EXECUTIVE SUMMARY

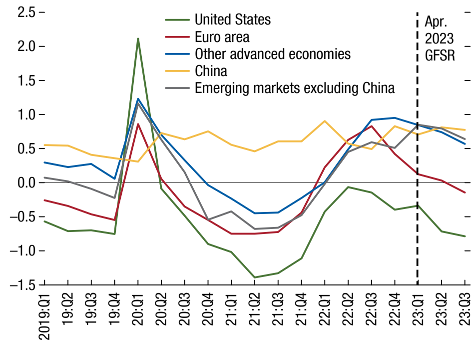
Soft Landing or Abrupt Awakening?

With core inflation still high and declining only slowly in many advanced economies, central banks may need to keep monetary policy tighter for longer than is currently priced in markets. In emerging market economies, progress on lowering inflation appears to be more advanced, with the benefits of early rate hikes becoming apparent. However, there are discrepancies across regions. Widening divergence of inflation and economic outlook could mark the beginning of the desynchronization of the global monetary policy.

Yet, optimism about a soft landing of the global economy, whereby disinflation continues apace and a recession is avoided, has fueled asset valuation since the April 2023 *Global Financial Stability Report*. Despite the declines in equity prices since September, driven by rising long-term real rates, financial conditions for advanced economies have eased on net (Figure ES.1). Taking a slightly longer view, so far this year, stock prices in Europe and the United States have climbed about 10 and 12 percent, respectively, and corporate credit spreads remain near the lowest levels since the beginning of this rate hike cycle. In Japan, equities have outperformed other advanced economies, supported in part by continued monetary policy accommodation and stronger corporate profits. Emerging markets such as Chile, Hungary, India, Mexico, and Poland have also seen notable equity price increases, consistent with the appreciation of most major emerging market currencies in the first half of the year. Upside surprises to the inflation outlook would challenge this soft-landing narrative, resulting in a potentially sharp repricing of assets.

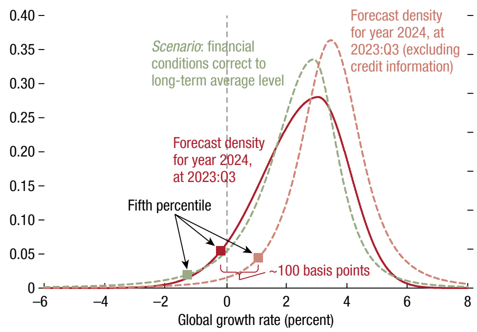
While acute stress in the global banking system has subsided, a weak tail of banks remains in some countries. In addition, cracks in other sectors may also become apparent and could turn into worrisome fault lines. In the event of an abrupt tightening of financial conditions, adverse feedback loops could be triggered and again test the resilience of the global financial system. Most notably, the global credit cycle has started to turn as borrowers' debt repayment capacity diminishes and credit growth slows. The IMF's growth-at-risk measure summarizes this assessment, indicating that risks to global growth are skewed to the downside, similar to the assessment in April 2023 (Figure ES.2). In a scenario wherein the hoped-for soft landing does not materialize, investors pull back from risk taking, and financial conditions tighten toward the long-term average, the growth-at-risk forecasts the growth distribution to be even more firmly skewed to the downside.

Figure ES.1. Financial Conditions Indices
(Number of standard deviations over a long-term average)



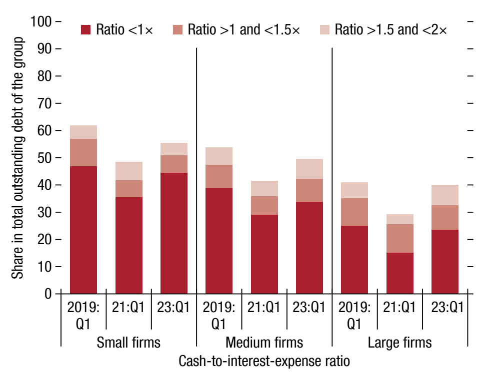
Source: Bloomberg Finance L.P.
Note: GFSR = *Global Financial Stability Report*; Q = quarter.

Figure ES.2. Global Growth at Risk
(Probability density of global growth in 2024)



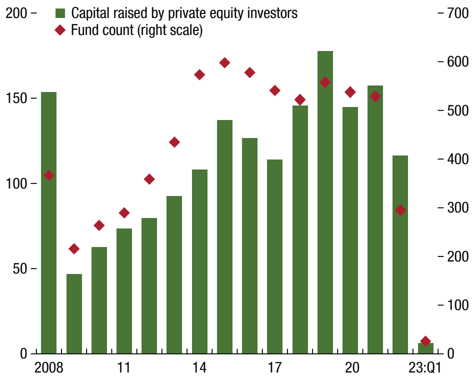
Sources: Bloomberg Finance L.P.; and IMF staff calculations.
Note: Q = quarter.

Figure ES.3. Corporate Cash-to-Interest-Expense Ratios in Emerging Markets Excluding China
(Percent)



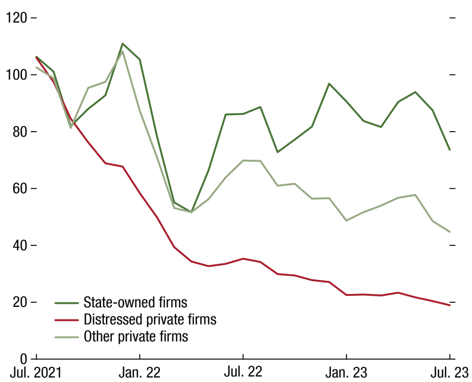
Sources: Bloomberg Finance L.P.; and IMF staff calculations.
Note: Cash includes cash and cash equivalents. Interest expense includes those on loans and bonds; Q = quarter.

Figure ES.4. Private Equity Real Estate Fundraising
(Billions of US dollars, left scale; fund count, right scale)



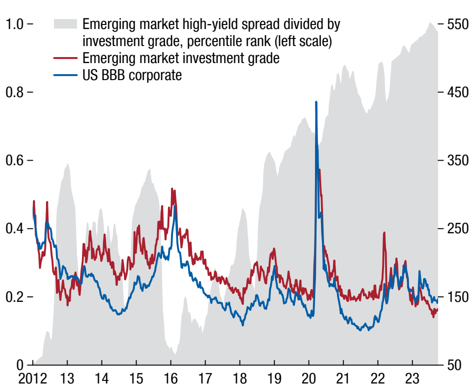
Sources: Preqin; and IMF staff calculations.
Note: Q = quarter.

Figure ES.5. Chinese Property Sales Volume, by Developer Type
(Average of the first half of 2021 = 100, three-month moving average)



Sources: Bloomberg Finance L.P.; and CEIC.

Figure ES.6. Emerging Market Sovereign Spreads
(Percentile rank, left scale; basis points, right scale)



Sources: Bloomberg Finance L.P.; Federal Reserve; national authorities; and IMF staff calculations.
Note: The gray area tracks the ratio of emerging market high-yield sovereign spreads to emerging market investment-grade sovereign spreads, expressed in historical percentiles.

Vulnerabilities

Over the past year, the transmission of rate hikes may have been dulled as corporations and households extend their debt repayment horizon or use savings accumulated during the pandemic to shore up their balance sheets and interest payments. However, these factors may not be sufficient to stave off a trend of rising repayment difficulties. Indeed, the share of firms with low cash-to-interest-expense ratios—that is, weaker firms with fewer buffers—has rebounded over the past two years, including in emerging markets, as firms face tighter funding conditions (Figure ES.3). This rebound is especially evident among small and medium firms. Likewise, mortgage borrowers will continue to face a higher repayment burden, leading to a slowdown in housing activity and a further decline in home prices. Global real house prices have been falling since late 2022, as major central banks have aggressively tightened monetary policy. In advanced economies, real house prices fell 8.4 percent in the first quarter of 2023, whereas emerging markets saw a smaller decline of about 2.4 percent. Countries with a large share of floating-rate mortgages and house prices above the prepandemic average recorded double-digit declines in home prices.

Given the size and concentration of commercial real estate (CRE) and its strong connections with the broader financial system and the real economy, stress in that sector can have significant financial stability implications. As a share of GDP, CRE-related debt equates to nearly 12 percent of GDP in Europe and 18 percent in the United States. Concerns about the risk of a widening funding gap have emerged, as funding sources become less available for CRE borrowers needing to refinance—banks have reported tighter lending standards, private equity fundraising activity has slowed sharply (Figure ES.4), and the issuance of commercial mortgage-backed securities has gone tepid. The prospect of interest rates remaining higher for longer, combined with declining property valuations, will keep refinancing conditions strained in the CRE sector.

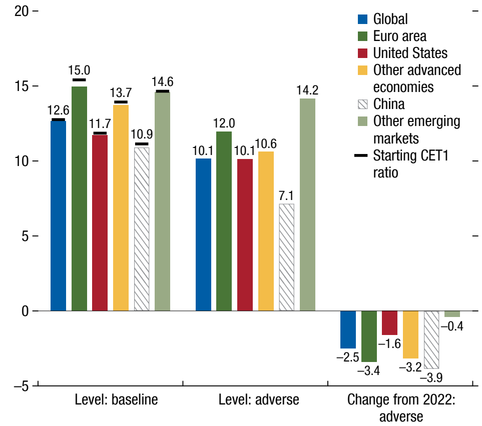
In China, weakening economic momentum, a deepening property sector downturn, and growing strains on local government financing weigh heavily on market sentiment. The renminbi has faced notable downward pressure as equity prices have fallen sharply. Disinflationary pressures have grown, prompting the People's Bank of China to cut policy rates—one of the few central banks to ease monetary policy. However, such easing and other announced stimulus measures have not yet restored confidence among businesses, consumers, and, importantly, homebuyers. Stronger private property developers and even state-owned developers have experienced materially lower home sales volumes in recent months (Figure ES.5), and a large private developer missed interest payments on its bonds due in August. Continued stress in the property sector has spilled over to local government finances as investors have become increasingly concerned about the debt sustainability of local government financing vehicles (LGFVs). In addition, a major asset manager, which suspended payments and redemptions on its wealth management and trust products, has raised concerns about further financial stress if the public were to lose confidence in investment products.

Investors continue to differentiate between emerging market economies with stronger fundamentals and policy buffers and those considered less resilient and more vulnerable to shocks. Most emerging market sovereign credit spreads have remained narrow despite the continued tightening of monetary policy and higher yields (Figure ES.6). However, the gap between the investment-grade and high-yield segments of emerging market sovereign debt markets remains wide. Repeated credit downgrades since the pandemic have pushed the average frontier sovereign rating lower, driving implied spreads and financing costs higher across many emerging market economies.

As the primary lenders in the global economy, banks are expected to deal with greater credit costs as higher interest rates reduce borrowers' ability to repay loans. In aggregate, the banking system appears to have prudently added provisions for more defaults, and loan-loss reserves seem adequate to cover nonperforming loans in many countries. Higher rates should also support net interest margins on new bank loans. That said, history has shown that credit exposures can deteriorate rapidly, and loan demand can plummet when an economy enters a recession, affecting bank profitability. Chapter 2 presents the IMF's assessment of the quantum of banks vulnerable to higher inflation and interest rates using two new approaches. The assessment conducts an enhanced version of the IMF's global stress test, complemented by a new forward-looking monitoring framework that incorporates analyst forecasts of key risk indicators—bank balance sheet, valuation, and profitability metrics. Both approaches indicate the presence of a notably weak tail of banks. The global stress test shows a wide set of banks will suffer capital losses under an adverse stagflationary scenario, including several systemically important institutions in China, Europe, and the United States (Figure ES.7). This finding is consistent with the key risk indicators which project that some Chinese and US banks are likely to remain under pressure given lower expected earnings and the depressed price-to-book ratios of Chinese banks.

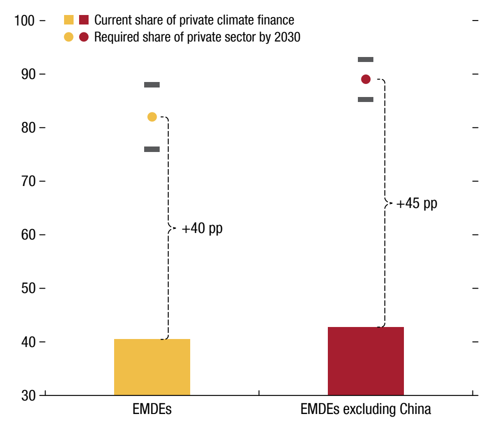
An environment of high interest rates is likely to benefit some nonbank financial intermediaries while challenging the resilience of others. For institutions with longer-term financial obligations, such as insurers and pension funds, elevated interest rates have reduced the present value of their liabilities and improved funded ratios. Such institutions' key risk stems from having moved during the extended period of extremely low interest

Figure ES.7. CET1 Ratios, under Global Stress Test
(Percent for levels, percentage points for changes)



Sources: Bloomberg Finance L.P.; Capital IQ; Fitch Analytics; Vitek 2018; October 2023 *World Economic Outlook*; and IMF staff estimates.
Note: CET1 = Common Equity Tier 1.

Figure ES.8. Projected Private Financing Share in Climate Investments
(Percent)



Source: IMF staff calculations.
Note: EMDEs = emerging market and developing economies; pp = percentage points.

rates into less liquid and more risky assets, like private credit. On the other hand, investment funds with shorter funding structures, especially those providing daily liquidity, could face redemption pressure from their investors, as higher interest rates reduce the value of their fixed-income assets. Those using leveraged investment strategies predicated on swift disinflation may be forced to unwind positions should inflation stay doggedly high.

Chapter 3 shows that, by 2030, climate mitigation investment needs in emerging market and developing economies (EMDEs) are estimated to reach about $2 trillion per year. The private sector is key to financing the required investments in EMDEs, given limited fiscal space and challenging market conditions. By 2030, the share of private finance must increase to about 80 percent of climate mitigation investment needs in EMDEs, and the proportion should be even greater in EMDEs outside of China (Figure ES.8).

Policy Recommendations

Ultimately, sustainable economic growth requires both price and financial stability. Central banks must remain determined in their fight against inflation until there is tangible evidence that it is moving sustainably toward targets, although the stance of monetary policy should reflect a country-specific pace of economic recovery and disinflationary processes. Communication remains crucial to convey policymakers' resolve.

Progress on inflation in a number of emerging market economies has been notable, but central banks should be cautious not to ease policy rates too aggressively. Countries should integrate their policies, including, where applicable, within the Integrated Policy Framework, the IMF's macrofinancial framework for countries to manage the risks stemming from volatile capital flows amid uncertainty in global monetary policy and the foreign exchange environment. Optimal policy combinations depend on the nature of the shock and country-specific characteristics. Any response measures should be part of a plan that tackles underlying macroeconomic imbalances and allows for needed adjustments.

Sovereign borrowers in emerging market economies, frontier markets, and low-income countries should strengthen efforts to contain risks associated with their high debt vulnerabilities, including through dialogue with creditors, multilateral cooperation, and support from the international community. If applicable, the Group of Twenty Common Framework—a reformed quicker and more effective version—should be used, including in preemptive restructurings. Bilateral and private sector creditors should find ways to coordinate preemptive and orderly restructuring to avoid costly hard defaults and prolonged loss of market access. Where feasible, refinancing or liability management operations should be executed to rebuild buffers.

In China, robust policies to restore confidence in the real estate sector will be critical to limit the risk of negative spillovers to the financial sector, corporations, and local governments. Priority should be given to facilitating the completion of housing projects, which could stem the slump in homebuyer sentiment, and the timely resolution and restructuring of troubled property developers. Easing monetary policy further and reorienting fiscal support toward households are necessary to support economic growth. A comprehensive strategy is needed to address the LGFV debt issue to restore LGFVs' debt-servicing capacity and achieve sustainable levels of local government debt. Although authorities have taken steps in recent years to mitigate systemic risks emanating from the asset management sector, further progress is needed to address risky exposures to real estate and LGFVs and liquidity mismatches between their assets and liabilities. For banks, maintaining adequate loss-absorbing buffers, phasing out forbearance policies that could delay loan-loss recognition, and expediting efforts to restructure weak banks are critical for mitigating financial stability risks.

The sizable tail of weak banks in the global financial system and the risk of contagion to healthy institutions highlights the urgent need to implement international standards in a consistent manner across jurisdictions, assess whether specific features of these standards performed as intended during the recent turmoil, and enhance supervision where necessary. Adequate minimum capital and liquidity requirements across large and small institutions alike are essential to contain financial stability risks. Authorities should be more prepared to intervene early to address weaknesses in banks, including ensuring their banks' preparedness to access central bank facilities, and strengthening where needed their bank resolution regimes and preparedness to deploy them.

National authorities should deploy stringent stress tests to estimate the potential effects of diminished borrowers' repayment capacity and a sharp decline in residential real estate prices on household balance sheets and, ultimately, on financial institutions. Continued vigilance is warranted to monitor vulnerabilities in the CRE sector, including reviews of banks' CRE valuations, and ensure that provisions are adequate. Buffers should be built to help guard against future losses and to support the continued provision of credit during stress times. For example, authorities may raise countercyclical capital buffers or sectoral systemic risk buffers if circumstances allow. To avoid procyclical effects, the raising of buffers should be conditioned on the absence of signs that credit is already being constrained by the adequacy of banks' capital.

A broad mix of structural and financial policies is needed to create an attractive investment environment for private capital to support climate finance needs in EMDEs. A stronger climate information architecture—data, disclosures, and alignment approaches (including taxonomies)—is necessary to attract private investors. Financial sector policies should be focused on creating climate impact. Transition taxonomies in EMDEs can help institutions identify activities that may reduce greenhouse gas emissions over time, including in the most carbon-intensive sectors. Disclosures and labels for sustainable investment funds should enhance market transparency, market integrity, and alignment with climate impact–oriented outcomes. Through its convening power, the IMF has a crucial role to play in mobilizing private climate finance, particularly in lower-income countries. The Resilience and Sustainability Facility can be a catalyst for private finance through its policy conditionality, supporting reforms that can help attract private capital.