Unprecedented policy support has:

- Kept markets functioning
- Maintained the flow of credit
- Avoided adverse macro-financial feedback loops…
- …and widespread bankruptcies

… but may exacerbate future vulnerabilities:

- Real-financial disconnect
- Rising debt and insolvencies
- Depletion of bank buffers
- Excessive risk-taking
Financial Conditions Have Remained Accommodative

Global Financial Conditions Indices
(Standard deviations from mean)

Key Drivers of Global Financial Conditions Indices
(Standard deviations from mean)
The Flow of Credit To the Economy Has Been Maintained

AE Corporate Bond and Leverage Loan Issuance
EM Corporate and Sovereign Bond Issuance
(Billions of US dollars)

Bank Credit Growth in AEs and EMs, 2020:Q2
(Percent)

Investment grade
High yield
Non-rated
Leveraged loans

2015-19 average
2020:Q2

Lending to corporate
Lending to household

AE
EM
2019 Avg
Feb.
Apr.
Jun.
Aug.
Sep. est

US
Euro area
Other AE
China
Other EM

AE
EM
2019 Avg
Feb.
Apr.
Jun.
Aug.
Sep. est

US
Euro area
Other AE
China
Other EM
Risk of EM Outflows Has Declined; EM Local Markets Have Stabilized

Note: “APP economies” refer to countries where the central bank deployed asset purchase programs.
Global Financial Stability Risks Have been Contained

Near-Term Growth Forecast Densities
(Probability Densities)

- Density for year 2020: at 2020:Q1
- Density for year 2021: at 2020:Q3

Near-Term Growth-at-Risk Forecasts
(Percentile rank)

- Quintiles: Worst, Average, Best

0 20 40 60 80 100
The Real-Financial Disconnect Persists
Strong Rebound Has Led to Stretched Valuations in Equity Markets...

**S&P500: Decomposition of Equity Market Performance**
(Percent contribution to cumulative returns)

- Risk-free rate
- Equity risk premiums
- Earnings (current and projected)
- Price return

**Global Stock Markets Performance**
(Indices; 2/19/20=100)

- Top five US stocks
- S&P 500 ex. top five
- Global equity ex-US
- MSCI EM
Vulnerabilities are rising…
Corporate Sector: Policy Trade-offs

From “whatever it takes” today...

...to phasing out extraordinary policy support

More liquidity support today...
• Collapse in revenues led firms to increase borrowing
• Liquidity support kept bankruptcies at bay
• Impact uneven across countries and sectors

... solvency risks shift into the future
• Liquidity extended to nonviable firms
• Debt overhang
• Misallocation of resources
Increased borrowing has pushed corporate debt levels to new highs in several countries.

Firms in sectors most affected by the pandemic have seen higher default rates.

Aggregate Nonfinancial Corporate Debt
(Percent of GDP)

Global Speculative Grade Corporate Default Rates
(12-Month Trailing, Percent)
As Asset Quality of Risky Credits Has Weakened

Interest coverage ratios have dropped sharply, especially in the loan market

Default forecasts have risen but the forecast dispersion is high

... including in risky credit markets

Median Interest Coverage Ratio for US High-Yield and Leveraged Loan Issuers
(EBITDA-to-Interest Expense)

US Speculative-Grade Default Rate: Actual and Forecasts by Credit Rating Agencies
(Trailing 12-month rate, percent)

Implied Correlations from North American CDX HY
(between default rates of synthetic CDS tranches)
Banks: Policy Trade offs

From “whatever it takes” today…

Greater use of buffers by banks today…
- Banks entered the crisis with strong capital & liquidity
- Borrower support policies and flexibility in regulatory frameworks have further supported bank lending

...to phasing out extraordinary policy support

... less capacity to lend tomorrow
- With low profitability & rising NPLs ahead, depletion of capital & liquidity buffers may
  - leave banks vulnerable
  - and force them to scale back lending
Banks May Face Sizable Losses in the WEO Adverse Scenario

Distribution of Bank Assets by Capital Ratio under Adverse Scenario, with Policy Mitigation:
(CET 1 ratio, percent)

- <4.5%
- 4.5% - 6%
- 6% - 12%
- >= 12%

Bank Capital Shortfall under Adverse Scenario
(Billions of US dollars)

Sample: ~350 banks in 29 jurisdictions.

Note: The shortfall (RHS chart) is measured against bank-specific and fully loaded capital requirements, including a minimum CET1 of 4.5%, a GSIB buffer, a systemic risk buffer, a stress capital buffer, a conservation capital buffer, and a countercyclical capital buffer.
Are Banks Beginning to Prepare for Tough Times Ahead?

New Loans, Credit Lines, and Government Guarantees, in Major Advanced Economies, 2020
(Billions of USD)

Bank Lending Standards
(Net percentage of banks reporting tighter lending standards)
NBFIs: Policy Trade offs

From “whatever it takes” today...

...to phasing out extraordinary policy support

NBFIs entered crisis with elevated vulnerabilities...
- Significant fund outflows revealed...
- … liquidity risks & maturity mismatches
- Public support prevented de-stabilizing blow ups

... and risks remain elevated
- Fund inflows returned thanks to policy support
- Propelled by search-for-yield
- Investments into riskier credit and less liquid assets
Inflows Return to Investment Funds, but Vulnerabilities Remain Elevated

Cumulative Fund Flows
(Percent of assets under management)

Bid-Ask Spreads of Fixed-Income Funds’ Portfolios
(Percent)
Sovereign Debt Levels and Contingent Liabilities Have Increased
Public Debt Is Rising Globally

Public Debt
(percent of GDP)

Fiscal Deficit
(percent of GDP)

Source: IMF Fiscal Monitor and IMF staff calculations.
Emerging and Frontier Markets Face Financing Challenges
Some Emerging Markets Face Financing Challenges

Global Emerging Market Debt Dedicated Fund Flows & Returns
(Cumulative, year to date, billions of US dollars, left scale; percent, right scale)

Local Currency Government Bond Gross Issuance
Completed Relative to Estimated Total Issuance
(Percents of total)
Funding Costs for Frontier Markets Are High; Some Lost Market Access

Hard Currency Bond Yields in Emerging and Frontier Markets
(Percent)

External Debt-Service, through the End of 2021
(Share of foreign reserves, percent, as of July 2020)
Asset Purchase Programs in Emerging Market Economies
What’s Different This Time?

The need for emergency spending and the hit to revenues from the sharp economic shock of the COVID-19 crisis increased budget deficits ...

... and most central banks have aggressively cut rates, some to all-time lows.

General Government Deficit
(Percent of GDP)

Monetary Policy Rates
(10th–90th percentile range, percent)

Emerging Market Policy Response to the COVID-19 Pandemic

Central banks have responded forcefully to the COVID-19 crisis with an array of measures to boost market liquidity and stabilize economic and financial conditions …

Central Bank Policy Actions
(Number of central banks on y-axis; percent of sample in brackets)

… and for the first-time, number of emerging markets implemented asset purchase programs. These programs differ in scope, size, and duration from those in advanced economies.

Central Bank Asset Purchases through August
(Percent of GDP)
Emerging market asset purchases rose significantly in March and April but have moderated recently …

… for some economies, the central bank purchases helped offset portfolio outflows during the crisis period.

Asset Purchases by Major EM Central Banks
(Billions of US dollars)

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Change in Local Currency Government Bond Holdings, end-Feb–June 2020 (Percent of 2020 GDP)

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**A Consistent Message: APPs Have Been Effective**

*APPs lowered bond yields and term premia, had little effect on currencies, and reduced market stress*

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**EM 10-yr Bond Yields**  
(Basis points)

**EM Currencies (vs US Dollar)**  
(Indexed at 1 at time t)

**LSI: APP vs non-APP Economies**  
(Index)

APP announcements

APPs announced in most countries in sample
Policy Priorities
Vulnerabilities in Multiple Sectors; Policy Space Shrinking

- Corporate, Bank, and Sovereign Vulnerabilities in the S29 Economies

**Note:** Red dots denote countries with medium high to high sovereign vulnerabilities.
A Bridge to Recovery