

# EXECUTIVE SUMMARY

## Bridge to Recovery: October 2020 *Global Financial Stability Report* at a Glance

- Near-term global financial stability risks have been contained for now. Unprecedented and timely policy response has helped maintain the flow of credit to the economy and avoid adverse macro-financial feedback loops, creating a bridge to recovery.
- However, vulnerabilities are rising, intensifying financial stability concerns in some countries. Vulnerabilities have increased in the nonfinancial corporate sector, as firms have taken on more debt to cope with cash shortages, and in the sovereign sector, as fiscal deficits have widened to support the economy.
- As the crisis unfolds, corporate liquidity pressures may morph into insolvencies, especially if the recovery is delayed. Small and medium-sized enterprises are more vulnerable than large firms with access to capital markets. The future path of defaults will ultimately be shaped by the extent of continued policy support and the pace of the recovery, which is expected to be uneven across sectors and countries.
- While the global banking system is well capitalized, there is a weak tail of banks, and some banking systems may experience capital shortfalls in the October 2020 *World Economic Outlook* adverse scenario even with the currently deployed policy measures.
- Some emerging and frontier market economies face financing challenges, which may tip some of them into debt distress or lead to financial instability and may require official support.
- As economies reopen, accommodative policies will be essential to ensure that the recovery takes hold and becomes sustainable—see the following Policy Road Map. The post-pandemic financial reform agenda should focus on strengthening the regulatory framework for the non-bank financial sector and stepping up prudential supervision to contain excessive risk taking in a lower-for-longer interest-rate environment.

## Monetary and Financial Policy Road Map after the Great Lockdown

### Gradual Reopening under Uncertainty

**Monetary policy**—Maintain accommodation to support the recovery

**Liquidity support**—Maintain support but adjust pricing to incentivize a gradual exit

**Credit provision**—Encourage banks to use capital and liquidity buffers to continue lending

**Nonfinancial private sector**—Extend moratoria on debt service only if necessary to prevent widespread insolvencies, support viable firms through restructuring and efficient out-of-court workouts to reduce the debt burden, as well as by providing solvency support (as appropriate)

**Multilateral support**—Provide support to emerging and frontier market economies facing financing difficulties

### Pandemic under Control

**Monetary policy**—Maintain accommodation until monetary policy objectives are achieved

**Liquidity support**—Gradually withdraw

**Credit provision**—Require banks to gradually rebuild capital and liquidity buffers, develop credible plans to reduce problem assets, and create markets for problem assets

**Nonfinancial private sector**—Recapitalize, restructure, or resolve nonviable firms

**Green recovery**—Encourage more proactive management of climate-related risks and green investments

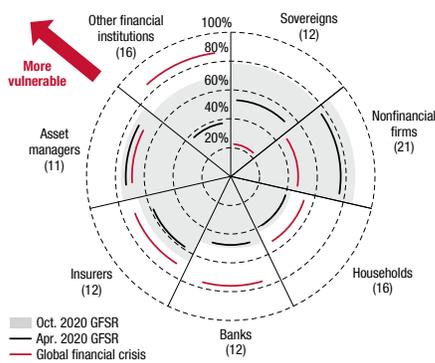
**Digitalization**—Encourage greater digital investment to enhance financial sector efficiency and inclusion

### Post-pandemic Financial Reform Agenda

**Nonbank financial sector**—Strengthen the regulatory framework to address vulnerabilities exposed during the coronavirus disease (COVID-19) crisis

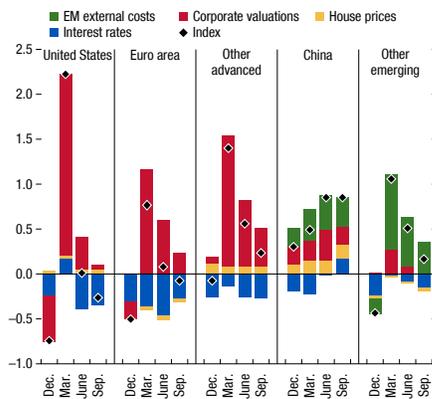
**Lower for longer**—Implement prudential measures to contain risk-taking in the lower-for-longer interest-rate environment

**Figure 1. Proportion of Systemically Important Countries with Elevated Vulnerabilities, by Sector**  
 (Percent of countries with high and medium-high vulnerabilities, by GDP or assets; number of vulnerable countries in parentheses)



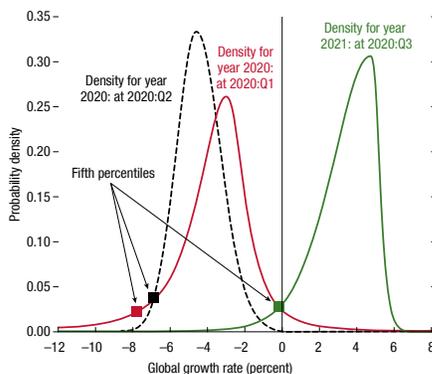
Sources: Bank for International Settlements; Haver Analytics; national authorities; Standard & Poor's; WIND Information Co.; and IMF staff calculations.  
 Note: Based on 29 jurisdictions with systemically important financial sectors (see Chapter 1 for details). "Global financial crisis" reflects the maximum 2007–08 vulnerability value. GFSR = *Global Financial Stability Report*.

**Figure 2. Key Drivers of Global Financial Conditions Indices**  
 (Standard deviations from mean)



Sources: Bank for International Settlements; Bloomberg Finance L.P.; Haver Analytics; IMF, International Financial Statistics database; and IMF staff calculations.  
 Note: Higher number indicates a tightening of financial conditions. See Chapter 1 for details. EM = emerging market.

**Figure 3. Near-Term Global Growth Forecast Densities**  
 (Probability densities)



Sources: Bank for International Settlements; Bloomberg Finance L.P.; Haver Analytics; IMF, International Financial Statistics database; and IMF staff calculations.  
 Note: Forecast density estimates are centered around the respective *World Economic Outlook* forecasts for 2020 and 2021. Given the unprecedented nature of the current crisis, model-based growth-at-risk estimates are inevitably subject to larger-than-usual uncertainty bounds.

Confronted with a global health and economic crisis, policymakers have taken extraordinary measures to protect people, the economy, and the financial system. However, prospects for recovery remain highly uncertain and will depend on the availability of reliable COVID-19 treatments and vaccines. In addition, many countries have entered the crisis with elevated preexisting vulnerabilities in some sectors—asset management, nonfinancial firms, and sovereigns—and vulnerabilities are rising, representing potential headwinds for the recovery (Figure 1).

Since the June 2020 *Global Financial Stability Update*, global financial conditions have remained accommodative on the back of continued policy support. In advanced economies, low interest rates and a recovery in risk asset markets have continued to support further easing in financial conditions (Figure 2). Financial conditions have generally eased also in emerging markets (excluding China) over the same period, although external costs for many countries are still above pre-COVID-19 levels (Figure 2). In China, financial conditions have remained broadly stable, as authorities have scaled back expectations for further interest rate reductions amid improving economic activity and rising financial sector risks.

Although the sharp easing of financial conditions since late March has helped prevent a financial crisis and cushion the impact of COVID-19 on the economy, the deterioration of the economic outlook has shifted the expected distribution of global growth in 2020 deeply into negative territory (Figure 3). Looking ahead, the global economy is expected to grow by 5.2 percent in 2021, according to the October 2020 *World Economic Outlook* (WEO). This expected rebound and easy financial conditions imply that the odds of negative growth next year are low, though the balance of risks is tilted to the downside (Figure 3).

Unprecedented policy actions taken in response to the pandemic have been successful in boosting investor sentiment and maintaining the flow of credit to the economy. To cope with cash flow pressures, firms have stepped up bond issuance, tapped bank credit lines (most notably in the United States), and taken advantage of government-guaranteed loans (see Chapter 3).

Hard currency bond issuance in emerging markets has been strong as well. Aggregate portfolio flows have recovered from their March lows, though about half of emerging market economies have continued to experience outflows over the past three months. Easy financial conditions have improved the outlook for portfolio flows to emerging markets, with the probability of

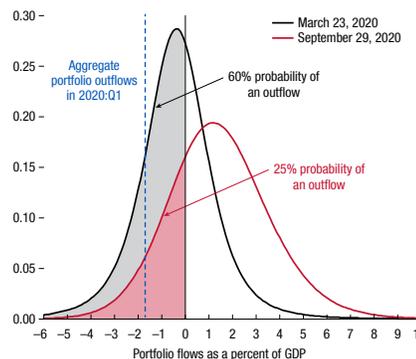
outflows over the next three quarters falling from about 60 percent at the peak of market turmoil to 25 percent in September (Figure 4), though still above its pre-COVID-19 level.

Global equity markets have rebounded strongly from pandemic lows, with notable differentiation across countries depending on the spread of the virus, the scope of policy support, and sectoral composition. Equity markets in China and the United States have outperformed other markets, driven by technology stocks (dark and light green bars, Figure 5), notwithstanding the market correction in September. More contact-intensive sectors (hotels, restaurants, leisure) have been hurt by lockdowns and social distancing. The underperformance of the energy and financial sectors (red and yellow bars, Figure 5) reflects investors' assessments of weaker growth prospects.

The disconnect between rising market valuations and the evolution of the economy, discussed in the June 2020 *Global Financial Stability Update*, persists. For example, analysis of year-to-date US stock market performance shows that a sharp decline in the corporate earnings outlook has been more than offset by lower risk-free rates and a compression of the equity risk premium, reflecting central banks' policy rate cuts and other measures that have boosted investor sentiment despite higher economic uncertainty (see Chapter 1). Similarly, the decline in corporate bond yields has been driven by the fall in risk-free rates and the compression in credit spreads—in many cases below values estimated to be consistent with economic fundamentals (Figure 6). The spread compression can be partly attributed to policy support and, in the case of emerging markets, it can also be traced to policy easing by central banks in advanced economies. If markets believe that policy support will be maintained or scaled up in response to deterioration in the economic outlook, current risk asset valuations could be sustained for some time. However, if investors reassess the scope for policy support or if the recovery is delayed, the odds of a sharp adjustment may rise.

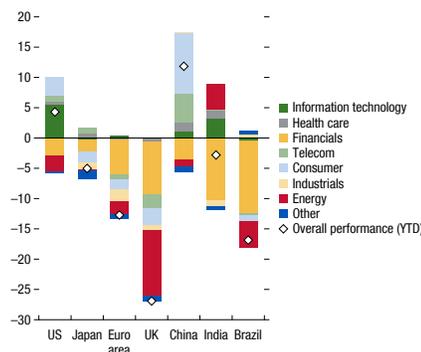
Nonfinancial firms have come under significant liquidity strains following the COVID-19 outbreak. More vulnerable firms—with weaker solvency and liquidity positions, as well as smaller firms—have experienced greater financial stress than their peers in the early stages of the crisis (see Chapter 3). To cope with cash shortages, many firms—notably those whose earnings fell short of their interest expenses—have increased their borrowing (Figure 7), adding to the already high corporate debt levels in several economies (Figure 8). Default rates have been on the rise as well. As the crisis continues to unfold,

**Figure 4. Capital Flows at Risk: Near-term Forecasts of Portfolio Flows**  
(Probability density function)



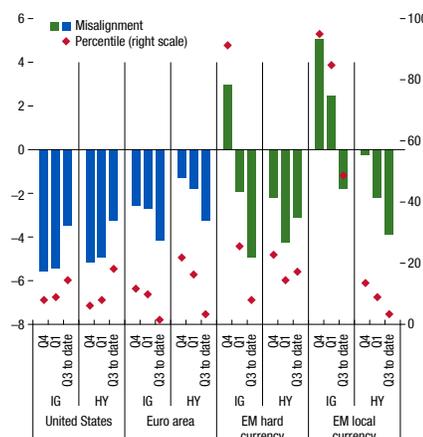
Sources: Bloomberg Finance L.P.; Haver Analytics; IMF, World Economic Outlook database; JP Morgan estimates; national sources; and IMF staff estimates. Note: Based on debt and equity portfolio flows for 19 largest emerging markets; near term = next 3 quarters. See Chapter 1 for details.

**Figure 5. Stock Market Performance in 2020: Sectoral Contributions**  
(Percent, year to date)



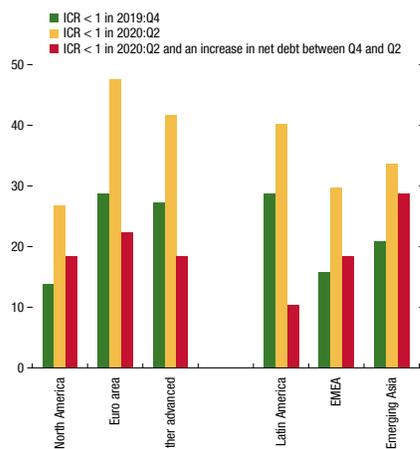
Sources: Bloomberg Finance L.P.; MSCI; and IMF staff calculations. Note: All country indices are local currency MSCI sub-indices. Overall performance is based on aggregation of sectoral indices. "Consumer" is the sum of the consumer discretionary and consumer staples sectors and "other" is the sum of the utilities, materials, and real estate sectors. UK = United Kingdom; US = United States; YTD = year to date.

**Figure 6. Bond Spread Misalignment**  
(Deviation from fair value per unit of risk, left scale; percentile based on 1995–2020, right scale)



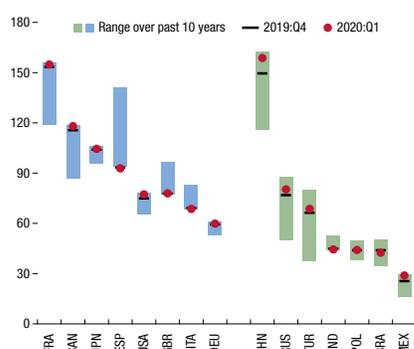
Sources: Bloomberg Finance L.P.; Consensus Economics; Haver Analytics; Refinitiv I/B/E/S; and IMF staff calculations. Note: Misalignment is the difference between market- and model-based values scaled by the standard deviation of monthly changes in spreads; negative values on the left scale indicate overvaluation. See Chapter 1 for details. EM = emerging market; HY = high yield; IG = investment grade.

**Figure 7. Publicly Listed Firms: Debt at Risk**  
(Percent of debt of sample firms)



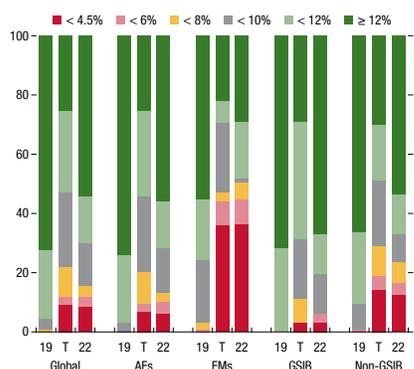
Sources: Bank for International Settlements; Bloomberg L.P.; Haver Analytics; Institute of International Finance; S&P Global Ratings; S&P Leveraged Commentary and Data; and IMF staff calculations.  
Note: The sample includes firms with quarterly statements. The bars show the share of debt at firms with ICR < 1 and with an increase in net debt as a share of total debt in the sample. EMEA = Europe, Middle East, and Africa; ICR = interest coverage ratio.

**Figure 8. Aggregate Nonfinancial Corporate Debt**  
(Percent of GDP)



Sources: Bank for International Settlements; Haver Analytics; and IMF staff calculations.  
Note: For France, corporate debt is reported on an unconsolidated basis. Data labels use International Organization for Standardization (ISO) country codes.

**Figure 9. Distribution of Bank Assets by Capital Ratio under the October 2020 WEO Adverse Scenario, with Policy Mitigation**  
(CET1 ratio, percent)



Sources: Bloomberg Finance L.P.; Fitch; IMF, World Economic Outlook database; and IMF staff estimates.  
Note: The scenario takes into account mitigation policies (see Chapter 4 for details). AEs = advanced economies; CET1 = common equity Tier 1; EMs = emerging markets; GSIB = global systemically important bank; T = trough year.

and especially if a sustainable recovery is delayed, liquidity pressures may morph into insolvencies.

Barring a significant tightening in funding conditions, large firms with access to capital markets are likely to avoid significant solvency pressures. Firms in sectors most affected by the pandemic, however, are facing weaker growth prospects and greater liquidity strains, and hence a higher risk of default and insolvency. Small and medium-sized enterprises, which are generally more vulnerable, could be a significant channel for transmission of the economic shock. Furthermore, small and medium-sized enterprises tend to dominate some of the most contact-intensive sectors (hotels, restaurants, entertainment), which have taken a beating from COVID-19.

Banks entered the COVID-19 crisis with significantly stronger capital and liquidity buffers than they had in 2008–09. This has allowed them to continue to provide credit to the economy. Policies aimed at supporting borrowers and encouraging banks to use the flexibility built into the regulatory framework have likely supported banks’ willingness and ability to lend. However, some banks are already starting to tighten their lending standards, which could have adverse implications for the recovery. A forward-looking analysis of bank solvency in 29 countries (not including China) shows that in the October 2020 WEO *baseline scenario* most banks will be able to absorb losses and maintain capital buffers above the minimum capital requirements (see Chapter 4). In the WEO *adverse scenario* characterized by a deeper recession and a weaker recovery, a sizable weak tail of banks could see their capital buffers depleted to the levels that could constrain their lending capacity (Figure 9). These weak banks’ capital shortfall relative to broad regulatory requirements—which include the countercyclical capital buffer, capital conservation buffer, and systemic buffers—could reach \$220 billion, even after accounting for borrower- and bank-oriented mitigation policies (see Chapter 4).

Nonbank financial institutions (NBFIs) have entered the crisis with elevated vulnerabilities (Figure 10). They have managed to cope with the pandemic-induced market turmoil thanks to policy support, but fragilities remain high. Asset managers, for example, could be forced into fire sales if portfolio losses are larger and redemptions last longer than during the March sell-off. NBFIs play a growing role in credit markets, including riskier segments, and the increased links between NBFIs and banks imply that fragilities could spread through the financial system.

Sovereign vulnerabilities have increased because countries have expanded fiscal support, and sovereigns may face a sharp rise in contingent liabilities. Vulnerabilities have increased across multiple sectors, with 6 out of 29 jurisdictions with systemically important financial sectors now showing elevated vulnerabilities in the corporate, banking, and sovereign sectors (Figure 11).

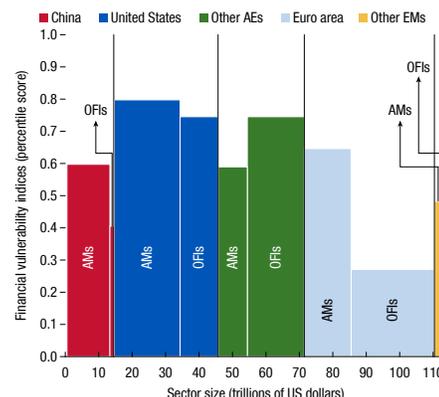
Because of the pandemic, the financing needs of emerging markets have risen sharply. Concerns about new debt supply and weak domestic fundamentals may have curtailed demand for local currency bonds from foreign investors (Figure 12), especially where they hold large shares of debt and where the domestic investor base may not be sufficiently deep. Some emerging market central banks purchased a substantial share of bonds in the secondary market to stabilize market conditions (see Chapter 2). Frontier market economies face even greater financing challenges, as the COVID-19 shock pushed borrowing costs for many to prohibitive levels—calling for official support.

As policymakers build a bridge to recovery, policies will have to adjust, depending on the evolution of the pandemic and the pace of the economic rebound (see Policy Road Map in the at-a-glance box at the beginning of this Executive Summary). At each step, policymakers should be mindful of intertemporal trade-offs and of unintended consequences—the benefits of using available buffers today should be carefully balanced against the possible need for further support in the future, as well as the risk of exacerbating future vulnerabilities.

As economies reopen, continued monetary policy accommodation and targeted liquidity support will be essential for sustaining the recovery. A robust framework for debt restructuring will be critical for reducing debt overhangs and resolving nonviable firms. Low-income countries with financing difficulties may require multilateral support. Despite its adverse effect on firms' environmental performance, the COVID-19 crisis also presents an opportunity to engineer a transition to a greener economy (see Chapter 5).

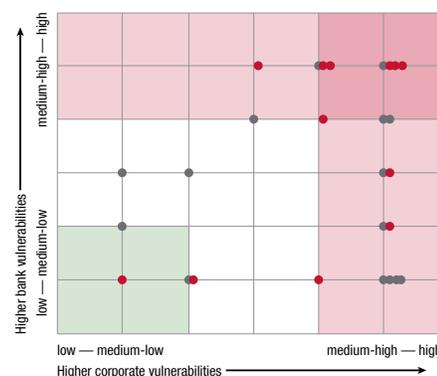
After the pandemic is fully under control, policy support can be gradually withdrawn and policy priorities should focus on rebuilding bank buffers, strengthening regulation of nonbank financial institutions and stepping up prudential supervision to contain excessive risk taking in a lower-for-longer interest-rate environment.

**Figure 10. Nonbank Financial Institutions: Financial Vulnerability Indices and Sector Size**



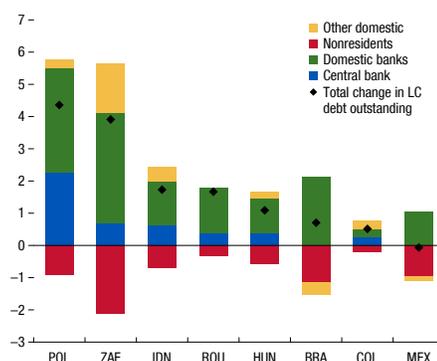
Sources: Banco de Mexico; European Central Bank; Haver Analytics; Reserve Bank of India; Securities and Exchange Commission of Brazil; WIND Information Co.; and IMF staff calculations.  
 Note: See Chapter 1 for details. AEs = advanced economies; AMs = asset managers; EMs = emerging markets; OFIs = other financial institutions.

**Figure 11. Corporate, Bank, and Sovereign Vulnerabilities in 29 Jurisdictions with Systemically Important Financial Sectors**



Sources: Bank for International Settlements; Haver Analytics; Institute of International Finance; IMF, October 2020 *World Economic Outlook*; and IMF staff estimates.  
 Note: Based on the data underlying Figure 1; red dots denote countries with medium-high or high sovereign vulnerabilities.

**Figure 12. Change in Local Currency Government Bonds Outstanding by Holder, end-February–June 2020 (Percent of GDP)**



Sources: Bloomberg Finance L.P.; Haver Analytics; IMF, *World Economic Outlook* database; national sources; and IMF staff estimates.  
 Note: Data are not adjusted for inflation-linked debt. South Africa total differs slightly from aggregated component changes. Indonesia central bank holdings of government securities reported as net of monetary operations by source. Data labels use International Organization for Standardization (ISO) country codes. LC = local currency.