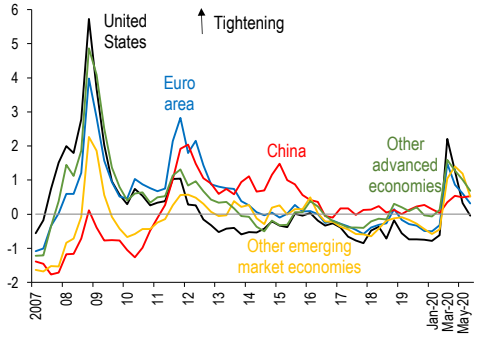
GLOBAL FINANCIAL STABILITY UPDATE

Financial Conditions Have Eased, but Insolvencies Loom Large

The *Global Financial Stability Update* at a Glance

- Risk asset prices have rebounded following the precipitous fall early in the year, while benchmark interest rates have declined, leading to an overall easing of financial conditions.
- Swift and bold actions by central banks aimed at addressing severe market stress have boosted market sentiment, including in emerging markets, where asset purchases have been deployed in a number of countries for the first time, helping bring about the easing in financial conditions.
- Amid huge uncertainties, a disconnect between financial markets and the evolution of the real economy has emerged, a vulnerability that could pose a threat to the recovery should investor risk appetite fade.
- Other financial system vulnerabilities may be crystallized by the COVID-19 pandemic. High levels of debt may become unmanageable for some borrowers, and the losses resulting from insolvencies could test bank resilience in some countries.
- Some emerging and frontier market economies are facing refinancing risks, and market access has dried up for some countries.
- Authorities, while continuing to support the real economy, need to closely monitor financial vulnerabilities and safeguard financial stability.

Figure 1. Global Financial Conditions Indices
(Standard deviations from mean)



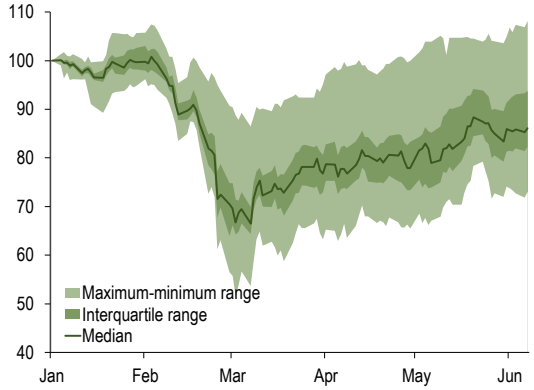
Sources: Bank for International Settlements; Bloomberg Finance L.P.; Haver Analytics; IMF, International Financial Statistics database; and IMF staff calculations.

Risk asset prices have rallied on the back of unprecedented central bank measures.

Over the two months since the publication of the April 2020 *Global Financial Stability Report*, global financial conditions have eased significantly following the sharp tightening early in the year. This easing has been driven by the combination of a marked fall in interest rates and a strong rebound in risk asset market valuations (Figure 1).

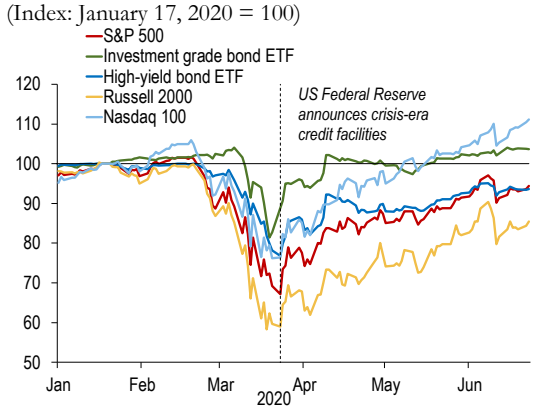
Looking at economies with systemically important financial sectors, equity markets have bounced back from their March troughs, on balance, recovering to about 85 percent of their mid-January

Figure 2. Equity Prices in Selected Economies, 2020
(Index: January 17, 2020 = 100)



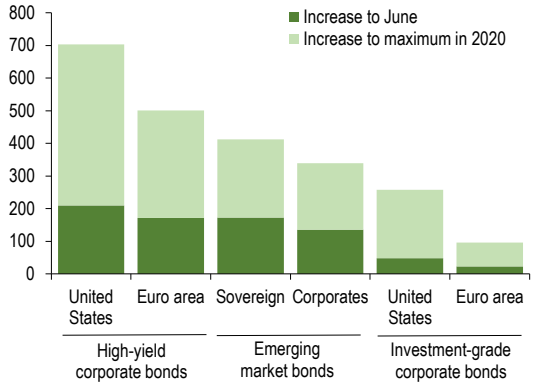
Sources: Bloomberg Finance L.P; and IMF staff calculations.
Note: The figure shows equity prices across the S29 economies (see footnote 1 in text) since January 17, 2020, when investor concerns about the impact of COVID-19 on the economy came to the fore.

Figure 3. US Equities and Credit Indices
(Index: January 17, 2020 = 100)



Sources: Bloomberg Finance L.P; and IMF staff calculations.
Note: ETF = exchange-traded fund.

Figure 4. Change in Credit Spreads
(Basis points, since January 17, 2020)



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

levels, on average, though there is some dispersion (Figure 2).[1] While some equity markets have recouped all of their losses, others are still about 25 percent lower than they were in mid-January. In tandem with the recovery in prices, equity market volatility has fallen from its peak in March, though it remains above its long-term average.

Swift and unprecedented central bank measures have been a major factor in the market recovery. For example, in the United States the turnaround in risk asset prices occurred around March 23 following the announcement by the US Federal Reserve of $2.3 trillion in crisis-era credit facilities (Figure 3). A similar pattern is evident in broader financial markets.

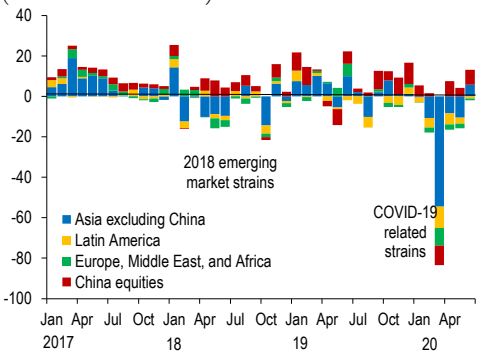
In credit markets, spreads have narrowed significantly from their earlier peaks. On average, about 70 percent of the initial widening has been retraced (Figure 4). There is, however, some divergence in the level of spreads across ratings and geography. Bond issuance has surged for higher-rated borrowers, and markets have reopened for speculative grade borrowers as well.

Investor sentiment toward emerging market economies has also improved notably. Portfolio flows to these economies have stabilized following the historic outflows earlier this year (Figure 5). Investors, however, continue to differentiate across emerging and frontier economies, with some inflows of capital into selected countries and asset classes. Higher rated countries have also been able to issue hard currency debt at a historically high pace so far this year, faster than economies with lower credit ratings. This difference underscores the external pressures that some emerging market economies are still facing.

This broad recovery in financial markets has been accompanied by growing investor optimism about

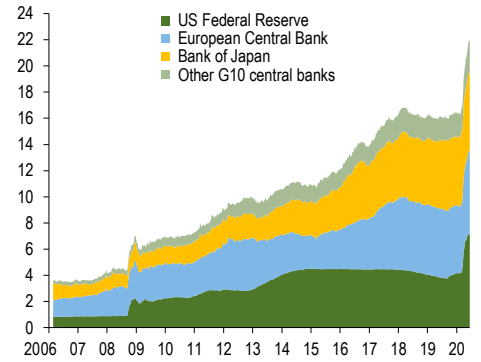
[1]Here, economies with systemically important financial sectors are those for which financial stability assessments under the Financial Stability Assessment Programs are mandatory every five years, that is, the S29 economies: Australia, Austria, Belgium, Brazil, Canada, China, Denmark, France, Finland, Germany, Hong Kong SAR, India, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Norway, Poland, Russia, Singapore, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

Figure 5. Emerging Market Portfolio Flows
(Billions of US dollars)



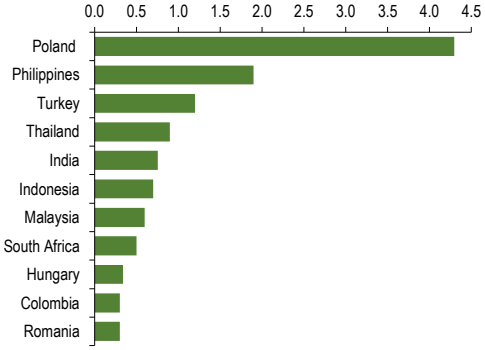
Sources: Bloomberg Finance L.P; Institute of International Finance (IIF); and IMF staff calculations.
Note: The figure is based on high frequency daily or weekly flows as reported by Bloomberg and the IIF.

Figure 6. G10 Central Bank Assets
(Trillions of US dollars)



Sources: Bloomberg Finance L.P; and IMF staff calculations.
Note: G10 = Group of Ten; other G10 central banks = central banks of Canada, Sweden, Switzerland, and the United Kingdom.

Figure 7. Selected Emerging Market Central Bank Government Bond Purchases, March–June 2020
(Percent of GDP)



Sources: Bloomberg Finance L.P.; JP Morgan; and IMF staff calculations.
Note: In some cases, central banks are purchasing other assets as well as government bonds. For India and Indonesia, the figure includes primary and secondary market purchases; for the Philippines this includes temporary and short-term funding for the government's COVID-19 measures.

the prospects of a speedy economic recovery. Market sentiment has been bolstered by the reopening of some economies and the easing of COVID-19–related lockdown measures. In addition, investors apparently expect unprecedented monetary policy accommodation to continue to support the global economy for quite some time.

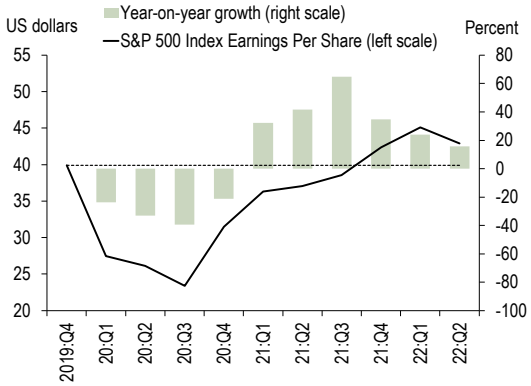
Actions by central banks have boosted investor risk appetite. Policy rates in a number of countries have been cut further and investors expect interest rates to remain at very low levels for several years. Balance sheets of advanced economies' monetary authorities have swelled following new rounds of asset purchases, liquidity support for the banking system, US dollar swap lines, and other facilities intended to sustain the flow of credit to the economy (Figure 6). Aggregate assets of the Group of Ten (G10) central banks have increased by about $6 trillion since mid-January, more than double the increase seen during the two years of the global financial crisis from December 2007, with the rise in assets accounting for almost 15 percent of G10 GDP.

A number of emerging market central banks have embarked on unconventional policy measures for the first time. In some countries, these asset purchase programs were started to support monetary policy; in other countries, the motivation was to support market liquidity (Figure 7). These programs have included purchases of a range of assets, including government bonds, state-guaranteed bonds, corporate debt, and mortgage-backed securities.

Fiscal and financial policy measures have also helped support investor sentiment. Governments around the world have provided large emergency lifelines to people and firms amounting to near $11 trillion (as shown in the IMF's *Fiscal Monitor* Database of Country Fiscal Measures in response to the COVID-19 Pandemic).[2] Financial authorities have also bolstered market confidence through a series of policies,

[2] The database of fiscal measures is available at http://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19.

Figure 8. S&P 500 Index Consensus Earnings Forecasts

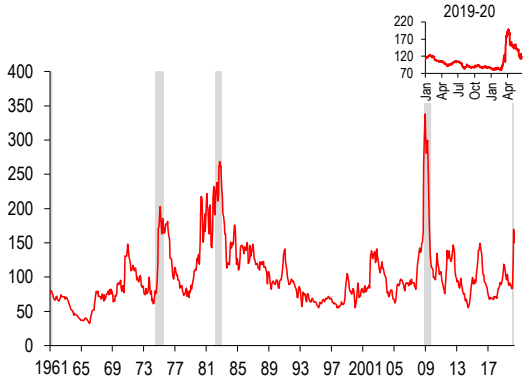


Sources: Bloomberg Finance L.P.; and IMF staff calculations.

Figure 9. US Equity Prices and Consumer Confidence
(Indices)

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

Figure 10. US Corporate Bond Spreads
(Basis points)



Sources: Federal Reserve Board; and IMF staff calculations.
Note: The figure shows the spread between Baa-rated and Aaa-rated bond yields. The shaded areas show periods of severe economic contraction, defined as when the Organisation for Economic Co-operation and Development leading indicator of US economic growth is below its 5th percentile.

including government credit guarantees, support for the restructuring of loans, and encouraging banks to use available capital and liquidity buffers to support lending (see the *IMF Policy Tracker on responses to COVID-19*).[3]

This combination of unprecedented policy support appears to have been successful in maintaining credit flows. The lift to investor risk appetite has helped raise bond issuance in markets, and banks have also continued to lend in most major economies.

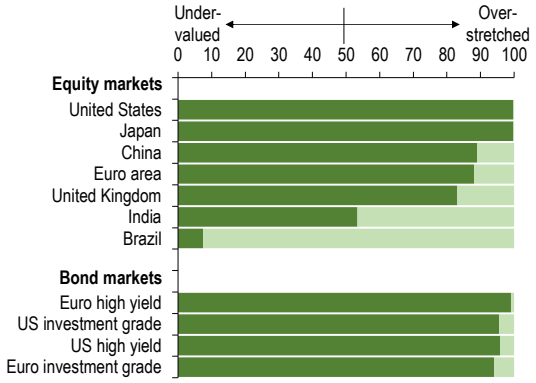
A disconnect between financial market optimism and the evolution of the global economy has emerged.

The bullish mood among investors is predicated on strong policy support amid huge uncertainties about the extent and speed of the economic recovery. Markets appear to be expecting a quick "v-shaped" rebound in activity, as illustrated by the strong recovery in the S&P 500 consensus forecasts of company earnings (Figure 8). Recent economic data and high frequency indicators, however, suggest a deeper-than-expected downturn, as discussed in the June 2020 *World Economic Outlook Update*. This has created a divergence between the pricing of risk in financial markets and economic prospects, as investors are apparently betting on continued and unprecedented support by central banks. This tension can be illustrated, for example, by the recent rally in the US equity market, on the one hand, and the steep decline in consumer confidence, on the other hand (Figure 9). This decoupling raises questions about the possible sustainability of the current equity market rally if not for the boost of sentiment provided by central bank support.

This disconnect between markets and the real economy raises the risk of another correction in risk asset prices should investor risk appetite fade, posing a threat to the recovery. For example, in

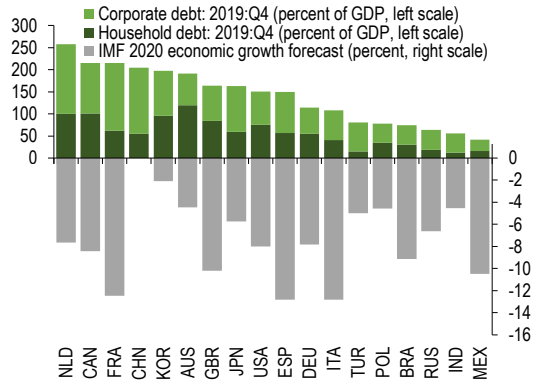
[3] The policy tracker is available at https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19#top.

Figure 11. Asset Price Misalignments, 2020:Q2
(Percentile during 1990–2020)



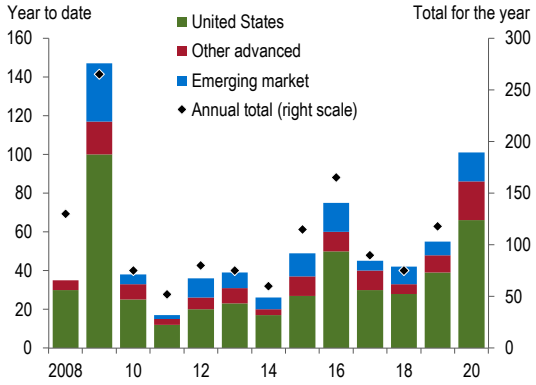
Source: IMF staff calculations.
Note: If data are not available for 1990, the earliest available data are used instead.

Figure 12. Nonfinancial Private Sector Debt and Economic Growth Forecasts



Sources: Bank for International Settlements; IMF, World Economic Outlook database; and IMF staff calculations.
Note: Positive growth forecasts are not shown. Data labels use International Organization for Standardization (ISO) country codes.

Figure 13. Number of Corporate Bond Defaults



Sources: S&P Global; and IMF staff calculations.

equity markets, bear market rallies have occurred before, during periods of significant economic pressure, often only to unwind subsequently. In corporate bond markets, spreads of investment-grade companies are currently relatively contained, contrary to the sharp widening experienced during previous significant economic shocks (Figure 10).

In fact, market valuations appear stretched across many equity and corporate bond markets. According to IMF staff models, the difference between market prices and fundamental valuations is near historic highs across most major advanced economy equity and bond markets, though the reverse is true for stocks in some emerging market economies (Figure 11).[4]

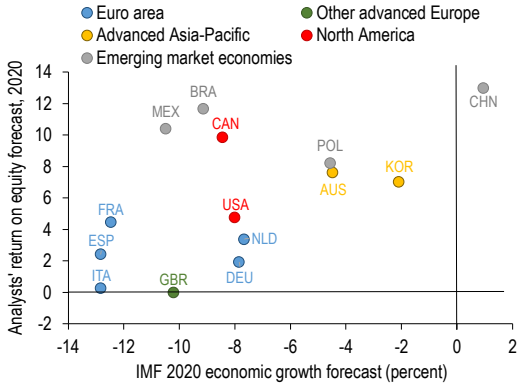
A number of triggers could result in a repricing of risk assets, a development that could add financial stress on top of an already unprecedented economic recession. For example, the recession could be deeper and longer than currently anticipated by investors. There could be a second wave of the virus, and containment measures could be reinstated. Market expectations about the extent and length of central banks' support to financial markets may turn out to be too optimistic, leading investors to reassess their appetite for, and pricing of, risk. A resurgence of trade tensions could sour market sentiment, putting the recovery at risk. Finally, a broadening of social unrest around the globe in response to rising economic inequality could lead to a reversal of investor sentiment.

The pandemic could crystallize other financial vulnerabilities that have built up over the past decade.

First, in advanced and emerging market economies alike, corporate and household debt burdens could become unmanageable for some

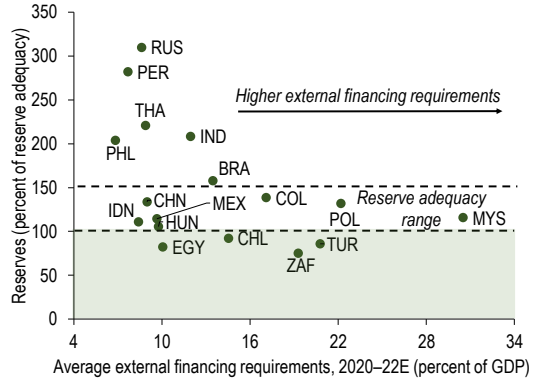
[4]The model-based estimates of fundamental valuations may not fully account for the unprecedented financial policy measures that have been taken in recent months, including central bank asset purchases and facilities intended to sustain the flow of credit to the economy, as well as credit guarantees that have been provided by some governments. More information on the models is available in the Online Annex to the October 2019 Global Financial Stability Report at: https://www.imf.org/~/media/Files/Publications/GFSR/2019/October/English/onlineannex11.ashx?la=en.

Figure 14. Bank Profitability and Economic Growth Forecasts



Sources: Bloomberg Finance L.P.; IMF, World Economic Outlook database; and IMF staff calculations.
Note: The vertical axis shows the median return on equity forecast for a sample of listed banks in each economy. Data labels use International Organization for Standardization (ISO) country codes.

Figure 15. Reserve Adequacy and External Financing Requirements



Sources: IMF, Assessing Reserves Adequacy database; and IMF, World Economic Outlook database.
Note: External financing requirements are calculated using estimates for the current account balance and short-term external debt to remaining maturity. The metric used for calculating reserves adequacy is adjusted for capital controls. Data labels use International Organization for Standardization (ISO) country codes. E = estimated.

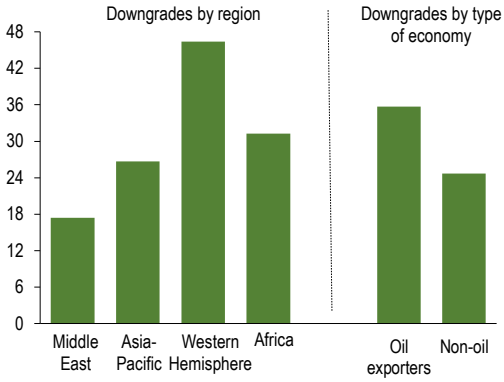
borrowers in a severe economic contraction. As has been discussed in previous *Global Financial Stability Reports*, aggregate corporate debt has been rising over several years to stand at historically high levels relative to GDP. Household debt has also increased, particularly in countries that managed to escape the worst impact of the 2007-8 global financial crisis. This means that there are now many economies with high levels of debt that are expected to face an extremely sharp economic slowdown (Figure 12). This deterioration in economic fundamentals has already led to the highest pace of corporate bond defaults since the global financial crisis, and there is a risk of a broader impact on the solvency of companies and households (Figure 13).

Second, insolvencies will test the resilience of the banking sector. Banks have entered the crisis with higher liquidity and capital buffers as a result of post-crisis reforms, and they can draw down these buffers to support lending and absorb losses. Some banks have already started to provision more for expected losses on their loans, as evidenced in their first quarter earnings reports. This is likely to continue as banks assess the ability of borrowers to repay their loans, while also accounting for the support that governments have given households and companies.[5] The expectation of further pressure on banks, along with the low level of interest rates, is reflected in analysts' forecasts of bank profitability (Figure 14).

Third, nonbank financial companies and markets may face further stress. The events in March, where nonbank financial intermediaries benefited from large policy support, suggests that they are vulnerable to procyclical corrections in the face of an external shock. These companies now have a greater role in the financial system than before, as discussed in the April 2020 *Global Financial Stability Report*, and the behavior of this larger sector during a deep downturn is untested.

[5] This support has been provided in different ways, including through state loans, public credit guarantees, restructuring of loan terms, and moratorium on payments.

Figure 16. Emerging Market Ratings Downgrades
(Percent of rated economies)



Sources: Bloomberg Finance L.P.; and IMF staff calculations.
Note: The figure shows a downgrade by at least one of the main rating agencies. Changes in the ratings outlook are not included.

There is a risk that nonbank financial companies could also face shocks in the event of a broad wave of insolvencies. These companies could also act as an amplifier of this stress. For example, a substantial shock to asset prices could lead to further outflows from investment funds, which could, in turn, trigger fire sales from those fund managers that would exacerbate market pressures.

Fourth, some emerging and frontier markets are facing high external refinancing requirements. In the current environment, economies that need to refinance more debt run a greater risk that this debt may have to be rolled over at a higher cost. Some countries with high refinancing requirements also have a relatively low level of reserve adequacy (Figure 15). This could make it harder for authorities in these economies to react to any further portfolio outflows, especially if they do not have a flexible exchange rate. Credit ratings downgrades could put additional pressure on funding costs and capital flows. So far this year, more than one-third of oil exporting economies that are covered by the main rating agencies have been downgraded, which compares to downgrades to about one quarter of other economies (Figure 16).

Authorities need to strike the right balance in their policy response to the pandemic.

In an environment of difficult policy trade-offs, authorities need to continue to support the recovery while ensuring the soundness of financial institutions and preserving financial stability, as highlighted in the "Financial Policy Priorities in Response to the Crisis" box below. Authorities need to be mindful of the intertemporal risk implications of this support. The unprecedented use of unconventional tools has undoubtedly cushioned the impact of the pandemic on the global economy and lessened the immediate danger faced by the global financial system. However, care needs to be taken to avoid a further buildup of vulnerabilities in an environment of easy financial conditions. Once the recovery is firmly underway, policymakers should urgently address

financial fragilities that could sow the seeds of future problems and put growth at risk in the medium term.

Financial Policy Priorities in Response to the Crisis

Central banks should maintain their accommodative stance of monetary policy in pursuit of their inflation and financial stability mandates through conventional and unconventional tools for as long as needed to support the flow of credit to households and firms. They should also continue to provide liquidity to prevent impairments to funding conditions and functioning in major money, foreign exchange, and securities markets. At the same time, central banks should carefully assess which markets are critical for maintaining financial stability and design support programs to minimize moral hazard and risks to themselves.

Authorities in emerging market and developing economies should use flexible exchange rates to absorb external pressures, where feasible. For countries with adequate reserves, exchange rate intervention can lean against market illiquidity and play a role in muting excessive volatility in currency markets. In the face of an imminent crisis, capital outflow management measures could be part of a broad policy package, though such measures should be implemented in a transparent manner, be temporary, and be lifted once crisis conditions abate. Sovereign debt managers should put in place contingency plans for dealing with limited access to external funding markets for a prolonged period.

Bank capital, liquidity, and macroprudential buffers should be used to absorb losses and manage liquidity strains and to help support lending to the economy. Banks should halt dividend payments and buybacks while the crisis lasts to help support capital buffers. In cases where banks face sizable and long-lasting shocks, and where bank capital adequacy is affected, supervisors should take targeted actions, including asking banks to submit credible capital restoration plans. Throughout the process, transparent risk disclosure and clear guidance from supervisors will be important.

Insurance company regulators in countries facing periods of extreme market stress may need to use the flexibility embedded in regulations, for example, to extend the allowed recovery period of affected insurers. Supervisors, however, should not lower standards and should ask insurers to prepare credible plans to ensure they can restore their solvency positions while continuing to provide necessary coverage to policyholders.

Asset managers should continue to ensure that liquidity risk management frameworks are being applied in a robust and effective manner. Regulators should support the availability of a wide set of liquidity management tools and encourage fund managers to make full use of the available tools where it would be in the interest of unit holders to do so. Standard setters should revisit the macroprudential framework for asset managers.

Multilateral cooperation is needed to protect the global financial system. Bilateral and multilateral swap lines may need to be provided to a broader range of countries to alleviate foreign currency funding pressures. Furthermore, any rollback of international financial system regulation or fragmentation through domestic actions that undermine international standards should be avoided.