

FOREWORD

The global economy has struggled to withstand the stress of a yearlong pandemic—but, even as an economic recovery approaches, new challenges confront all economies. With the risk of global financial instability high, policymakers must be ready to adapt their policies to meet potentially volatile conditions.

The IMF's forecast has been upgraded to 6 percent global growth for 2021, boosted by the \$1.9 trillion fiscal stimulus in the United States. The stimulus since the start of the pandemic has contained the number of bankruptcies, restrained the increase in unemployment, and reduced economic scarring more generally. In addition, central bank asset purchases at nearly \$10 trillion globally have played a crucial role in keeping interest rates low and financial conditions accommodative.

But the picture is starting to change, as longer-term interest rates are rising. The yield on the 10-year US Treasury note has increased from just over ½ percent in August 2020 to about 1¾ percent recently, almost matching its pre-pandemic level. This reflects improved prospects for inflation and growth—real yields and market-implied inflation have both risen—but medium-term inflation expectations remain anchored.

Central banks face stark trade-offs. The rise in yields could tighten financial conditions weighing on funding costs. Further asset purchases to undo such tightening may have unintended consequences in market-based finance at a time when the macro- and microprudential toolkit remains incomplete. Rising vulnerabilities in the corporate and nonbank sector could put medium-term financial stability at risk.

Emerging markets have already felt the brunt of rising yields. Borrowing costs for corporate and sovereign issuers have been steadily increasing at a time when financing needs remain exceedingly high. The still-easy financial conditions remain supportive,

but the volatility in financial markets and portfolio flows presents significant risks. Emerging market policymakers could face difficult times ahead, with more constrained monetary policy space on the back of rising inflation, unless positive spillovers from the reemerging global economy take over.

Bank profitability is expected to be low in many jurisdictions, and it is becoming a disincentive against the use of capital buffers to support the recovery. While markets see a boom in finance, bank lending might become strained and challenge the stance of monetary policy in many countries. Worryingly, the sovereign-bank nexus has intensified markedly in emerging markets, with 60 percent of sovereign debt issued after January 2020 ending up on domestic banks' balance sheets.

The corporate sector is now at a crossroads. While some firms benefited from the easing in financial conditions and repaired their balance sheets, some continue to struggle and rely heavily on policy support. The solvency risk remains elevated at small and mid-sized firms—and even at some large firms in both advanced and emerging markets. This report presents a decision framework for the corporate sector to help policymakers triage among alternative policies.

Markets for assets that follow environmental, social, and governance (ESG) standards have boomed since the beginning of the recovery phase of the pandemic. In the run-up to the United Nations Climate Change Conference (COP26) in November 2021, the IMF is working with other international financial institutions, standard-setting organizations, and the Network for Greening the Financial System to establish climate disclosure standards, define climate taxonomy, and improve climate data.

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