

FOREWORD

Twice a year, the *Global Financial Stability Report* (GFSR) assesses the degree to which developments in the financial sector may affect future economic conditions by analyzing macro-financial linkages and then identifies policies to mitigate risks to growth from the financial sector. At the current juncture, investor risk appetite is buoyant globally: since the last report in April, funding conditions have continued to improve, asset return volatility has receded to multiyear lows across markets, and global capital flows have surged. This easing of financial conditions has supported global growth and financial inclusion, with credit being allocated to benefit a broad range of borrowers. These favorable conditions create a window of opportunity to strengthen the financial system that should be seized, since experience has taught us that it is during times of easy financial conditions that vulnerabilities build.

Chapter 1 of this GFSR documents how the continuation of monetary accommodation in advanced economies—necessary to support activity and boost inflation—is associated with rising asset valuations and higher leverage, and how this environment makes the system more vulnerable to future shocks. Chapter 2 focuses on household leverage, showing that ample credit growth portends benign conditions in the near term but larger downside risks in the medium term—and thus creates an intertemporal tradeoff. Chapter 3 takes this logic a step further and directly links the easing of financial conditions to downside risks to GDP growth. Easy financial conditions fuel growth in the shorter term, but when those conditions are coupled with a buildup in leverage, risks to growth rise in the medium term. In fact, we propose to measure financial stability by a measure of Growth

at Risk, defined as the value at risk of future GDP growth as a function of financial vulnerability.

The analysis in all three chapters underscores that some of the factors that have contributed to recent gains in financial stability could put growth at risk in the medium term in the absence of appropriate policies to address rising financial vulnerabilities. Macroprudential policies, such as those that address underwriting standards, are the primary tool for guarding against future risks to growth from the global financial system. Now is the time to further strengthen that system, particularly by focusing on nonbank institutions, whose vulnerabilities are rising. Macroprudential policies that mitigate the buildup of medium-term risks can also help to better balance monetary policy tradeoffs.

Whereas vulnerabilities are rising in the nonbank financial system, the safety of the global systemically important banks (GSIBs) has improved significantly. Those banks have more capital and more liquidity and are subject to tighter supervision, thanks to the pivotal reforms undertaken after the 2008 global financial crisis. Yet some GSIBs still struggle to adapt their business models to ensure their continued health and profitability, which is critical if they are to fulfill their primary mandate: lending to the real economy. A review of the unintended consequences of the postcrisis regulatory reforms will likely lead to some streamlining in the implementation of banking regulations, but it is essential that the overall high level of capital and liquidity be preserved, regulatory uncertainty be avoided, and the global financial regulatory reform agenda be completed. Equally essential is continuing international regulatory cooperation.

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