Over the past six months, the twists and turns of trade disputes have continued to buffet financial markets, business sentiment has weakened further, and concerns about downside risks to the global economy have increased. The shift toward a more dovish monetary policy stance across the globe, which has been accompanied by a pronounced decline of longer-term yields, helped mitigate such concerns. Market pricing now suggests that rates will remain lower for longer than anticipated at the beginning of the year, and about $15 trillion of outstanding debt features negative yields.

Lower government bond yields have contributed to easing of global financial conditions compared with six months ago, particularly in the United States and the euro area. While easier financial conditions have supported economic growth and helped contain downside risks to the outlook in the near term, they have also encouraged more financial risk-taking and a further buildup of financial vulnerabilities, putting medium-term growth at risk.

Indeed, the analysis presented in this report points to elevated vulnerabilities in the corporate and in the nonbank financial sectors in several large economies. Lower yields have compelled insurance companies, pension funds, and other institutional investors with nominal return targets to invest in riskier and less liquid securities. As a result, these investors have become a larger source of funding for nonfinancial firms, which, in turn, facilitated a rise in corporate debt burdens. According to the analysis in this report, the share of debt owed by firms with weak debt repayment capacity is already sizable in several major economies and could reach post-global financial crisis levels in the event of a material economic downturn. Furthermore, low rates in advanced economies have spurred capital flows to emerging and frontier economies, facilitating further accumulation of external debt.

The search for yield in a prolonged low-interest-rate environment has led to stretched valuations in risky asset markets around the globe, raising the possibility of sharp, sudden adjustments in financial conditions. Such sharp tightening could have significant macroeconomic implications, especially in countries with elevated financial vulnerabilities.

Vulnerabilities are also present in the global US dollar funding markets. In this report, we take a deep dive into the funding profile of US dollar–denominated assets of non-US banks. While postcrisis financial regulation has improved the resilience of banking sectors in many dimensions, US dollar funding fragilities amplify adverse shocks and create spillovers to countries that borrow in US dollars from foreign non-US banks, thus becoming a source of vulnerability for the global financial system.

Policymakers should lean against the buildup of vulnerabilities by deploying and developing macroprudential tools as warranted and by maintaining stringent financial supervision. Macroprudential tools are well developed in some markets and jurisdictions. For example, many countries have demand-side tools for the housing market (such as limits on loan-to-value and debt-to-income ratios), but more jurisdictions would benefit from the activation of broad-based macroprudential tools, such as the countercyclical capital buffer. For the corporate sector, and for market-based finance more broadly, macroprudential tools are often lacking, highlighting the need to urgently develop such tools.

Of course, the main drivers of global downside risks have been trade tensions and policy uncertainties. Thus, the main priorities for policymakers are to resolve trade disputes, to provide clarity of economic policies, and to develop and deploy macroprudential tools to address the rise of financial vulnerabilities.