The COVID-19 pandemic has triggered a global economic crisis of unprecedented magnitude. The World Economic Outlook forecasts a sharp global economic contraction for 2020. Despite the expected rebound in growth in 2021, the level of global output is anticipated to remain below precrisis levels for several years. The swift, aggressive, and broad economic policy response has contained the immediate damage, providing a bridge to recovery. Central banks have eased monetary policy across the globe, with a nearly $7.5 trillion balance sheet expansion to date in G10 countries, and with about 20 emerging market central banks deploying asset purchases for the first time. The post-2008 regulatory framework has been put to the test for the first time, and has been proven largely successful, as the global banking system entered the crisis with relatively high capital and liquidity buffers. In addition, a fiscal policy response of $12 trillion globally has provided substantial support to households and firms.

As a result of these policy actions, the adverse macro-financial feedback loops that were so prevalent and pernicious in the 2008 crisis have largely been contained. Financial conditions have eased significantly and rapidly since late March, allowing countries and firms to benefit from continued access to capital market and bank funding, and preventing liquidity pressures from turning into broad-based insolvencies. Capital flows to emerging markets have started to rebound, with many economies regaining market access. While insolvency risks still loom large, widespread corporate and banking distress has, to date, been contained. In fact, the global banking system remains fairly well capitalized against additional adverse shocks.

But financial vulnerabilities are rising, putting medium-term macro-financial stability and growth at risk. Stretched valuations in risk asset markets persist, despite the September repricing in equity markets, giving rise to a disconnect between the evolution of the economy and the assessment of risk in financial markets, reflecting in part investor expectations of continued policy support. Corporate debt is rising, and it is estimated to be at record levels relative to gross domestic product in most countries. Despite the resilience exhibited so far, there is a weak tail of fragile banks in some countries. Fragilities in the nonbank financial sector became clearly evident during the financial market strains in March, with market volatility jumping, margin calls rising, and liquidity in even the most liquid and deep bond markets drying up. Furthermore, sovereign debt is at historically high levels. This is a critical issue for many low-income countries and some emerging market economies, where a debt crisis might be inevitable without prompt and decisive policy action—a theme that is explored at length in the Fiscal Monitor.

Policymakers face stark trade-offs between short-term support and medium-term macro-financial stability risks, and they need to closely monitor any potential unintended consequences of their unprecedented support. In the corporate sector, massive liquidity may lead to significantly higher debt and medium-term resource misallocation, potentially allowing insolvent firms to survive for years. For banks, the usage of buffers may lead to too little capital being available in the future to cushion shocks. In capital markets, the easing of financial conditions may fuel future vulnerabilities. For emerging markets, limited policy space can prevent optimal policies in the short and the medium term. For many frontier economies and low-income countries—many of which continue to be shut out of international markets—further pandemic pressure and the challenging global economic environment are formidable headwinds for their macro-financial stability.

In this Global Financial Stability Report, we take stock of key recent market developments and present a forward-looking analysis of banks, nonbank financial

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institutions, nonfinancial firms, and emerging market capital flows that can help policymakers navigate difficult policy trade-offs in the next phases of the pandemic and recovery. We also attempt to quantify the impact of policies in our asset valuation assessments, which can help policymakers better assess risks to financial conditions. In addition, we assess the pandemic’s impact on firms’ environmental performance to gauge the extent to which the crisis may result in a reversal of the gains posted in recent years. The analysis underscores the importance of climate policies and green investment packages to support a green recovery and the transition to a low-carbon economy.

Tobias Adrian
Financial Counsellor