EXECUTIVE SUMMARY

The global financial system is undergoing a number of challenging transitions on the path to greater stability. As the economic recovery in the United States gains footing, U.S. monetary policy has begun to normalize. Emerging market economies are transitioning to more sustainable growth in the financial sector, while addressing macroeconomic vulnerabilities amid a less favorable external financial environment. The euro area is strengthening bank capital positions as it moves from fragmentation to a more robust framework for integration.

These transitions are far from complete, and stability conditions are far from normal. Since October, bouts of financial turbulence have highlighted the substantial adjustment that lies ahead. In advanced economies, financial markets continue to be supported by extraordinary monetary accommodation and easy liquidity conditions. They will need to transition away from these supports if they are to create an environment of self-sustaining growth, marked by increased corporate investment and growing employment.

For advanced and emerging market economies alike, a successful shift from "liquidity-driven" to "growth-driven" markets requires a number of elements, including a normalization of U.S. monetary policy that avoids financial stability risks; financial rebalancing in emerging market economies amid tighter external financial conditions; further progress in the euro area's transition from fragmentation to robust integration; and the successful implementation of "Abenomics" to deliver sustained growth and stable inflation in Japan.

Transition from Liquidity- to Growth-Driven Markets

United States	**Normalizing monetary policy:** a "Goldilocks" exit?
Emerging markets	**As the tide of liquidity ebbs:** more financial balancing needed
Euro area	**From fragmentation to robust integration:** progress, but picture still mixed
Japan	**From deflation to reflation:** so far so good, but much work lies ahead

The gradual shift to self-sustaining growth is most advanced in the United States, where green shoots are evident from the economic recovery under way, as noted in the April 2014 *World Economic Outlook*. The U.S. transition presents several challenges to financial stability. The "search for yield" is becoming increasingly extended, with rising leverage in the corporate sector and weakening underwriting standards in some pockets of U.S. credit markets. Weaker market liquidity and the rapid growth of investment vehicles that are vulnerable to redemption risk could amplify financial or economic shocks. In this transitional period, the reduction in U.S. monetary accommodation could have important spillovers to advanced and emerging market economies alike as portfolios adjust and risks are repriced.

Amid this shifting global environment, emerging market economies face their own transition challenges, but with substantial differences across economies. Private and public balance sheets have become more leveraged since the beginning of the crisis and thus are more sensitive to changes in domestic and external conditions. Macroeconomic imbalances have increased in a number of economies in the past few years, while the increased participation of foreign investors in domestic bond markets exposes some economies to an additional source of market volatility and pressure on capital flows.

These developments have created a "systemic liquidity mismatch," that is, a disjunction between the potential scale of capital outflows and the capacity of local institutions and market makers (in particular, international banks) to intermediate them. This bottleneck could magnify the impact of any shocks emanating from other economies and broaden the impact on asset prices, particularly if asset managers seek to hedge exposures by taking positions in more liquid but unrelated markets. The mismatch could create circumstances where authorities may have to provide liquidity to particular distressed markets to keep local bond and money markets working and contain spillovers across economies.

In the corporate sector of emerging market economies, this report suggests companies in many cases have sufficient buffers to withstand normal domestic or international shocks, although some vulnerabilities are evident. In a severe and adverse scenario where borrowing costs escalate and earnings deteriorate significantly, the debt at risk held by weaker, highly leveraged firms could increase by $740 billion, rising on average to 35 percent of total corporate debt in the sample of firms. In most emerging market economies, reported bank capital buffers and profitability generally remain high and should be sufficient to absorb moderate shocks to nonfinancial companies. Nonetheless, in several economies, weak provisioning and lower levels of bank capital could present difficulties in the event of further balance sheet deterioration in the corporate sector.

In China, the challenge for policymakers is to manage an orderly transition toward more market discipline in the financial system, including the removal of implicit guarantees. In this process, investors and lenders will have to bear some costs of previous financial excesses, and market prices will need to adjust to more accurately reflect risks. Pace is important. If the adjustment is too fast, it risks creating turmoil; if too slow, it will allow vulnerabilities to continue building. Other keys to the success of an orderly transition include upgrading the central bank's ability to address unpredictable shifts in liquidity demand, timely implementation of deposit insurance and interest rate liberalization, and strengthening the resolution framework for failed financial institutions.

In the euro area, policies implemented at both the national and European levels are supporting the transition to a more robust framework for integration, but important challenges remain. The restructuring of the debt-burdened euro area corporate sector has been stalled by the unfinished repair of bank balance sheets. Moreover, credit conditions remain difficult in stressed euro area economies. Although market sentiment regarding stressed euro area banks and sovereigns has improved markedly, it may be running ahead of the necessary balance-sheet repair. Thus, European policymakers must push ahead with a rigorous and transparent assessment of the current health of the banking system, followed by a determined cleansing of balance sheets and the removal of banks that are no longer viable. Additional measures to improve nonbank credit and equity channels are also required. The resulting tangible strengthening of balance sheets will help reinforce the improved optimism in financial markets.

In Japan, continued monetary accommodation is necessary but not sufficient for renewed economic dynamism to take root. The transition to higher sustained growth and lower debt-related risks requires the enactment of persuasive structural reforms. The first stages of Abenomics have been largely successful in altering deflationary expectations, but consolidating these gains in financial stability and expanding them will require continued efforts.

More broadly, maintaining the momentum and impetus for reform and good policies may prove challenging, amid a crowded electoral calendar in many countries. Geopolitical risks related to Ukraine could also pose a more serious threat to financial stability if they were to escalate. Greater spillovers to activity beyond neighboring trading partners could emerge if further turmoil leads to a renewed bout of increased risk aversion in global financial markets, or from disruptions to trade and finance. Against this backdrop, there is a need for strengthened and cooperative policy actions to help reduce risks of renewed turmoil in the global economy, both by reducing external imbalances and their associated internal distortions and by improving market confidence. Furthermore, an enhanced dialog between supervisors in advanced and emerging market economies should help ensure that cross-border liquidity and credit are not disrupted.

Chapter 2 discusses the evolving landscape of portfolio investment in emerging market economies over the past 15 years. Their financial markets have deepened and become more globalized. Greater direct participation by global investors has stimulated the development of new asset class segments, including local currency sovereign debt markets. The mix of global investors has also changed, and bond funds have become more prominent—especially local currency funds, open-end funds with easy redemption options, and funds investing only opportunistically in emerging market economies. Chapter 2 draws on a variety of methods and relatively unexploited data to examine the implications of these changes for the stability of portfolio flows and asset prices in emerging market economies.

It finds that changes in the composition of global portfolio investors are likely to make overall portfolio flows more sensitive to global financial shocks. The share of more volatile bond flows has risen, and larger foreign participation in local markets can transmit new instability. The growing activity of institutional investors is potentially more stable, but when facing an extreme shock, they can pull back even more strongly and persistently than other asset managers. While domestic macroeconomic conditions matter, herd behavior among global funds continues, and there are few signs that differentiation along local macroeconomic fundamentals during crises has increased over the past 15 years.

However, the progress made so far by emerging market economies in promoting a larger local investor base, deepening their banking sectors and capital markets, and improving their institutions has reduced their sensitivity to global financial shocks. A continuation of these efforts can help emerging market economies reap benefits from financial globalization while minimizing its potential costs.

Chapter 3 looks at how implicit funding subsidies for banks considered too important to fail (TITF) have changed over the past few years. Government protection for TITF banks creates a variety of problems: an uneven playing field, excessive risk taking, and large costs for the public sector. Because creditors of TITF institutions do not bear the full cost of failure, they are willing to provide funding without paying much attention to the banks' risk profiles, thereby encouraging leverage and risk taking. During the global financial crisis, governments intervened with large amounts of funds to support distressed banks and safeguard financial stability, leaving little uncertainty about their willingness to bail out failing TITF institutions. These developments have further reinforced incentives for banks to become large, and indeed, the concentration of the banking sector in many economies has increased. In response, policymakers have undertaken ambitious financial reforms to make the financial system safer, including addressing the TITF problem.

Chapter 3 assesses whether these policy efforts are sufficient to alleviate the TITF issue. In particular, it investigates the evolution of the funding cost advantages enjoyed by systemically important banks (SIBs). The expectation of government support in case of distress represents an implicit public subsidy to those banks. This subsidy rose in all economies during the crisis. Although it has declined in most economies since then, it remains elevated, especially in the euro area, likely reflecting different speeds of balance-sheet repair as well as differences in the policy response to the problems in the banking sector. Nonetheless, the expected probability that SIBs will be bailed out in case of distress has remained high in all regions.

Although not all measures have been implemented yet, there is still scope for a further strengthening of reforms. These reforms include enhancing capital requirements for SIBs or imposing a financial stability contribution based on the size of the liabilities of banks. Progress is also needed in facilitating the supervision and resolution of cross-border financial institutions. In these areas, international coordination is critical to avoid new distortions and negative cross-country spillovers, which may have become even more important because of country-specific policy reforms.