

The October 2019 *Global Financial Stability Report* at a Glance

Key Vulnerabilities in the Global Financial System

- Rising corporate debt burdens
- Increasing holdings of riskier and more illiquid assets by institutional investors
- Greater reliance on external borrowing by emerging and frontier market economies

What Should Policymakers Do?

- Address corporate vulnerabilities with stricter supervisory and macroprudential oversight
- Tackle risks among institutional investors through strengthened oversight and disclosures
- Implement prudent sovereign debt management practices and frameworks

Financial markets have been buffeted by the ebb and flow of trade tensions and growing concerns about the global economic outlook. Weakening economic activity and increased downside risks have prompted a shift toward a more dovish stance of monetary policy across the globe, a development that has been accompanied by sharp declines in market yields. As a result, the amount of bonds with negative yields has increased to about \$15 trillion. Investors now expect interest rates to remain very low for longer than anticipated at the beginning of the year. Chapter 1 discusses how investors' search for yield has left asset prices in some markets overstretched and fostered a further easing in financial conditions since the April 2019 *Global Financial Stability Report*.

Accommodative monetary policy is supporting the economy in the near term, but easy financial conditions are encouraging financial risk-taking and are fueling a further buildup of vulnerabilities in some sectors and countries. Chapter 2 shows that corporate sector vulnerabilities are already elevated in several systemically important economies as a result of rising debt burdens and weakening debt service capacity. In a material economic slowdown scenario, half as severe as the global financial crisis, corporate debt-at-risk (debt owed by firms that are unable to cover their interest expenses with their earnings) could rise to \$19 trillion—or nearly 40 percent of total corporate debt in major economies—above crisis levels.

Very low rates are prompting investors to search for yield and take on riskier and more illiquid assets to generate targeted returns, as discussed in Chapter 3. Vulnerabilities among nonbank financial institutions are now elevated in 80 percent of economies with systemically important financial sectors (by GDP). This share is similar to that at the height of the global financial crisis. Vulnerabilities also remain high in the insurance sector. Institutional investors' search for yield could lead to exposures that may amplify shocks during market stress: similarities in investment funds' portfolios could magnify a market sell-off, pension funds' illiquid investments could constrain their ability to play a role in stabilizing markets as they have done in the past, and cross-border investments by life insurers could facilitate spillovers across markets.

Capital flows to emerging markets have also been spurred by low interest rates in advanced economies (see Chapter 4). These inflows of capital have supported additional borrowing: median external debt in emerging market economies has risen to 160 percent of exports from 100 percent in 2008. In some countries, this ratio has increased to more than 300 percent. In the event of a sharp tightening in global financial conditions, increased borrowing could raise rollover and debt sustainability risks. For example, some overindebted state-owned enterprises may find it harder to maintain market access and service their liabilities without sovereign support.

Greater reliance on external borrowing in some frontier market economies could also increase the risk of future debt distress.

Regulation put in place in the wake of the global financial crisis has improved the overall resilience of the banking sector, but pockets of weaker institutions remain. Negative yields and flatter yield curves—along with a more subdued growth outlook—have reduced expectations of bank profitability, and the market capitalization of some banks has fallen to low levels. Banks are also exposed to sectors with high vulnerabilities through their lending activities, leaving them susceptible to potential losses. In China, the authorities had to intervene in three regional banks. Among non-US banks, US dollar funding fragilities—which were a cause of significant stress during the global financial crisis—remain a source of vulnerability in many economies, as discussed in Chapter 5. This dollar funding fragility could amplify the impact of a tightening in funding conditions and could create spillovers to countries that borrow in US dollars from non-US banks.

Environmental, social, and governance (ESG) principles are becoming increasingly important for borrowers and investors. ESG factors could have a material impact on corporate performance and may give rise to financial stability risks, particularly through climate-related losses. Authorities have a key role to play in developing standards for ESG investing. This role, along with the need to close data gaps and encourage more consistent reporting, is discussed in Chapter 6.

Against the backdrop of easy financial conditions, stretched valuations in some markets, and elevated vulnerabilities, medium-term risks to global growth and financial stability continue to be firmly skewed to the downside. *Macroeconomic and macroprudential policies* should be tailored to the particular circumstances facing each economy. In countries where economic activity remains robust but vulnerabilities are high or rising amid still easy financial conditions, policymakers should urgently tighten macroprudential policies, including broad-based macroprudential tools (such as the countercyclical capital buffer). In economies where macroeconomic policies are being eased in response to a deterioration in the economic outlook, but where vulnerabilities in particular sectors are still a

concern, policymakers may have to use a more targeted approach to address specific pockets of vulnerability. For economies facing a significant slowdown, the focus should be on more accommodative policies, considering available policy space.

Policymakers urgently need to take action to tackle financial vulnerabilities that could exacerbate the next economic downturn:

- *Rising corporate debt burdens:* Stringent supervision of bank credit risk assessment and lending practices should be maintained. Efforts should be made to increase disclosure and transparency in nonbank finance markets to enable a more comprehensive assessment of risks. In economies where overall corporate sector debt is deemed to be systemically high, in addition to sector-specific prudential tools for banks, policymakers may consider developing prudential tools for highly leveraged firms. Reducing the bias in tax systems that favors debt over equity financing would also help reduce incentives for excessive borrowing.
- *Increasing holdings of riskier and more illiquid securities by institutional investors:* The oversight of nonbank financial entities should be strengthened. Vulnerabilities among institutional investors can be addressed through appropriate incentives (for example, to reduce the offering of guaranteed return products), minimum solvency and liquidity standards, and enhanced disclosure.
- *Increased reliance on external borrowing by emerging and frontier market economies:* Indebted emerging market and frontier economies should mitigate debt sustainability risks through prudent debt management practices and strong debt management frameworks.

Global policy coordination remains critical. There is a need to resolve trade tensions, as discussed in the April 2019 *World Economic Outlook*. Policymakers should also complete and fully implement the global regulatory reform agenda, ensuring that there is no rollback of regulatory standards. Continued international coordination and collaboration is also needed to ensure a smooth transition from LIBOR to new reference rates for a wide range of financial contracts around the world by the end of 2021.