FOREWORD

Ten years since the failure of Lehman Brothers the global economy continues to grow and progress toward a safer global financial system is undeniable. New supervisory and regulatory standards, tools, and practices have been developed and implemented across the globe. Banks are now stronger because the quality and quantity of capital has increased steadily, and minimum liquidity standards have been phased in around the world. Supervisory stress testing has been broadly adopted, and many jurisdictions now have macroprudential frameworks and policy tools with which to address systemic risks. Many shadow-banking activities that contributed to the global financial crisis have been curtailed or transformed into safer market-based finance.

So, looking back, a new financial architecture has been put in place, a testament to the resolve of policymakers to work together internationally to avoid a repeat of the Great Depression. But is the financial system safe enough? Looking ahead, clouds appear on the horizon. The global economic recovery has been uneven and inequality has risen, fueling inward-looking policies and contributing to increased policy uncertainty. Trade tensions have emerged, and a further escalation may damage market sentiment and significantly harm global growth. Support for multilateralism has been waning, a dangerous undercurrent that may undermine confidence in policymakers' ability to respond to future crises. Nonetheless, despite trade tensions and continued monetary policy normalization in a few advanced economies, global financial markets have remained buoyant and appear complacent about the risk of a sudden, sharp tightening in financial conditions.

A combination of rising U.S. interest rates, a stronger dollar, and the intensification of trade tensions have already led to market pressures and capital outflows in some emerging market economies. The most vulnerable countries have faced a difficult market environment, experiencing large currency depreciations, difficulties in rolling over external debt, and sharp reversals of portfolio flows. Although emerging market exchange rates have become more correlated recently, stress has continued to be largely idiosyncratic, and there is little evidence of broader spillovers to the asset class at this point. Robust global risk appetite has so far masked the challenges emerging markets may face should global financial conditions suddenly tighten sharply. In that eventuality, the risk of contagion to the broader emerging market universe could ensue, highlighting the importance of avoiding complacency.

A more significant tightening in global financial conditions will expose financial vulnerabilities that have built over the years and will test the resilience of the global financial system. The ratio of total nonfinancial sector debt to GDP in jurisdictions with systemically important financial sectors stands at an all-time high of 250 percent, asset valuations remain stretched across several sectors and regions, and underwriting standards are deteriorating, including in many segments of market-based finance. A new market structure has emerged in the decade since the crisis. The resilience of market liquidity provision in the new institutional environment has yet to be tested under more adverse conditions, and it will affect the ability of the financial system to absorb, rather than propagate, an adverse shock.

As clouds gather on the horizon, it is crucial for countries around the world to complete and implement the global regulatory reform agenda and to resist the call to roll back reforms. To counteract rising vulnerabilities, macro- and microprudential policies should be developed and deployed, as warranted. For example, more active use of countercyclical capital buffers may have merit at this juncture. Prudential regulation and supervision need to remain attentive to, and lean against, emerging risks, including those related to cyberthreats, new technologies, and other risky activities thriving outside the regulatory perimeter. International cooperation is crucial for maintaining global financial stability and fostering sustainable economic growth. The IMF remains a key player for promoting cooperative financial policies.

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