Global Financial Stability; Risks and Opportunities

Keynote Address by Shri Shaktikanta Das, Governor, Reserve Bank of India,

at the Future of Finance Forum 2024 organised by the Bretton Woods Committee, September 13, 2024, Singapore

I am happy to participate in the third annual conference of the Bretton Woods Committee's Future of Finance Forum. The conference brings together leaders and experts from the public and private sectors, multilateral institutions and think tanks to deliberate on emerging issues, trends and technologies in the financial sector. This comprehensive horizon scanning can enrich decision making and help to fashion strategies for exploiting opportunities, managing risks and building future resilience. Against this backdrop, I propose to focus on the global financial stability landscape and the evolving balance of risks and opportunities beyond the current macro-economic environment.

I. Current conditions

2. The global financial system has exhibited remarkable resilience in weathering several high impact shocks in the recent period. While global economic activity and trade have largely withstood downside risks, the last mile of disinflation has proved to be challenging, giving rise to financial stability risks. As market expectations about the future course of monetary policies re-align with policy guidance from central banks, the prospects of a hard landing appear to be receding. This is reflected in most forecasts, which suggest that near-term prospects are improving, notwithstanding the persisting uncertainties in the international economic and financial environment. Macro-financial health has been shored up by stronger balance sheets of financial intermediaries and supportive, and even proactive, micro and macroprudential policy responses. More recently, however, the implications of monetary policy divergence among countries are beginning to unfold, especially in the form of exuberance and sudden sell-offs in financial markets. Together with the recent unprecedented IT outage globally, these developments have shown how risks to the financial system can materialise on a global scale, and sometimes very quickly, as in a few banks in early 2023. These facts have brought home, once again, the importance of crisis preparedness and robust business continuity plans (BCP).

3. Nelson Mandela had said and I quote: "*After climbing a great hill, one only finds that there are many more hills to climb.*" While several near-term risks appear to have receded, the global financial system continues to face heightened uncertainty from the outer-term outlook. Some of these risks are well known and well acknowledged, but other risks are just emerging or are lurking in the background. As macroeconomic conditions diverge in different regions of the world and policy responses get increasingly unsynchronized, spillovers to advanced and emerging economies alike are getting amplified.

4. In this highly uncertain scenario, policy makers and financial sector regulators have to work with renewed urgency to buffer economic activity and financial sector from unforeseen shocks. **A flexible and robustly equipped regulatory architecture in the financial sector would be essential to stay ahead of the curve and minimise risks. Macroeconomic policy makers and other stakeholders must also be quick to adopt a forward-looking approach to navigate the difficult**

bends and turns on the road ahead. Employing sustainable business models and judiciously harnessing the full potential of technological advances will be the cornerstones of this approach.

II. Macroeconomic Outlook

5. The resilience of global economic activity in the first half of 2024 prompted a repricing of policy paths by financial markets. Accordingly, a better balance in the risks to the outlook began to emerge. Output path divergences started narrowing across economies. Cyclical effects also started waning. Going into the second half of the year, while global growth appears to be steady, it remains subdued by historical standards[1], with disparities between regions. Some emerging market economies (EMEs) continue to demonstrate resilience and adaptability, while others - mostly low-income countries (LICs) - are still in a vulnerable situation. A few advanced economies (AEs) are also at the risk of facing a slowdown.

6. In its July 2024 world economic outlook update, the International Monetary Fund (IMF) presented a cautiously optimistic outlook for the global economy[2]. In its view, varied momentum of activity is narrowing divergences across economies, while world trade is firming up. The growth of global trade is expected to align with the pace of global growth in 2024-25, thus keeping the trade-GDP ratio stable over the medium-term. At the same time, however, cross-border trade restrictions have increased amidst rising shipping costs and logistics disruptions. **Overall, the risks to the outlook are judged to be balanced, although in the near-term, they weigh on the downside. Let me now touch upon some salient risks to the global macroeconomic outlook.**

7. First, the momentum of global disinflation is slowing, warranting caution in easing monetary policy. The persistence of inflation, particularly in the services sector, poses a significant risk. Fuelled by a combination of elevated wage growth and constrained productivity, these factors are placing the balance sheets of financial intermediaries at risk from recognised and unrecognised valuation losses. The stickiness in inflation could delay the return to price stability which, in turn, increases external, fiscal and financial risks. In such a scenario, monetary policy management by Central Banks has to be prudent and supply side measures by government have to be proactive.

8. Second, unprecedented high levels of debt characterise the global economic landscape. It has reached a level of US$ 315 trillion or 333 per cent of global GDP according to the 2024 estimates of the Institute of International Finance. At these levels, the debt overhang poses significant spillover risks to EMEs. In particular, the low income and some middle-income countries are very vulnerable. Coexistence of high levels of debt and elevated interest rates can feed a vicious cycle of financial instability through impairment of government and private-sector balance sheets. Fiscal deficits or net accretions to debt stocks are higher than pre-pandemic levels. There also appears to be little scope for improvements in fiscal aggregates, given the fact that 2024 – the Great Election Year – is seeing 88 economies going into election

[1] The IMF projection of global growth in 2024 and 2025, respectively, is below the historical (2000–19) annual average of 3.8 percent.
[2] The forecast for global growth for 2024 was maintained at the IMF's April 2024 assessment of 3.2 per cent while for 2025 it was raised by 10 basis points to 3.3 per cent.

cycles. Needless to emphasise that fiscal consolidation has become even more crucial than before for achieving the arduous 'last mile of disinflation'. For emerging economies, such consolidation could also lessen the incidence and severity of capital outflows by improving their ratings.

9. Third, increased and persisting geopolitical risks can further add to the heightened risk aversion among investors, prompting flights to safety and volatility in asset prices. Countries at the receiving end of such a situation have to build their own buffers and strengthen their resilience through appropriate policy responses.

10. Fourth, with trade policy uncertainty reaching exceptionally high levels, the risks associated with protectionism and unilateral trade policies threaten to undermine the multilateral trading system. Such a scenario is filled with potential to create a protracted period of economic fragmentation and reduced global growth. Revival of multilateralism and co-ordinated policy action can mitigate the severity of this situation.

11. Fifth, climate change related adverse weather conditions are imparting considerable uncertainty to both growth and inflation trajectories. Inward-looking policies, including trade-distorting measures, could compromise the ability to tackle global challenges like climate change. Climate commitments made by nations must be fulfilled, while adhering to the widely accepted principle of common but differentiated approach.

12. **All these risks are getting increasingly interdependent, as changes in the profile of any one of the risks usually shifts expectations relating to others. The need of the hour for policy authorities and central banks is, therefore, to remain agile and craft appropriate forward looking measures and structural changes to overcome the risks.**

III. Global Financial Stability Risks

13. I would now like to outline a few global financial stability risks. First, global financial markets have displayed resilience in recent months, with equity and bond yields rallying, volatility remaining low for the most part, and narrowing of corporate bond spreads; but there has been a sharp increase in prices of relatively riskier assets. While stocks have been supported by strong earnings, the narrowing of corporate spreads has coincided with rising episodes of corporate defaults[3]. The current scenario also differs from past monetary policy tightening cycles when markets displayed risk-off sentiments and prices of riskier assets declined. To the extent that valuations are currently stretched, sudden shocks could precipitate stress that spreads contagiously across financial market segments through sell-offs and band-wagon effects.

14. Second, market expectations of higher interest rates in the United States (US) along with other factors, had kept the US dollar strong. The generalized global risk-on risk-off environment had increased the volatility of capital flows for many emerging

[3] The global corporate default tally stood at 87 as of July 2024, which is above its five-year average. Distressed exchanges accounted for two-thirds of defaults in July and are at their highest level since 2009. Further, these defaults were led by media and entertainment sector and consumer products sector – 'Default, Transition, and Recovery: Distressed Exchanges Reached Their Highest Level Since 2009', S and P Global, August 15, 2024.

markets[4]. Further, a strong USD increases debt service burdens and inflationary pressures for EMEs. To what extent this scenario will get impacted would depend upon the quantum and timing of policy pivot by the US Fed, following their recent pronouncements to this effect.

15. Third, the proliferation of non-bank institutions in financial intermediation may create risks to financial stability due to their size, complexity and interconnectedness with domestic and global financial systems. In recent years, a number of vulnerabilities have emerged in NBFIs in advanced economies, contributing to periods of market dysfunction[5]. Hidden leverage and liquidity mismatches of these institutions can amplify shocks and propagate strains throughout the financial system.

16. Fourth, private credit[6] has grown four-fold over the last ten years. It is now a major source of corporate financing among middle-market firms that have low or negative earnings, high leverage, and lack high-quality collateral. Proliferation of this asset class, along with intensifying competition with investment banks on larger deals, may shift supply-demand dynamics and result in poorer underwriting standards. As a consequence, the probability of credit losses can rise and make existing risk management models obsolete. The rapid growth of private credit, their increasing interconnectedness with banks and NBFIs, and their opacity creates vulnerabilities that could become systemic. Regulators world over need to give a closer look to these developments and come out with necessary guardrails.

17. Fifth, stress in the global commercial real estate (CRE) sector needs to be watched closely[7]. Banks exhibit high sensitivity to expected and unexpected CRE losses, due to the relatively high CRE coverage ratios in their loan books. Further, liquidity squeezes can materialise for banks with large CRE exposures, as short sellers may target them and investor confidence may slip further. As I said earlier, staying alert and undertaking forward looking regulatory measures ahead of the curve can contain the risks to bank balance sheets and systemic stability.

IV. Higher for Longer Interest Rates

18. The interaction of financial conditions with monetary policy can present overwhelming risks to financial stability. The synchronized monetary policy tightening in the last couple of years across the globe, is gradually giving way to monetary policy divergence in 2024. While quite a few central banks have started treading the path of rate cuts on account of recession worries[8], many still continue to maintain restrictive stances and refrain from reducing policy rates so as to break the back of inflation persistence decisively. The 'higher for longer' interest rate environment did bring forward financial stability risks, as seen in March 2023 in certain advanced economies.

[4] Global Financial Stability Report: The Last Mile: Financial Vulnerabilities and Risks, April 2024, International Monetary Fund

[5] Financial Stability Risks from Non-bank Financial Intermediation in Australia. Bulletin – April 2024; Reserve Bank of Australia.

[6] Nonbank corporate credit provided through bilateral agreements or small "club deals" outside the realm of public securities or commercial banks. This definition excludes bank loans, broadly syndicated loans, and funding provided through publicly traded assets such as corporate bonds. (Global Financial Stability Report, IMF, April 2024).

[7] According to the IMF, CRE prices fell by 12 per cent globally in real terms over the past year with the sector also remaining vulnerable to higher vacancy rates and rising financing costs.

[8] Bank of Canada, Bank of Japan, European Central Bank, Bank of England.

Tight financial conditions impacted balance sheets of banks in these jurisdictions. Market expectations of rate cuts are now regaining momentum, especially after indications of a policy pivot from the US Fed, but the adverse spillovers from the 'higher for longer' interest rate scenario remains a contingent risk. On the other hand there are central banks which naturally and justifiably remain averse to premature loosening of policy before inflation has been durably reined in their countries. Central Banks in these countries need to remain watchful of their domestic inflation–growth balance and make policy choices.

V. Geo-Political Risks

19. The resurgence of geopolitical risks and their persistence pose high risks to financial stability, given their high speed of transmission and the multi-faceted exposure of the financial sector. Geopolitical risks may emanate not only in the form of wars, terrorist attacks, trade disputes and political gridlocks, but also through supply chain strains, technology decoupling, cyberattacks and weaponisation of finance.

20. The geopolitical risk index[9] has spiked sharply in 2024 amidst increases in trade restrictions and financial sanctions, reversing the gains from several decades of global economic integration[10]. Geopolitical risks are imparting heightened volatility to capital flows and asset prices. They are even impacting bystanders or countries not directly involved in conflicts. These developments often result in strains on the international monetary system, undermining the efficiency of the global payments systems. Even as we reap the many benefits of increasing financial integration, it is evident that the contagion risks from geopolitical events can no longer be ignored, especially in the context of transactions in forex, equity and debt markets as well as in the banking system[11].

21. Geo-economic fragmentation is weighing on the medium-term outlook for global growth. This can delay the convergence of emerging and developing economies with better living standards. In addition, geopolitical tensions in the past have generally been associated with volatility in crude oil prices and disruptions in supply conditions. With their negative feedback loops, they aggravate the stress on the real economy and the financial system. While it may not be possible to completely insulate from such risks, it is important to deal with them through systematic monitoring, building buffers, devising contingency plans and fostering multilateral cooperation.

[9] Caldara, Dario. and Iacoviello, Matteo (2022), "Measuring Geopolitical Risk", American Economic Review, Vol. 112, No 4, April, pp. 1194 1225.
[10] Financial Stability Report, RBI; June 2024.
[11] NguyenHuu, T., & Örsal, D. K. (2024). Geopolitical risks and financial stress in emerging economies. The World Economy, 47, 217–237.

VI. Opportunities

22. **As we navigate these risks and challenges, we need to recognise that there are also huge opportunities ahead of us. Current challenges open pathways for economic resilience and a stronger global outlook, if addressed collaboratively and strategically. Let me highlight some of these opportunities.**

(i) Impending monetary policy pivots with a strong probability of soft landing provides hope that global inflation could be on a sustained downward trajectory. This would open up space to strengthen the foundations of growth in an environment of benign input costs and revival of the labour market. For emerging market economies in particular, this possibility offers opportunities to capitalise on robust fiscal, monetary, and financial policy frameworks to exploit the potential to attract investment and accelerate sustainable growth. This is also an apt time to consolidate the gains from the post–pandemic rebound with deeper structural reforms in both product and factor markets.

(ii) Despite the uncertainty surrounding the geo-political outlook, the latest projections suggest a turnaround in world trade is taking hold[12]. This offers another engine for economic expansion. Addressing trade policy uncertainties more forcefully and in coordination presents an opportunity to strengthen global prosperity.

(iii) It is important to acknowledge the role that finance will continue to play in the global growth story, particularly for emerging markets such as India[13]. This is an opportune time to enhance the breadth, access and efficiency of financial markets while also protecting consumer interests. A forward-looking approach would require developing regulatory sandboxes, fostering collaboration with innovators, and ensuring the integration of new players into the regulatory framework without compromising prudence and stability.

(iv) Digitalisation has been a game changer, driving empowerment, entrepreneurial innovation, productivity, and enabling an irreversible transformation of the economic landscape. Leveraging the digitalisation channel has the potential to bring in improvements in the field of financial inclusion, formalisation of finance and enhancements in cross-border payments systems.

(v) Climate change gives us another critical opportunity for innovation. Quest for new climate technologies and harnessing them can be instrumental in fostering energy independence, especially for developing countries. Climate-smart financial solutions such as issuance of green bonds also provide avenues for private sector involvement and engagement.

(vi) Reforming the international monetary and financial and system is crucial for ensuring global economic stability, fostering growth, and mitigating systemic risks. The current system, while having supported decades of economic expansion, is

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[12] The current value of the WTO Goods Trade Barometer, an early indicator of the trajectory of merchandise trade volume, stands at 103 — above both the quarterly trade volume index and the baseline value of 100.

[13] A well-developed financial sector is a precondition for the efficient allocation of resources and the exploitation of an economy's growth potential. As such, understanding the dynamic nature of the financial system by way of new sources of financing, savings and investment trends and even demographic changes is vital.

increasingly challenged by imbalances and inefficiencies, including the dominance of a few currencies in global trade and finance. While reforms should address these imbalances to enable greater inclusion of emerging economies in global financial governance, they should also focus on strengthening the global financial safety net (GFSN).

VII. Conclusion

23. As I proceed to conclude, let me briefly touch upon India's prospects in this unsettled and highly uncertain international environment. The Indian economy rebounded from the severe contraction imposed by the COVID-19 pandemic and averaged real GDP growth of above 8 per cent during 2021-24. For 2024-25, the Reserve Bank of India (RBI) projects real GDP growth at 7.2 per cent, with risks evenly balanced around this forecast. This growth outlook reflects the underlying strength of India's macro-fundamentals, with domestic drivers – private consumption and investment – playing a major role. Moreover, the growth trajectory is supported by an environment of macroeconomic and financial stability. Inflation has moderated from its peak of 7.8 per cent in April 2022 into the tolerance band of +/- 2 per cent around the target of 4 per cent, but we still have a distance to cover and can not afford to look the other way. The Reserve Bank's projections indicate that inflation is likely to ease further from 5.4 per cent in 2023-24 to 4.5 per cent in 2024-25 and 4.1 per cent in 2025-26. Meanwhile, fiscal consolidation is underway and public debt levels are on a declining trajectory over the medium-term. Corporate performance has improved strongly, enabling deleveraging and strong growth in profitability. Balance sheets of banks and non-banking financial intermediaries, regulated by the Reserve Bank of India, have also strengthened[14]. Our stress tests reveal that these financial intermediaries will be able to maintain regulatory capital and liquidity requirements even under severe stress scenarios.

24. India's vision of global progress emphasises international cooperation that is people-specific, ambitious, action-oriented and decisive. India's G20 Presidency in 2023 and its continuing contributions thereafter reflects India's vision of the world being one earth, one family with one future. These priorities include strengthening the Multilateral Development Banks (MDBs) to address shared global challenges of the 21st century; achieving financial inclusion and productivity gains through digital public

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[14] (i) Gross Non-Performing Assets (GNPA) ratio of banks was 2.7 per cent at end-June 2024, the lowest since end-March 2011. The annualised slippage ratio, which measures new NPA accretions as a percentage of standard advances, continued to decline to reach at 1.3 per cent at end-June 2024. The provision coverage ratio (PCR) continued to improve to reach at 76.5 per cent by end-June 2024. Capital to risk-weighted assets ratio (CRAR) stood at 16.8 per cent at end-June 2024, much above the regulatory threshold. The annualized profitability indicators, namely, return on assets (RoA) and return on equity (RoE) stood at 1.4 per cent and 14.5 per cent, respectively, at end-June 2024, showing continued improvement.
(ii) GNPA ratio of NBFCs was 2.8 per cent at end-June 2024, the lowest since end-March 2021. Similarly, NNPA ratio improved to 1.0 per cent at the end-June 2024. The annualised slippage ratio, which measures new NPA accretions as a percentage of standard advances, continued to decline to reach at 2.6 per cent at end-June 2024. The provision coverage ratio (PCR) continued to improve to reach at 61.5 per cent by end-June 2024. Capital to risk-weighted assets ratio (CRAR) stood at 26.6 per cent at end-June 2024, much above the regulatory threshold. The annualized profitability indicators, namely, return on assets (RoA) and return on equity (RoE) stood at 3.2 per cent and 11.6 per cent, respectively, at end-June 2024, showing continued improvement.

infrastructure; debt resolution for lower and middle-income countries; and financing cities of tomorrow, among many others.

25. In conclusion let me say that, India remains committed to the reshaping of the global order in the decades ahead for the betterment of the world. It is now time for everyone to work for ‘one future’ for the entire mankind.