EXECUTIVE SUMMARY

Financial Fragilities along the Last Mile of Disinflation

Financial market sentiment has been buoyant since the October 2023 *Global Financial Stability Report* on expectations that global disinflation is entering its "last mile" and monetary policy will be easing. Interest rates are down worldwide, on balance, stocks are up about 20 percent globally, and corporate and sovereign borrowing spreads have narrowed notably. As a result, global financial conditions have eased (Figure ES.1).

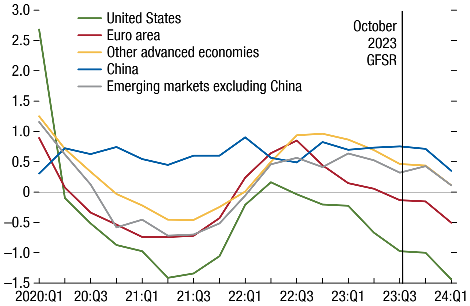
This risk-on environment has helped rekindle capital inflows for many emerging markets, on balance (Figure ES.2), and some frontier economies and low-income countries have taken advantage of strong investor risk appetite to issue sovereign bonds after a lengthy hiatus. Across all emerging markets, the estimated likelihood of capital outflows over the next year has declined.

Confidence in a soft landing for the global economy is growing against a backdrop of better-than-expected economic data in many parts of the world. Investors and central banks alike are expecting monetary policy to ease in the coming quarters, as cumulative interest rate increases over the past two years are believed to have created monetary conditions sufficiently restrictive to bring inflation back to central banks' targets. However, global inflation remaining persistently above those targets could challenge this narrative and may trigger instability. Recent oscillation of core inflation prints in some countries serves as a good reminder that the disinflation effort is not yet complete.

So far, cracks in the financial system—unmasked by high interest rates during the monetary tightening cycle—have not ruptured further. Financial and external sectors in major emerging markets have proven resilient throughout the interest rate upswing. Bank failures in Switzerland and the United States in March 2023 have not spread to other parts of the system, and soundness indicators for most financial institutions indicate continued resilience.

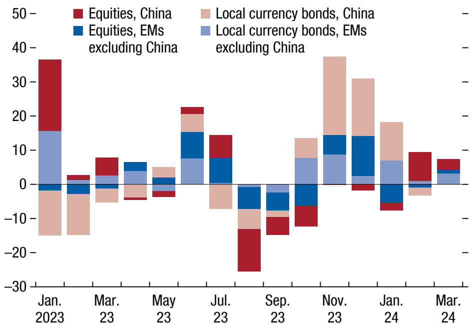
Near-term financial stability risks have therefore receded, and there is less of a downside risk to global growth in the coming year, based on the IMF's growth-at-risk framework analysis (Figure ES.3). The last mile of disinflation, however, may be complicated by several salient near-term financial fragilities.

Figure ES.1. Financial Conditions Indexes
(Standard deviations over long-term average)



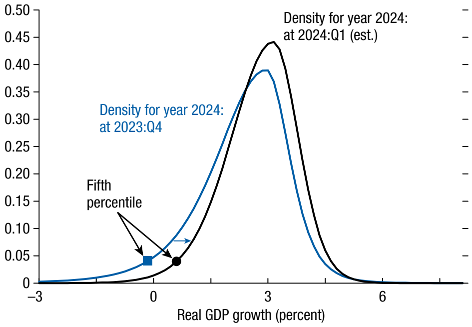
Sources: Bloomberg Finance L.P.; Dealogic; Haver Analytics; national data sources; and IMF staff calculations.
Note: GFSR = *Global Financial Stability Report*; Q = quarter.

Figure ES.2. Emerging Markets Portfolio Flow Tracking Local Currency Bonds and Equities
(Billions of US dollars)



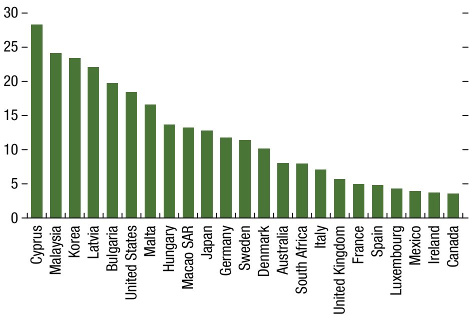
Sources: Bloomberg Finance L.P.; Haver Analytics; national authorities, and IMF staff calculations.
Note: EMs = emerging markets.

Figure ES.3. Global Growth-at-Risk
(Probability density)



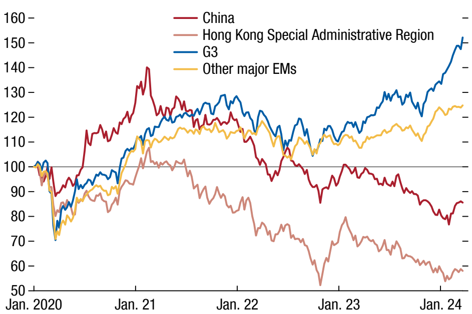
Source: IMF staff calculations.
Note: est. = estimation.

Figure ES.4. Bank CRE Exposures
(Percent of total loans)



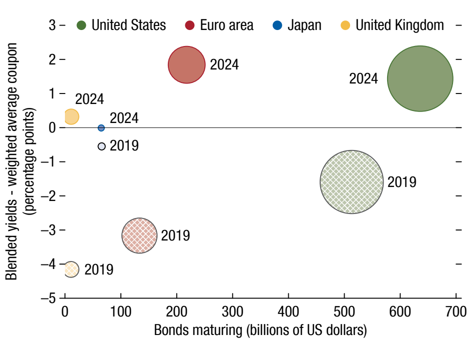
Source: IMF, Financial Soundness Indicators.
Note: Data are as of the third quarter of 2023, except Italy and Korea (2023:Q2), Australia and Germany (2023:Q1), and South Africa (2022:Q3). Ratio calculated using loans collateralized by commercial real estate, loans to construction companies, loans to companies active in the development of real estate in the numerator, and gross loans in the denominator. Some banking systems would have substantially lower ratios if non-CRE loans collateralized by commercial properties were excluded. The ratio does not fully capture the inherent risks from CRE, which also depend on other fundamental factors such as vacancy rates. CRE = commercial real estate; Q = quarter.

Figure ES.5. Chinese Stock Markets under Pressure
(Index = 100 in December 2020)



Sources: Bloomberg Finance L.P.; and IMF staff calculations.
Note: EMs = emerging markets; G3 = Group of Three.

Figure ES.6. Corporate Interest Rates Set to Go Up
(Percentage points, billions of US dollars)



Sources: Bloomberg Finance L.P.; S&P Capital IQ; and IMF staff calculations.
Note: The size of the bubbles corresponds to the size of the corporate bond market.

Salient Near-Term Risks

Commercial real estate (CRE) prices have declined by 12 percent globally over the past year in real terms amid rising interest rates and structural changes after the COVID-19 pandemic, with the US and European office sectors having seen the largest declines. Although banks appear well positioned to absorb CRE losses in aggregate, certain countries may experience more strains given that their banks hold large amounts of CRE loans (Figure ES.4), especially if these holdings are concentrated in CRE segments experiencing weak demand. Within a banking system, certain banks could suffer larger losses than others, in some cases exacerbated by issues such as less stable funding.

Residential home prices have continued to adjust downward in most countries but generally remain above prepandemic levels. Declines in real house prices have been driven by higher mortgage rates and have been more pronounced in advanced economies (–2.7 percent year over year) than in emerging markets (–1.6 percent). Still, household debt sustainability ratios are at modest levels globally, and a surge in residential mortgage defaults remains a tail risk.

Volatility has declined to multiyear lows for most asset classes, likely reflecting increased optimism that the global rate hike cycle is near its end. The average correlation across equities, bonds, credit, and commodity indices in both advanced economies and emerging markets exceeds the 90th historical percentile. Low volatility has masked the fact that financial conditions have become more responsive in this hiking cycle than in past cycles to economic data releases, especially inflation releases. Sizable inflation surprises could abruptly change investor sentiment, rapidly decompressing asset price volatility and causing simultaneous price reversals among correlated markets, thus prompting a sharp tightening in financial conditions.

Medium-Term Vulnerabilities

Beyond these more immediate concerns, medium-term vulnerabilities are building along the last mile. Both public and private debt continues to accumulate in advanced economies and emerging markets, which could exacerbate adverse shocks and worsen downside risks to growth down the road.

Major emerging markets continue to show resilience. With central banks having tightened policy aggressively and early, inflation has eased markedly in many emerging markets, allowing some to start their cutting cycles. At this juncture, the key question is whether emerging market resilience is at a turning point. For example, there are signs that investors are increasingly focused on medium-term fiscal sustainability. With interest rates and deficits still high, inflation declining, and growth moderating, more emerging markets are currently experiencing high real refinancing costs relative to economic growth.

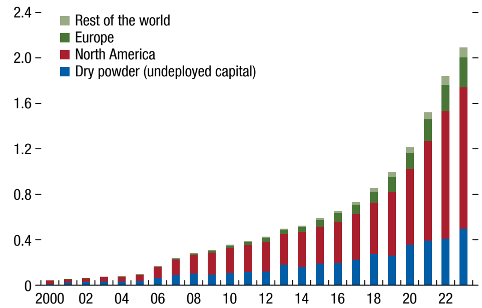
The easing of global financial conditions has benefited frontier economies and low-income countries. High-yield sovereign spreads have outperformed investment-grade spreads in recent months after reaching historically high levels in 2023. This is occurring at a critical time, with a substantial number of hard currency bonds maturing over the next two years in many countries. With external markets having been effectively closed for many low-income developing countries in prior years, local banking institutions have significantly increased their holdings of sovereign debt, increasing potential risks from a sovereign-bank nexus.

China's housing market downturn has shown few signs of bottoming out. Even though declines in new home prices have been moderate compared with housing-correction episodes in other countries, existing home prices and activity measures such as starts, sales, and real estate investments have sharply declined. Reflecting the property market ailment as well as further disinflationary pressures and the slowing growth outlook, China's stock market has come under pressure in recent months (Figure ES.5). The downturn in Chinese property and equity markets has caused heavy losses in parts of China's asset management industry, which could spill over to bond and funding markets. The steps authorities have taken to stabilize the markets since the third quarter of 2023 have yet to turn sentiments around.

Corporate credit spreads have narrowed since the October 2023 *Global Financial Stability Report*, although the recent rise in corporate earnings appears to be losing momentum in most parts of the world. Also, increasing evidence shows that cash liquidity buffers for firms in advanced economies and emerging markets eroded further over 2023, owing to still-high global interest rates. As of the third quarter of 2023, the share of small firms with a cash-to-interest-expense ratio below 1 was around one-third in advanced economies and more than half in emerging markets. Sizable amounts of corporate debt will mature in the coming year across countries at interest rates significantly higher than existing coupons, which could make refinancing challenging (Figure ES.6).

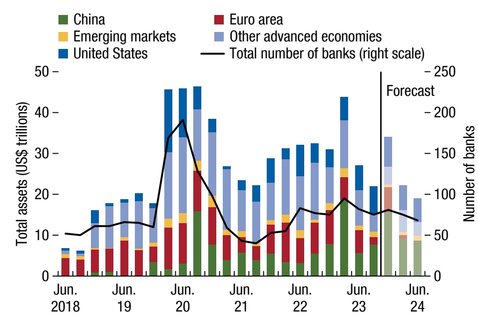
Even though defaults are on the upswing, growth in corporate borrowing globally is recovering more rapidly in this hiking cycle than in previous ones. Private credit—a rapidly growing market providing loans to midsize firms outside both the commercial bank sector and public debt markets—has helped fuel this trend (Figure ES.7). Chapter 2 identifies

Figure ES.7. Private Credit Growth
(Trillions of US dollars)



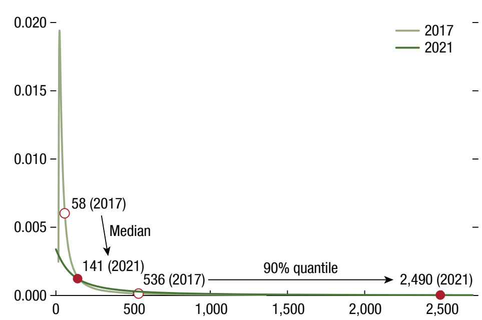
Source: Preqin.
Note: The measure of assets under management includes those from private credit funds, business development companies, and middle-market collateralized loan obligations, with the last two being mostly US focused.

Figure ES.8. Total Assets of Banks Flagged by Three or More KRIs
(Trillions of US dollars)



Sources: Visible Alpha; and IMF staff calculations.
Note: Constructed based on historical data from the first quarter of 2018 to the third quarter of 2023 and consensus forecasts for the fourth quarter of 2023 (for banks for which actual data are not available) and for the first two quarters of 2024. KRI = key risk indicator.

Figure ES.9. Estimated Distribution of Maximum Annual Firm Loss
(Density, millions of US dollars)



Source: Advisen Cyber Loss Data; Capital IQ; and IMF staff calculations.
Note: Green lines show the estimated posterior density function of the highest loss of all firms within a year. The solid (hollow) markers indicate the median and 90th percentile in 2021 (2017).

potential vulnerabilities of private credit markets, including relatively fragile borrowers compared with high-yield and leveraged finance markets, a growing share of semiliquid investment vehicles, multiple layers of leverage, stale and potentially subjective valuations, and interconnectedness across segments and players of financial markets.

Some advanced economies will likely require heavy government bond issuances to fund fiscal deficits. With the Bank of England, European Central Bank, and US Federal Reserve conducting quantitative tightening at annual paces of £100 billion, €212 billion, and $780 billion, respectively, along with the quantitative tightening programs being implemented by other central banks, the buyer base for government bonds has shifted. Most new marginal buyers of government bonds, such as hedge funds—which buy bonds partly for leveraged trading strategies to capture the price difference between bonds and futures—are arguably more price sensitive and more attuned to debt sustainability. This suggests more volatility in bond markets in the medium term. Some countries may find it increasingly difficult to service outstanding sovereign debt, which results in a "debt begets more debt" quandary.

The majority of banks showed resilience during the March 2023 turmoil. Strong capital and liquidity buffers and improved profitability have lifted bank stock prices across countries since then. Looking ahead, however, IMF staff's key risk indicators suggest that a subset of banks remains vulnerable. Banks with aggregate assets of $33 trillion, or 19 percent of global banking assets, have breached at least three of the five key risk indicators (Figure ES.8). Chinese and US banks constitute most of this subset. For some Chinese banks, the breaches are driven by thinning capital ratios and concerns about deteriorating asset quality, whereas some large regional banks in the United States face multiple pressures.

Among nonbanks, open-end bond funds, including ones focused on less liquid assets, have received large inflows in recent years. Excessive liquidity transformations that contributed to the global financial crisis and were evident at the start of the COVID-19 pandemic in March 2020 could reappear.

With growing digitalization, evolving technologies, and increasing geopolitical tensions, cyber incidents—especially those with malicious intent—are a rising concern for macrofinancial stability. Chapter 3 shows that although most losses from cyberattacks are modest, the risk of extreme losses has been increasing (Figure ES.9). The financial sector is particularly exposed to cyber risk, and although cyber incidents have not been systemic to date, they acutely threaten the financial system because of its exposure to sensitive data, high concentration, and technological and financial interconnectedness. Better cyber legislation and cyber-related governance arrangements at firms could help mitigate risks, but cyber policy frameworks often remain inadequate—especially in emerging market and developing economies.

Policy Recommendations

Central banks should avoid premature monetary easing and appropriately push back against overly optimistic market expectations for policy rate cuts that could add to the easing of financial conditions and complicate the last mile of disinflation. Where progress on disinflation is enough to suggest that inflation is moving sustainably toward the target, central banks should gradually move to a more neutral stance of policy.

Authorities should strengthen efforts to contain debt vulnerabilities, including in emerging market and frontier economies. In China, robust policies to restore confidence in the real estate sector are critical.

Supervisory and regulatory authorities should use appropriate tools, including stress tests and early corrective action, to ensure that banks and nonbank financial institutions are resilient to strains in commercial and residential real estate and to the credit cycle downturn. Further progress on resolution frameworks and a readiness to apply them is critical to address the problems of weak or failing banks, without undermining financial stability or risking public funds.

Quantitative tightening and the reduction in balance sheets need to proceed with care. Central banks should carefully monitor market functioning issues and mobilize to address potential market stresses. Ensuring that banks are prepared to access central bank liquidity and intervening early to address liquidity stress in the financial sector can mitigate financial instability.

Given the potential risks of the fast-growing private credit market, authorities should consider a more proactive supervisory and regulatory approach. It is key to close data gaps and enhance reporting requirements to comprehensively assess risks. Authorities should also strengthen cross-sectoral and cross-border regulatory cooperation and make risk assessments consistent across financial sectors.

A cybersecurity strategy can strengthen the cyber resilience of the financial sector, accompanied by effective regulation and supervisory capacity, as well as by improved reporting of cyber incidents. Delivering critical services to address disruptions is crucial to limit potential damage to the financial system. Financial firms should develop and test response-and-recovery procedures to remain operational in the face of cyber incidents. Given the global nature and systemic implications of cyberattacks, cross-border coordination is crucial.