EXECUTIVE SUMMARY

April 2021 *Global Financial Stability Report*: Preempting a Legacy of Vulnerabilities

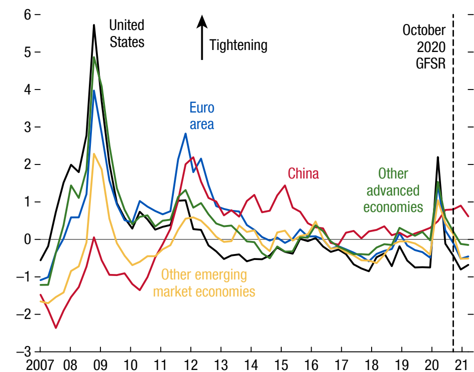
Extraordinary policy measures have eased financial conditions and supported the economy, helping to contain financial stability risks. But actions taken during the pandemic may have unintended consequences such as stretched valuations and rising financial vulnerabilities. The recovery is expected to be asynchronous and divergent between advanced and emerging market economies. Given large external financing needs, emerging markets face daunting challenges, especially if a persistent rise in US rates brings about a repricing of risk and tighter financial conditions. The corporate sector in many countries is emerging from the pandemic over-indebted, with notable differences depending on firm size and sector. Concerns about the credit quality of hard-hit borrowers and the profitability outlook are likely to weigh on the risk appetite of banks during the recovery. There is a pressing need to act to avoid a legacy of vulnerabilities. Policymakers should take early action and tighten selected macroprudential policy tools while avoiding a broad tightening of financial conditions. They should also support balance sheet repair to foster a sustainable and inclusive recovery.

Thanks to massive policy support, the global financial system has been resilient during the COVID-19 pandemic and financial conditions have eased significantly (Figure 1). This has helped maintain the flow of credit to households and firms, facilitated the recovery, and kept financial risks at bay. The improved economic outlook has clearly reduced the range of adverse outcomes, but notable downside risks to future GDP growth remain.

Two overarching themes are emerging. First, unprecedented policy support may have unintended consequences: excessive risk taking in markets is contributing to stretched valuations, and rising financial vulnerabilities may become structural legacy problems if not addressed. Equity markets have rallied aggressively since the third quarter of 2020 on expectations of a rapid economic recovery and continued policy backstops, and they are now trading at levels meaningfully higher than those suggested by models based on fundamentals (Figure 2). While earnings expectations have improved, historically low real risk-free rates (despite most recent increases) have provided material support so far to valuations. In the corporate bond market, spreads have remained very tight.

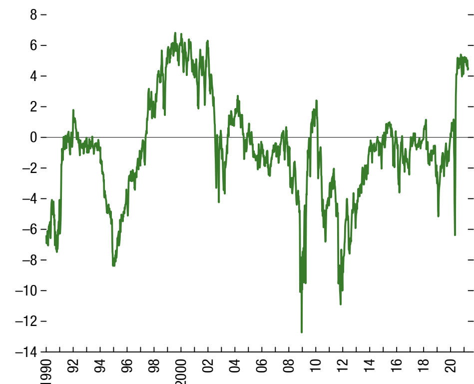
Long-term interest rates have increased significantly, especially in the United States, reflecting in part greater investor confidence in the outlook (Figure 3). While a

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



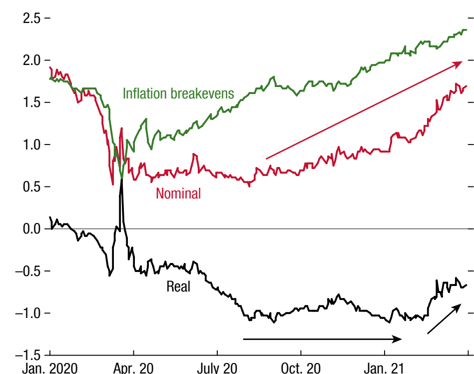
Source: IMF staff calculations.
Note: GFSR = *Global Financial Stability Report*.

Figure 2. US Equity Market Misalignment
(Deviation from fair value per unit of risk)



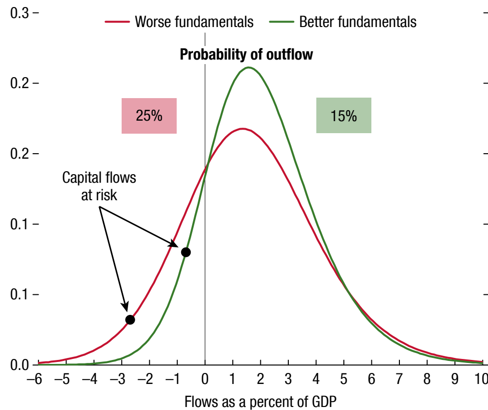
Source: IMF staff calculations.

Figure 3. US 10-Year Nominal and Real Rates
(Percent)



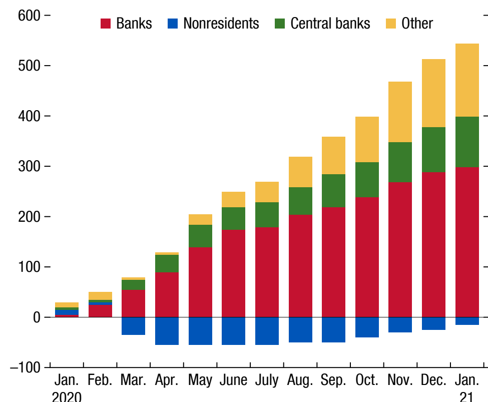
Sources: Bloomberg Finance L.P.; and IMF staff calculations.
Note: Inflation breakevens are measures of expected inflation derived from inflation-linked bonds.

Figure 4. Portfolio Flows at Risk for Countries with Better vs. Worse Fundamentals
(Probability density function)



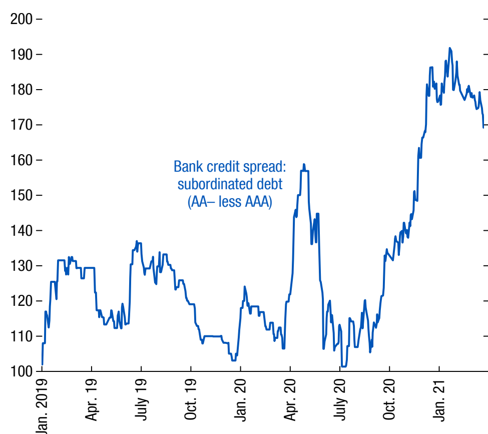
Source: IMF staff calculations.

Figure 5. Change in Domestic Sovereign Bond Holdings of Emerging Markets
(Billions of US dollars, cumulative change)



Sources: Haver Analytics; national sources; and IMF staff calculations.
Note: Based on a sample of 11 major emerging markets. Domestic bonds are primarily denominated in local currency. Figures are converted to US dollars at end-of-month exchange rates.

Figure 6. Chinese Banks: Debt Spreads
(Basis points, subordinated debt)



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

gradual rise in rates on the back of improving fundamentals may be welcome, a rapid and persistent increase, especially in real rates, may result in a repricing of risk in markets and a sudden tightening in financial conditions. Such a tightening could interact with elevated financial vulnerabilities, with repercussions for confidence and endangering macro-financial stability, especially in emerging markets.

Second, the recovery is expected to be asynchronous and divergent across economies (see the April 2021 *World Economic Outlook*). There is a risk that financial conditions in emerging market economies may tighten markedly, especially if policymakers in advanced economies take steps toward policy normalization. A less favorable financial environment may result in large portfolio outflows and pose a significant challenge to some emerging and frontier market economies, given the large financing needs they face this year. IMF staff analysis points to a continued improvement in the outlook for portfolio flows, primarily reflecting easier global financial conditions (Figure 4). Nevertheless, countries with weaker fundamentals or limited access to COVID-19 vaccines are vulnerable. The sovereign-bank nexus has worsened in emerging markets as domestic banks have absorbed the bulk of increases in domestic debt (Figure 5). For many frontier market economies, market access remains impaired.

China has recovered more rapidly than other countries, but at the cost of a further buildup in vulnerabilities, particularly risky corporate debt. Financial conditions may become less favorable amid expectations for policy tightening and new measures to impose discipline on banks, local governments, and property developers, as well as rising uncertainty about implicit guarantees. Funding conditions for capital instruments have tightened for weaker, smaller banks (Figure 6). National authorities face a delicate but urgent challenge in unwinding implicit guarantees—a task that must be handled delicately given the potential for disorderly repricing.

The global corporate sector has been hit hard by the pandemic. Extraordinary policy support has helped mitigate its impact. Large firms with market access have taken advantage of favorable conditions to issue debt and cope with liquidity pressures (Figures 7 and 8). But the buildup in corporate leverage resulting from easy financial conditions poses a dilemma for policymakers, as the short-term boost to economic activity must be weighed against an increase in vulnerabilities and downside risks to growth down the road (see Chapter 2).

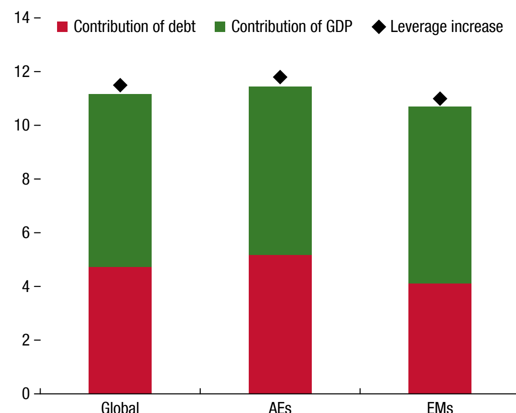
A more granular firm-level assessment finds that there are notable differences in performance across sectors and firm sizes. IMF staff analysis suggests that liquidity stress is high at small firms in most sectors and across countries, while solvency stress is high at small firms but also notable at mid-sized and even large firms in the most affected sectors (Figure 9). Chapter 1 proposes a framework to assess whether firms should rely on market financing, seek government support, or be restructured or liquidated.

The crisis has hit the commercial real estate sector hard (see Chapter 3). Commercial property transactions and prices slumped in 2020 (Figure 10). Part of the adverse impact on the retail, office, and hotel segments could be structural, as some activities increasingly take place virtually or are relocating outside of large cities. In the event of a structural decline in demand, commercial real estate fair values could drop sharply: a permanent increase in the vacancy rate by 5 percentage points is estimated to result, on average, in a drop in fair values by about 15 percent after five years (Figure 11). Since the pandemic, price misalignments appear to have increased. This development, if it persists, could pose downside risks to growth.

Banks came into the pandemic with high capital and liquidity buffers, thanks to regulatory reforms implemented after the 2007–08 financial crisis, and they have been resilient so far. But the extent to which they will continue to provide credit through the recovery is an open question. While growth of loans, particularly to businesses, has slowed in some countries, loan demand is expected to firm up once the recovery gains strength, especially where it has been weakest. But loan officers in most countries do not anticipate a loosening in lending standards (Figure 12). The phasing out of support policies could have a significant impact on some banks, likely weighing on their appetite for lending. Moreover, for most banks, uncertainties about credit losses and weak prospects for profitability are likely to discourage significant reduction in capital buffers to support the recovery. Such constraints may be particularly worrisome for firms with limited financing options that are more dependent on bank credit. Authorities should continue to encourage banks to use buffers, where prudent, to support the recovery.

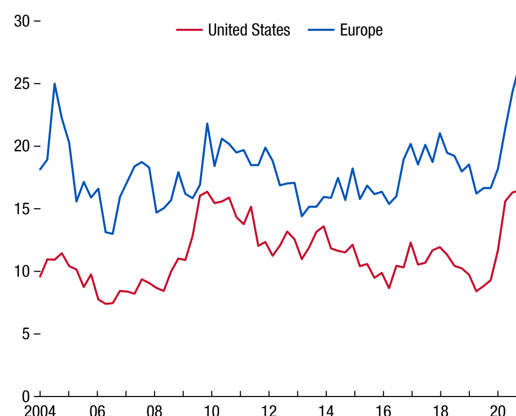
Ongoing policy support remains essential until a sustainable and inclusive recovery takes hold to maintain the flow of credit to the economy and prevent the pandemic from posing a threat to the global financial system. Monetary policy will need to remain accommodative until mandated policy objectives are achieved. Policymakers should act swiftly to prevent financial vulnerabilities from becoming entrenched and turning into legacy problems.

Figure 7. Nonfinancial Corporate Debt Change
(Percentage points of GDP, 2019:Q4 to 2020:Q3)



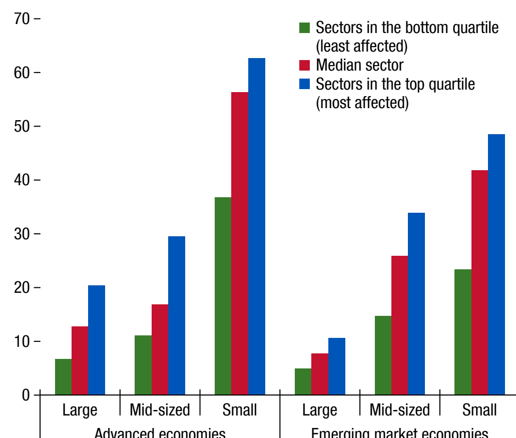
Sources: Institute of International Finance (IIF); and IMF staff calculations.
Note: AEs = advanced economies; EMs = emerging markets.

Figure 8. Median US and European High-Yield Issuer Cash
(Percent of debt)



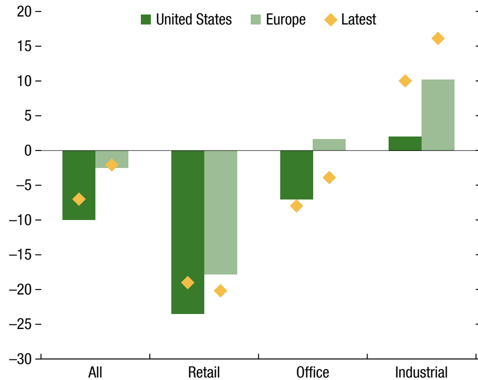
Sources: Morgan Stanley; and IMF staff.

Figure 9. Solvency Stress Indicators
(Share of debt at firms with elevated solvency stress in percent of total debt at all firms in respective segments)



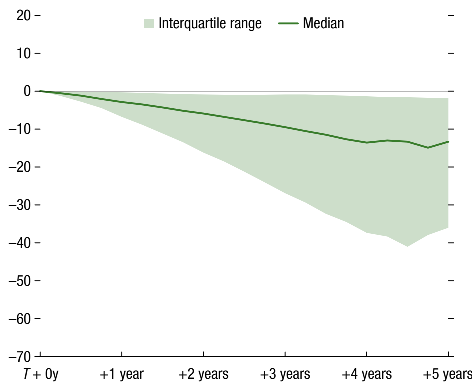
Sources: S&P Capital IQ; and IMF staff.
Note: Large, mid-sized, and small firms are defined by total assets.

Figure 10. Commercial Real Estate Prices
(Percent, 2020:Q2 and latest, year over year)



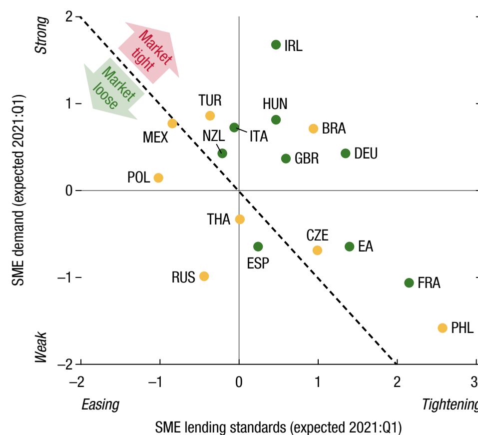
Source: Green Street Advisors.
Note: Latest data available are for January 2021 in Europe and February 2021 in the United States.

Figure 11. Response of Commercial Real Estate Prices across Economies to a Permanent Shock to the Vacancy Rate
(Percent)



Sources: Haver Analytics; MSCI Real Estate; and IMF staff calculations.
Note: See Chapter 3 for background. *T* denotes quarter of shock.

Figure 12. Small and Medium Firm Lending Standards and Loan Demand Expected
(Standard deviations)



Source: IMF staff calculations.
Note: Countries are identified by three-letter International Organization for Standardization (ISO) country codes. Expected refers to next 3 months. Green dots = advanced economies; yellow dots = emerging markets; EA = euro area; SME = small and medium enterprises.

Taking into consideration possible lags between the activation and impact of macroprudential tools, policymakers should take early action.

They should tighten selected macroprudential policy tools to tackle pockets of elevated vulnerability while avoiding a broad tightening of financial conditions. If such tools are not available (such as in some segments of the nonbank financial intermediation sector), policymakers should swiftly develop them. Given the challenges to designing and operationalizing macroprudential tools within existing frameworks, policymakers should also consider building buffers elsewhere to protect the financial system.

In emerging and frontier market economies, countries with market access should take advantage of favorable financing conditions to improve the composition of their debt structure. Countries with limited market access will likely need additional assistance from the international community. Other countries facing significant difficulties with debt burdens could benefit from deeper restructuring. The Group of Twenty (G20) Common Framework for Debt Treatments can help address debt vulnerabilities. Rebuilding buffers, where possible, should be a key priority to prepare for any sudden price adjustments and reversal of capital flows.

Repairing corporate balance sheets should be a priority to enable a sustainable and inclusive recovery. Direct and firm-specific targeted policy support may be needed for viable firms whose market access is limited and that are facing temporary liquidity or solvency risks. Given very limited fiscal resources in some jurisdictions, policymakers should also expedite reforms to enhance resolution frameworks, including the development of distressed debt and nonperforming loan markets.

Once the extent of structural changes in the commercial real estate sector becomes clearer, targeted macroprudential policy tools (such as limits on the loan-to-value or debt-service-coverage ratios) should be deployed to reduce downside risks to growth. The optimal timing of such policy measures should depend on the economy-specific pace of the recovery and the degree of financial vulnerabilities in the commercial real estate sector. Broadening the macroprudential toolkit to cover nonbank financial institutions active in some commercial real estate funding markets will also be crucial.

In the financial sector, regulatory guidance on provisioning for expected losses to avoid excessive procyclicality remains pertinent, but such provisioning should be subject to supervisory scrutiny. Restrictions on capital distributions should be maintained or be relaxed only progressively in countries overcoming the pandemic, subject to supervisory stress tests to ensure that banks remain well capitalized.