

The Financial System Is Stronger, But New Vulnerabilities Have Emerged in the Decade Since the Crisis

By Tobias Adrian

Although the global expansion has plateaued, easy monetary policies continue to support growth. But we shouldn't rest too easily. Chapter 1 of the latest *Global Financial Stability Report* finds that short-term risks to the financial system have increased somewhat over the past six months. Trade tensions have escalated, policy uncertainties have increased in a number of countries, and some emerging market economies are facing financial-market pressures.

Looking further ahead, risks remain elevated. To be sure, the financial system is stronger today than before the global financial crisis, thanks to a decade of reform and recovery. However, vulnerabilities continue to build, and the new financial system remains untested. Additional steps are needed to improve its resilience.

Before we discuss specific policy measures, let's take a closer look at the global financial landscape. So far, robust risk appetite has continued to support rising asset prices in major financial markets and financial conditions have remained relatively easy, despite policy rate hikes by the US Federal Reserve. However, the stronger dollar and higher US interest rates have made overseas borrowing more expensive for emerging markets, especially those with larger credit needs and weaker economic conditions or policy frameworks.

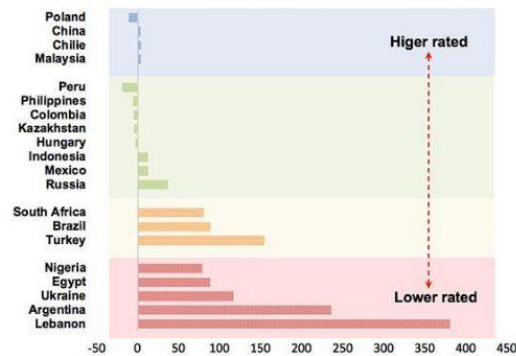
New vulnerabilities

If pressures on emerging market economies were to broaden and intensify, financial stability risks would increase significantly. Our analysis suggests that — in the medium term — there is a 5 percent probability that emerging market economies will experience portfolio debt outflows of \$100 billion or more. That is broadly similar in magnitude to outflows experienced during the crisis.

Costlier credit

The stronger dollar and higher US interest rates have made overseas borrowing more expensive for emerging markets, especially those with lower credit ratings.

(change in foreign currency credit spreads, in basis points, since mid-March)



Sources: Bloomberg Finance L.P.; and IMF staff estimates



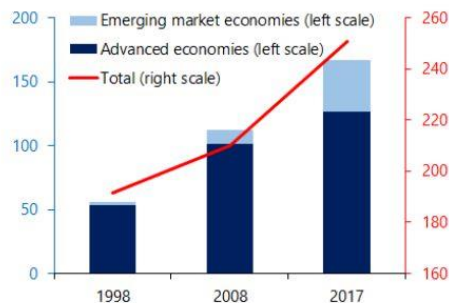
There are other ways stability risks could rise sharply. These include a broader escalation of trade tensions, a no-deal Brexit, renewed concerns about fiscal policy in some highly indebted euro area countries, and a faster-than-expected normalization of monetary policy in advanced economies.

Any of these concerns could expose the financial vulnerabilities that have grown over years of accommodative monetary policy. In economies with globally systemically important financial sectors, debt owed by governments, companies, and households has risen from around 200 percent of GDP a decade ago to almost 250 percent today. Emerging market economies are borrowing more in international markets and face the risk that they will be unable to refinance a substantial portion of their foreign currency debt. Banks are exposed to these highly indebted borrowers, and some global banks have large holdings of more illiquid and opaque assets. Asset valuations remain stretched across several sectors and regions, and underwriting standards are deteriorating.

Borrowing binge

Debt owed by governments, companies and households has risen sharply since the crisis.

(trillions of dollars, percent of GDP)



Sources: IMF Global Database (2018); and IMF staff calculations.

Note: The chart is based on debt in 29 jurisdictions with systemically important financial sectors.



This accumulation of vulnerabilities raises the urgency for policymakers to step up efforts to bolster the financial system:

- Micro-prudential, or firm level, policies should aim to strengthen bank balance sheets against solvency and liquidity risks.
- Broad-based macroprudential tools, such as the countercyclical capital buffer (which aims to increase bank capital when borrowing is rising in the economy), should be used more actively in countries where financial conditions remain accommodative and vulnerabilities high. Financial stability also requires new macroprudential tools to address vulnerabilities outside the banking sector, for example, to ensure sound underwriting standards in nonbank credit intermediation and to tackle liquidity risks by asset managers.
- For emerging market economies, reducing vulnerabilities and maintaining robust policies and sound policy frameworks remains critical. This includes building and maintaining adequate foreign exchange reserves and using these reserves judiciously.
- Regulators and supervisors must respond to new threats, including cyber risks. They should also support fintech's potential contribution to innovation, efficiency, and inclusion while safeguarding against risks to the financial system.

This is no time for complacency. More proactive measures should be adopted to safeguard financial stability. As noted in Chapter Two of the [Global Financial](#)

[*Stability Report*](#), released earlier, the financial regulatory reform agenda should be completed and a rollback of reforms avoided. And finally, international cooperation is crucial for maintaining global financial stability and fostering sustainable economic growth.