a comprehensive approach to reducing risks of liquidity runs on mutual funds and strengthening the provision of market liquidity services is needed to avoid the risk of amplifying market shocks.

The stakes are high. First, rising risks of weakening growth and more instability must be avoided. Then, growth must be strengthened and financial stability improved *beyond the baseline*. An ambitious policy agenda is required, comprising a more balanced and potent policy mix, including stronger financial reforms together with continuing monetary accommodation. Increased confidence in policies will help reduce vulnerabilities, remove uncertainties, and touch off a virtuous feedback loop between financial markets and the real economy.