International Monetary Fund

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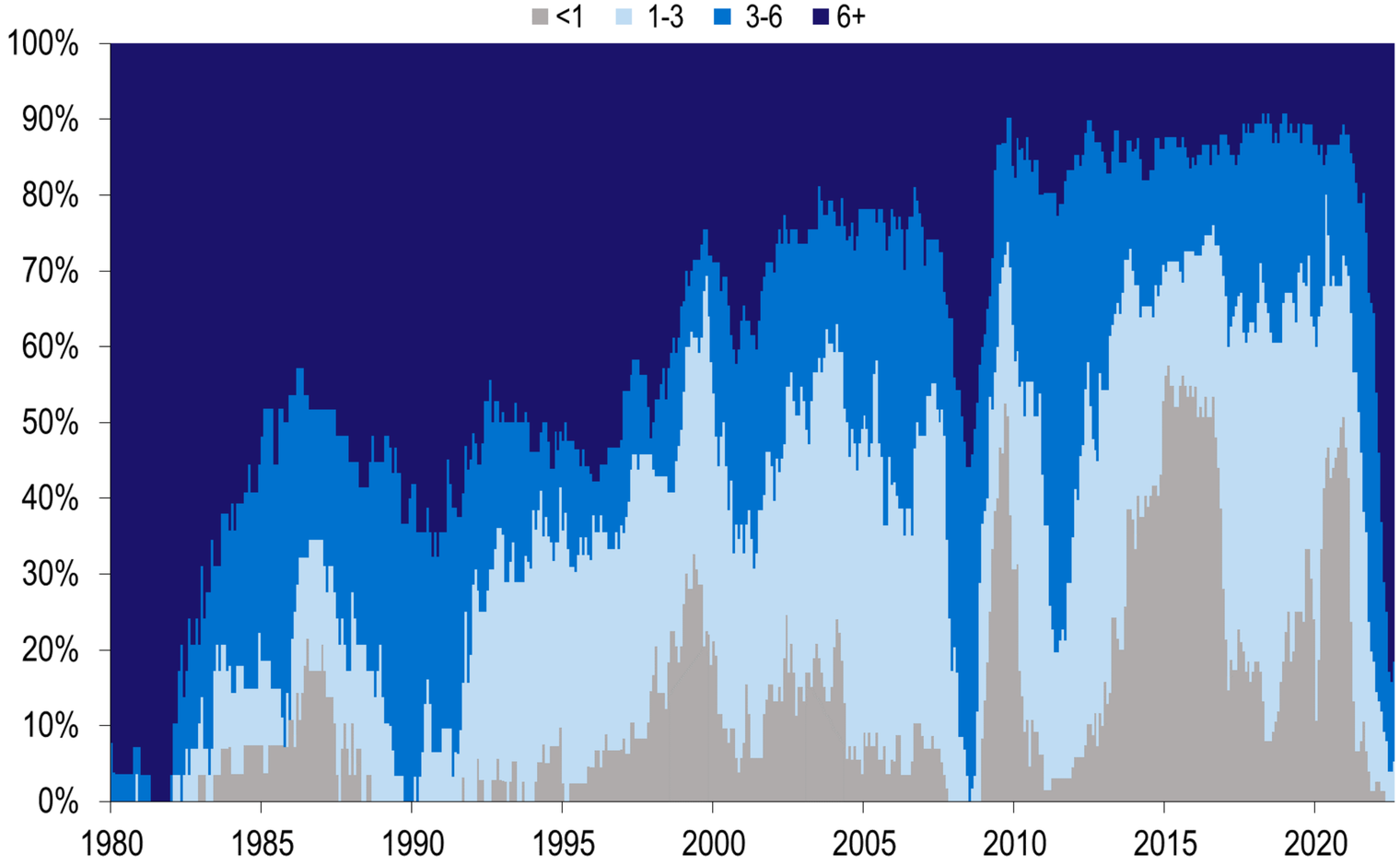
World Economic and Market Developments

Tobias Adrian

Financial Counsellor and Director
Monetary and Capital Markets Department

Worldwide Inflation Has Reached Multidecade Highs

Distribution of inflation globally
(Proportion of countries in each inflation band)

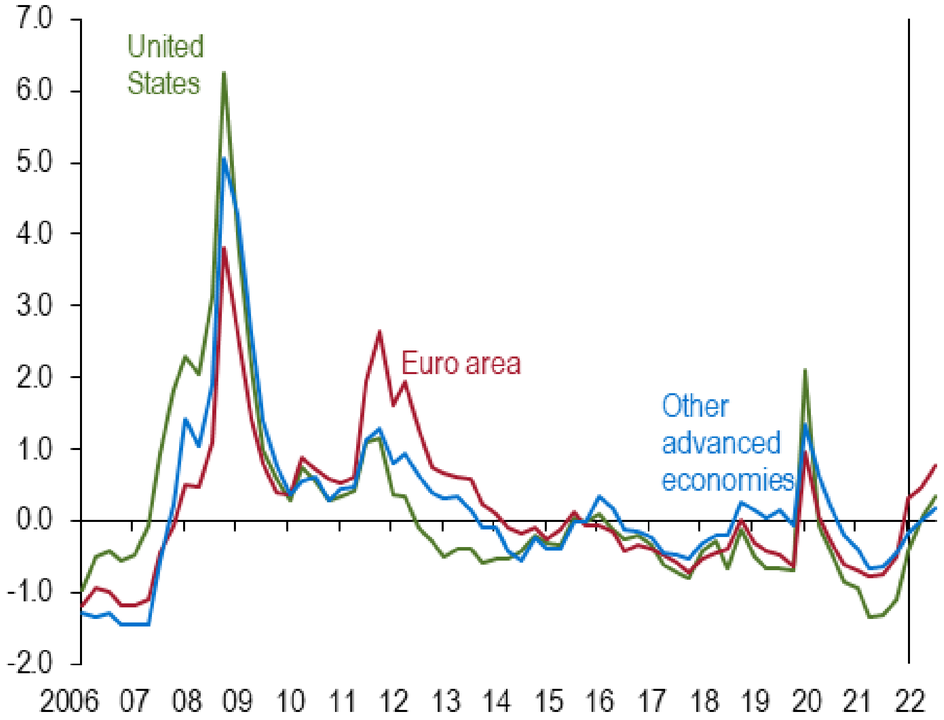


Note: Based on realized y/y headline inflation in 76 countries

Financial Conditions Have Tightened

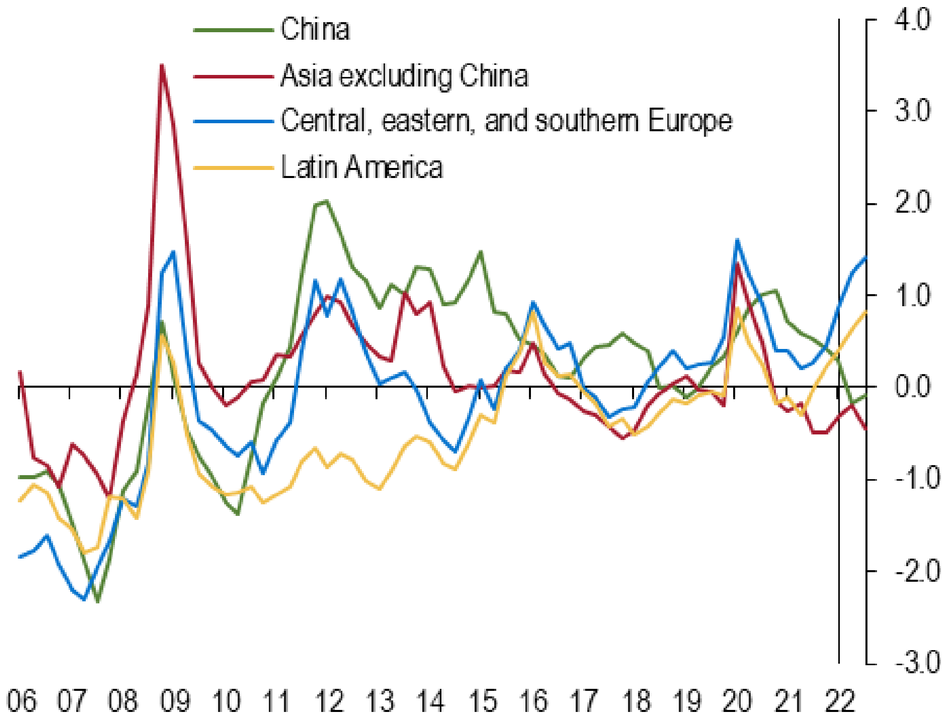
In AEs, FCIs have only risen to historical averages…

Financial Conditions: Advanced Economies
(Standard deviations from the mean)



… While in some EMs, they have reached March 2020 levels

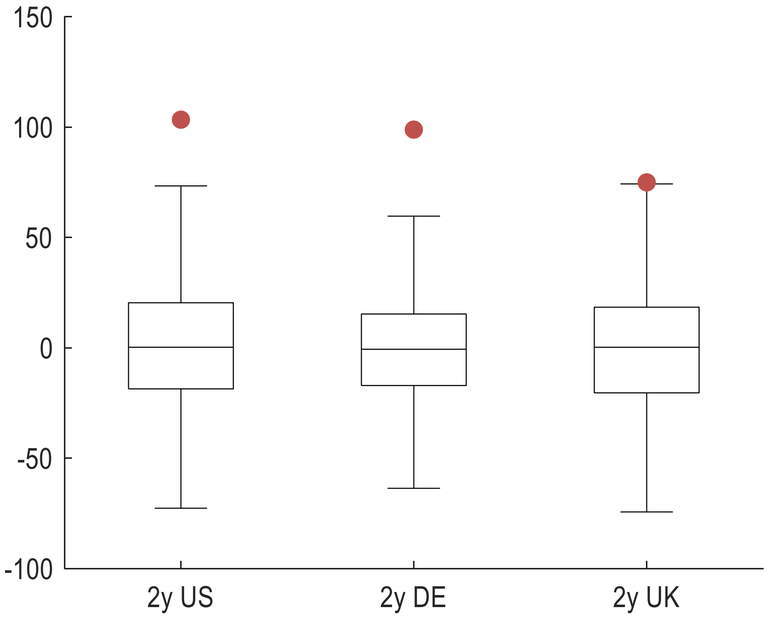
Financial Conditions: Emerging Markets
(Standard deviations from the mean)



With Accelerating Market Moves since Jackson Hole

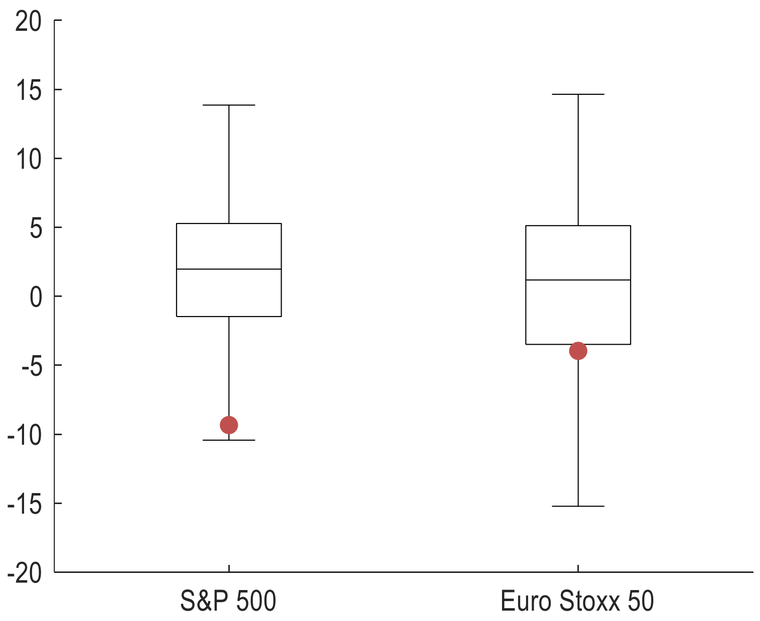
Since August Jackson Hole Meeting, Short-Term Yields Sharply Corrected…

Yield changes in the US, Germany & UK
(bi-monthly, basis points)



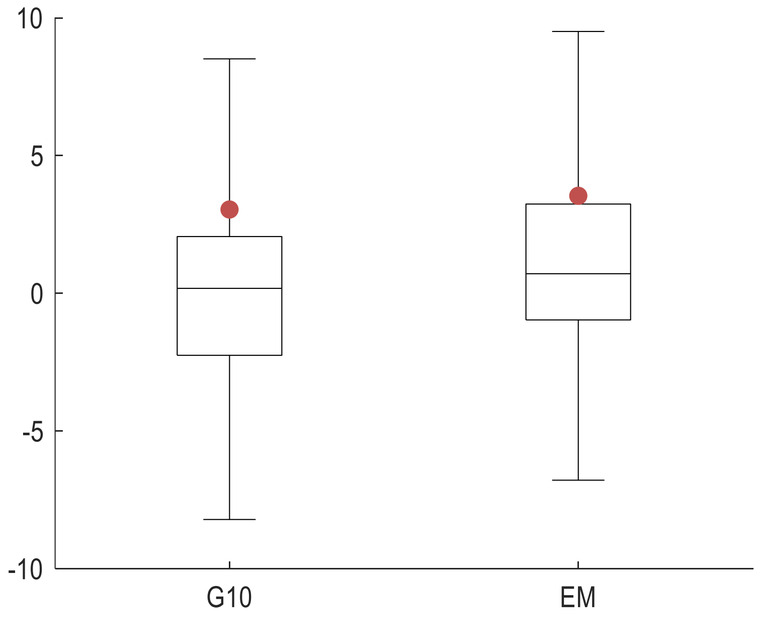
… Prompting Equity Markets in the US and in Europe to Selloff…

US and Euro Area Equity Returns
(bi-monthly, percent)



… Amid a Continuation of Dollar Dominance.

G10 and Emerging Market Currencies
(bi-monthly, percent)



Note: The black dots denote changes from August 26, 2022, to October 18, 2022. The Boxplots reflect bi-monthly data since January 1990. On each box, the central mark indicates the median, and the bottom and top edges of the box indicate the 25th and 75th percentiles, respectively. The whiskers extend to the most extreme data points not considered outliers. Given limited availability the EM currency index only starts in July 2010. Currency indices are shown as direct quotes, so that a positive return reflects US dollar appreciation.

Main Financial Stability Themes Since Last GFSR

1) **More tightening expected in many countries**

2) **Stagflation threats loom globally; energy crisis intensifies in Europe**

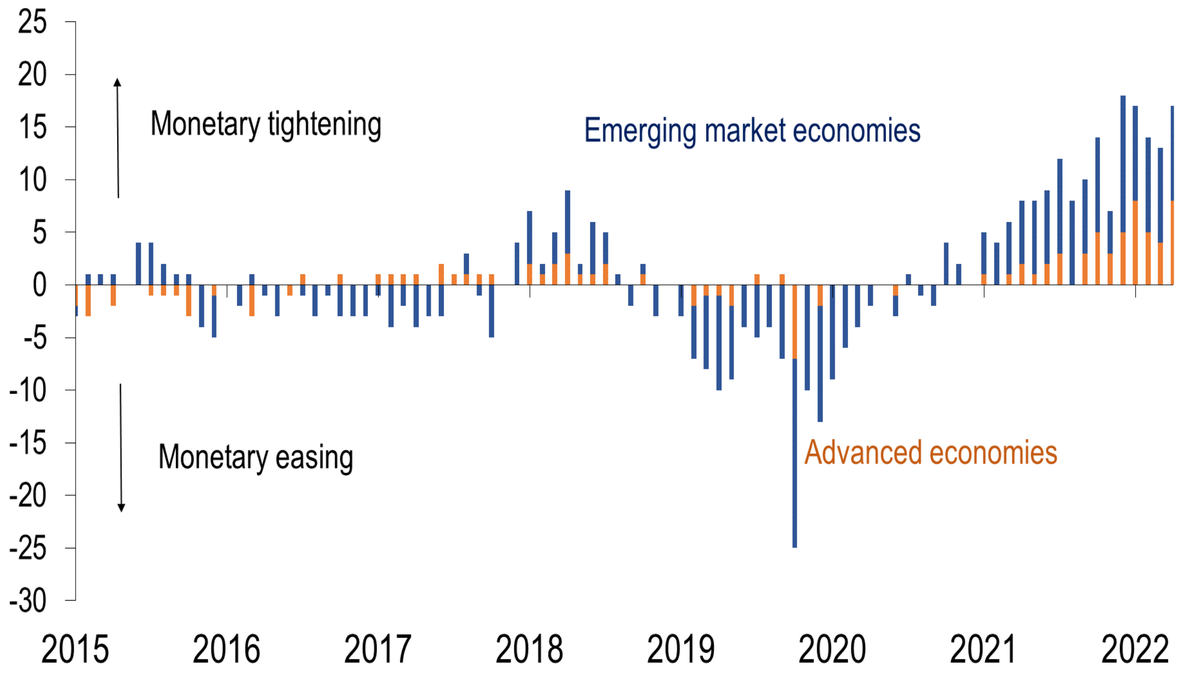
3) **Vulnerable EMDEs could face defaults and difficult restructurings**

4) **Global housing risks intensifying; China property market near crisis**

Persistent Inflation Prompted Central Banks to Act More Aggressively

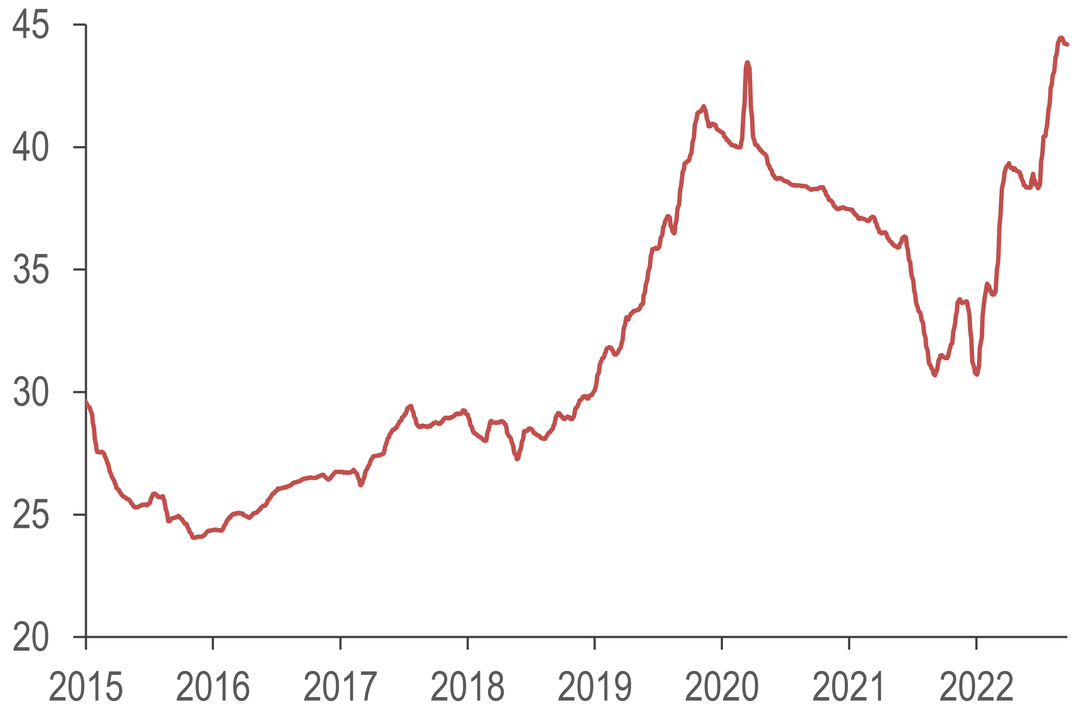
AE and EM central banks have dramatically synchronized monetary tightening…

Number of Central Banks changing policy rates
(net)



… so that correlation among global interest rates has been increasing.

Co-movement of G10 yield changes at select maturities
(Proportion of variance explained by common factor)

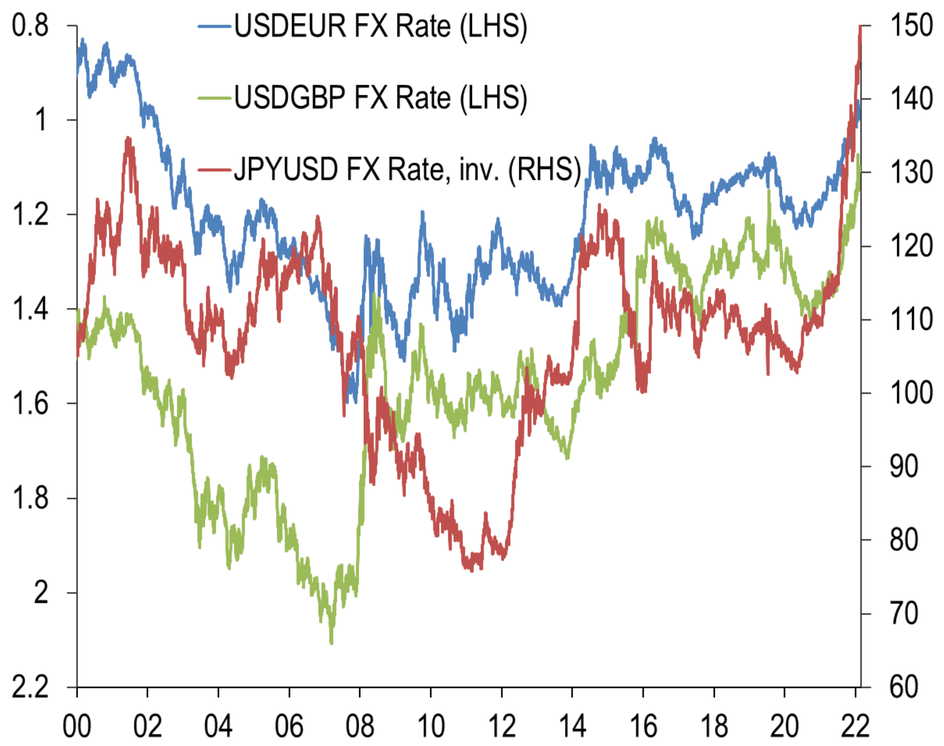


Note: Rolling proportion of G10 interest rate changes excluding Japan explain by a common factor, based on rolling 1-year principal component analysis.

Dollar has Strengthened on the Back of Fed Tightening

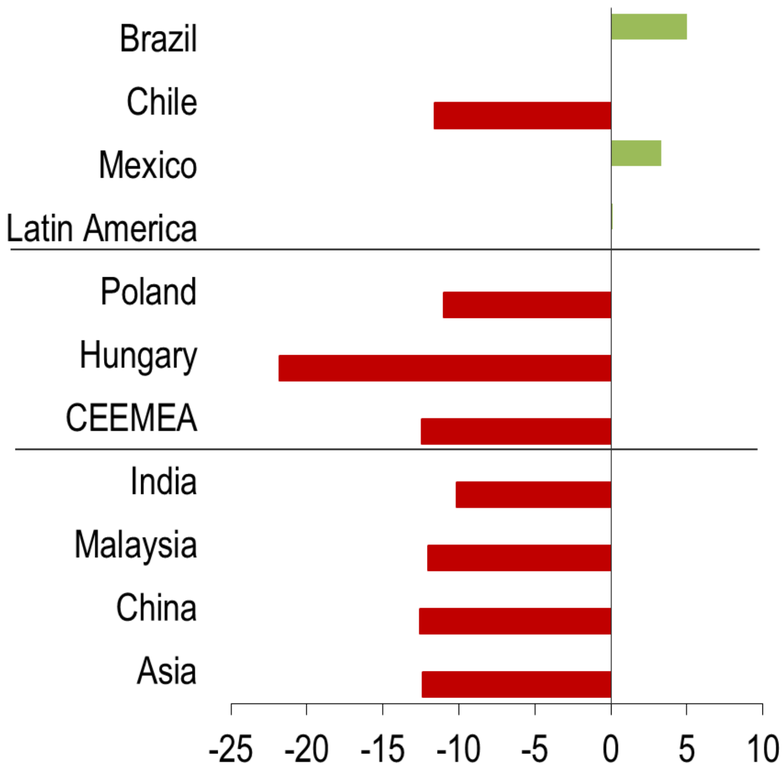
Interest rate differentials have driven USD to historic highs

Euro and Yen Exchange Rates vs Dollar since 2020
(EUR and GBP left scale, JPY right scale)



EM currencies have also depreciated, but with marked regional differences

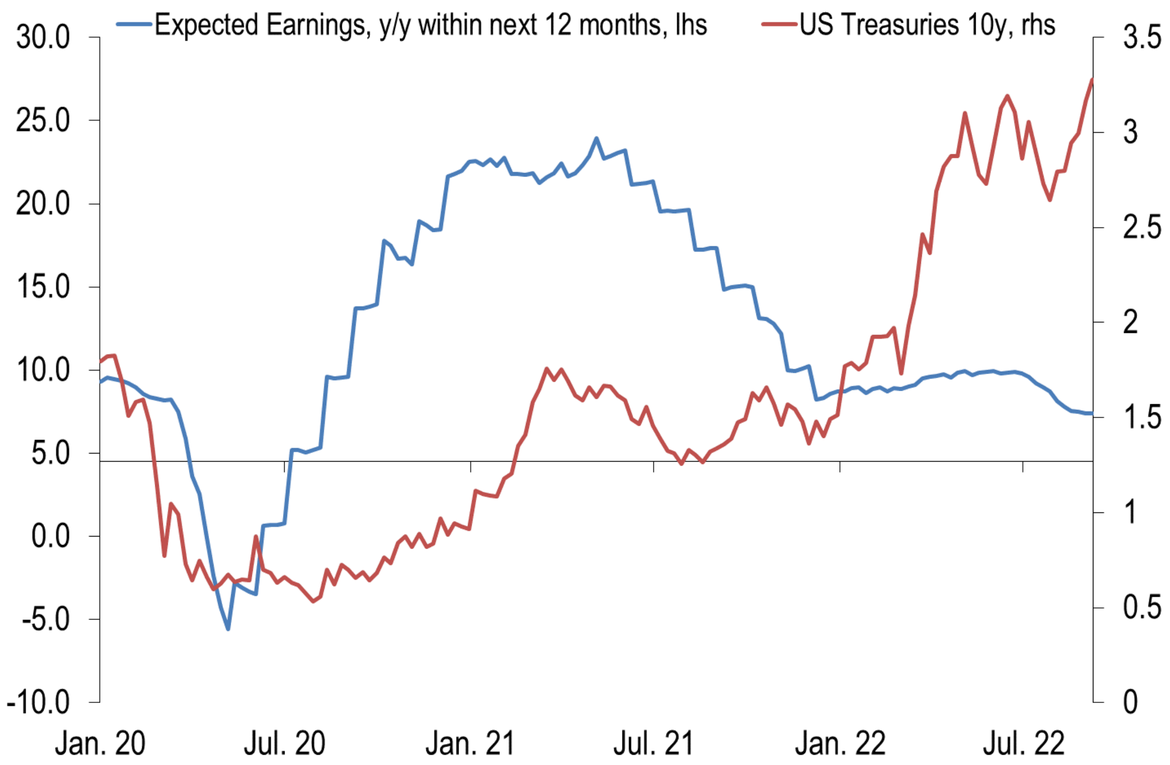
Emerging Market Regional Currencies
(2022 percent return versus US dollar)



Spectre of Stagflation Has Repriced Markets, But More Downside Risk Remains

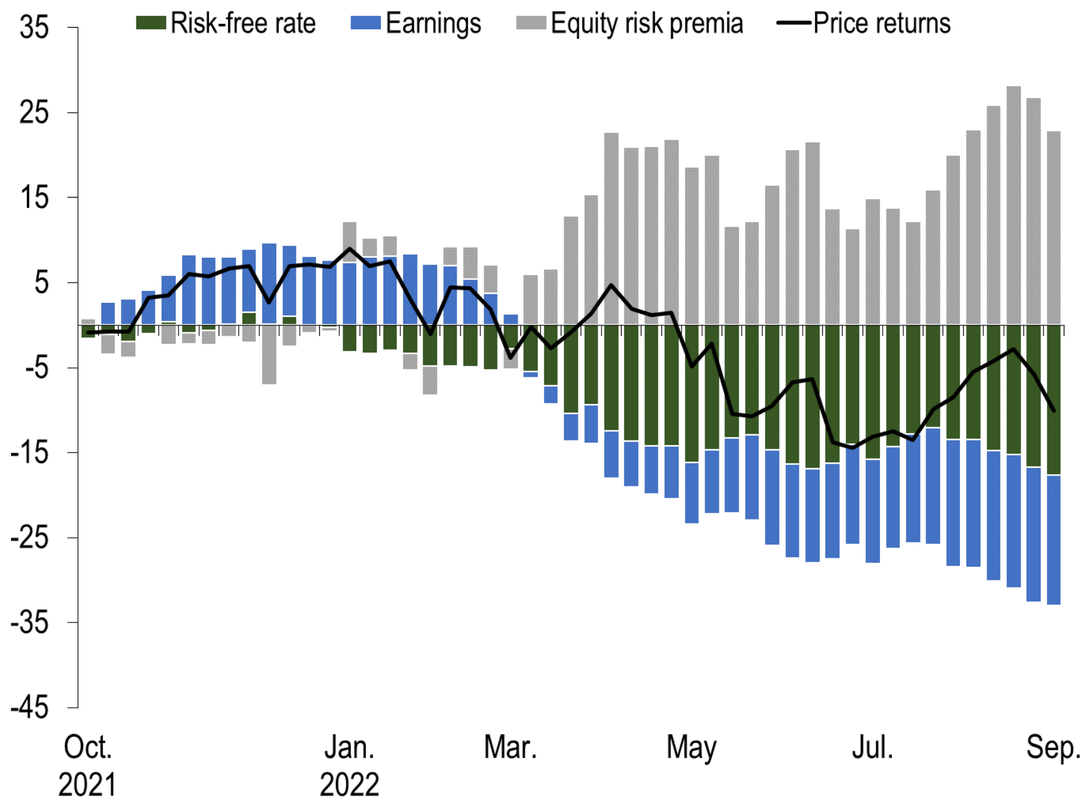
Rising rates and earnings downgrades have driven markets down…

Components of S&P 500 valuation
(y/y percent growth, left scale; percent)



…but a falling risk premium has blunted the selloff

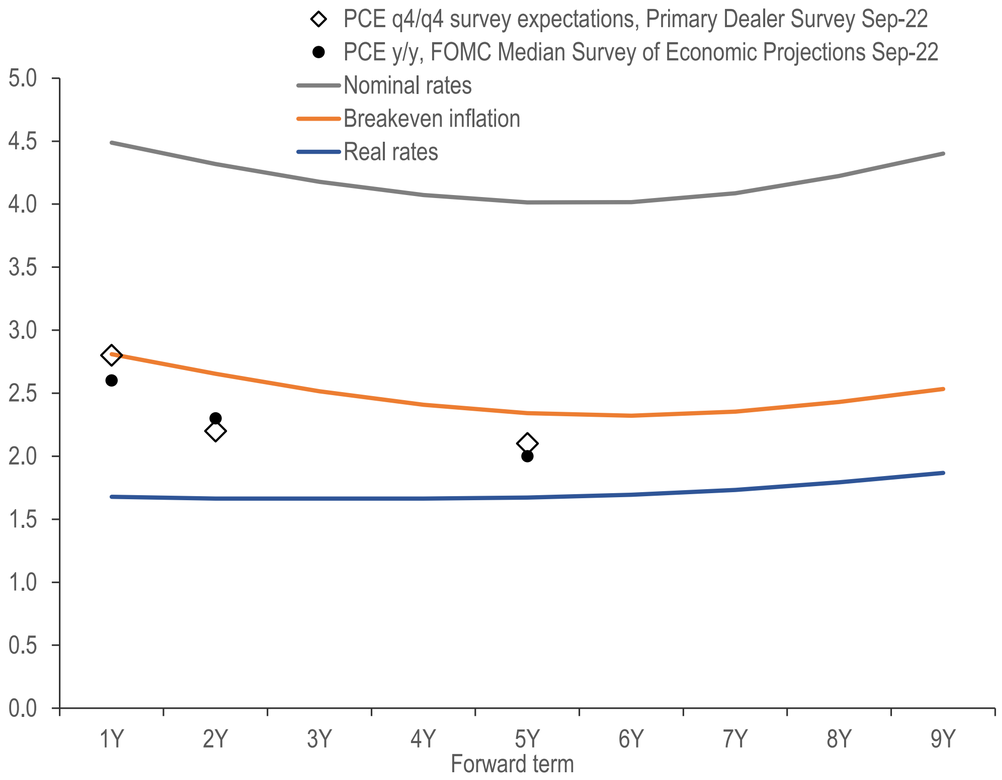
S&P 500 Equity Index Returns Decomposition
(percent)



Real Yield Curves Are Still Fairly Flat

The market expects the Fed to begin cutting rates next year

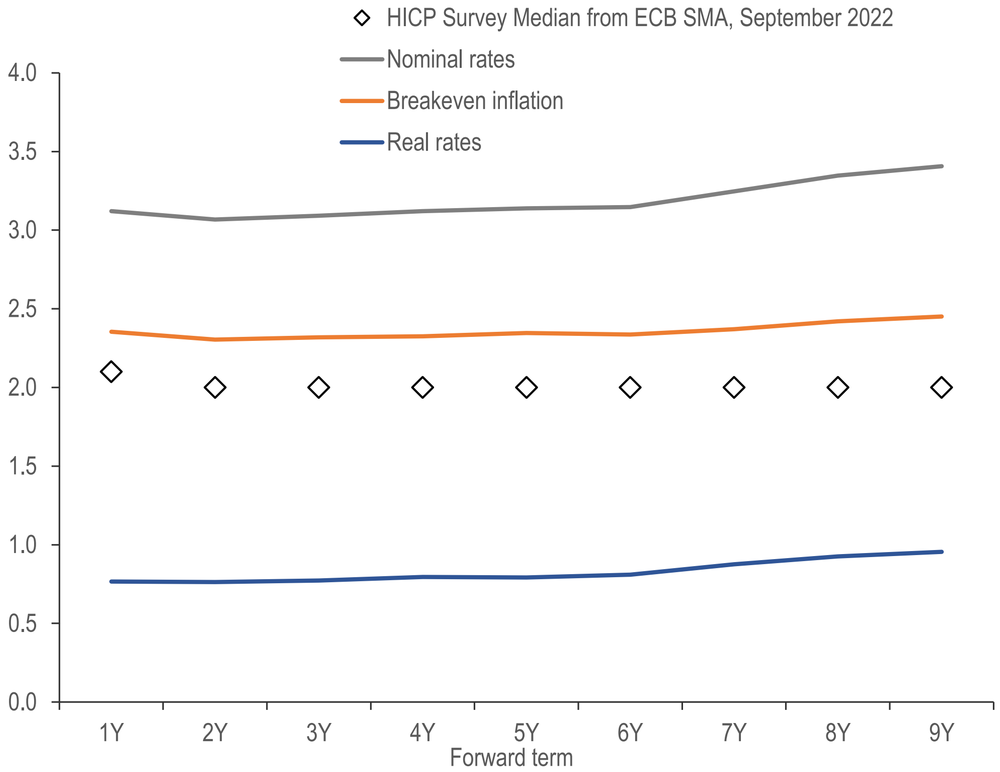
US Term Structure of 1y Forward Rates
(Percent, based on government bonds)



Note: Data as of Oct 24, 2022

In Europe, nominal yields expected to plateau at ~2%

Euro Area Term Structure of 1y Forward Rates
(Percent, based on swaps)



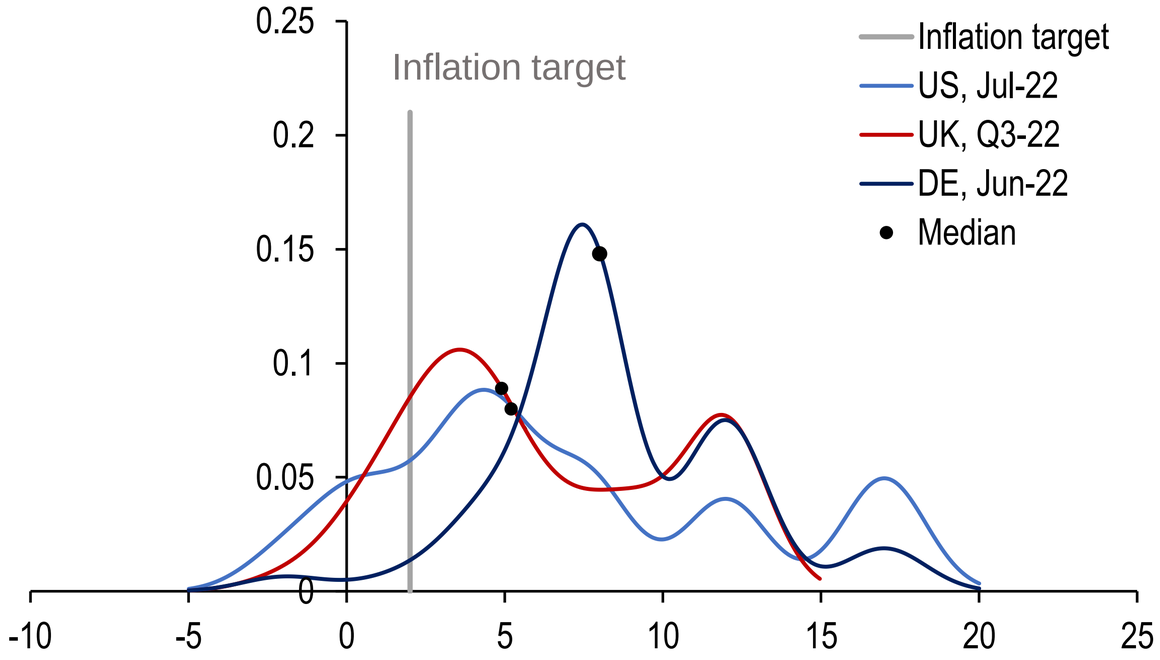
Note: Data as of Oct 24, 2022

Real rates remain very low in US and in Europe

Investors Expect Inflation to Remain Elevated

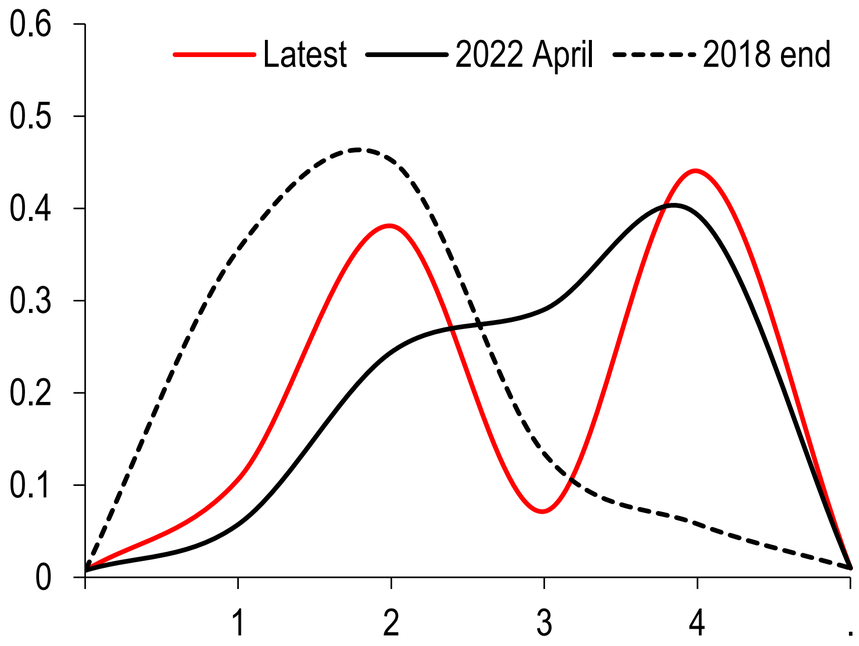
In AEs, household inflation expectations remain high

Household Expectations, 1 year horizon
(Latest, Share Of Respondents, Percent)



While in Euro Area, inflation options point to bi-modal inflation expectations

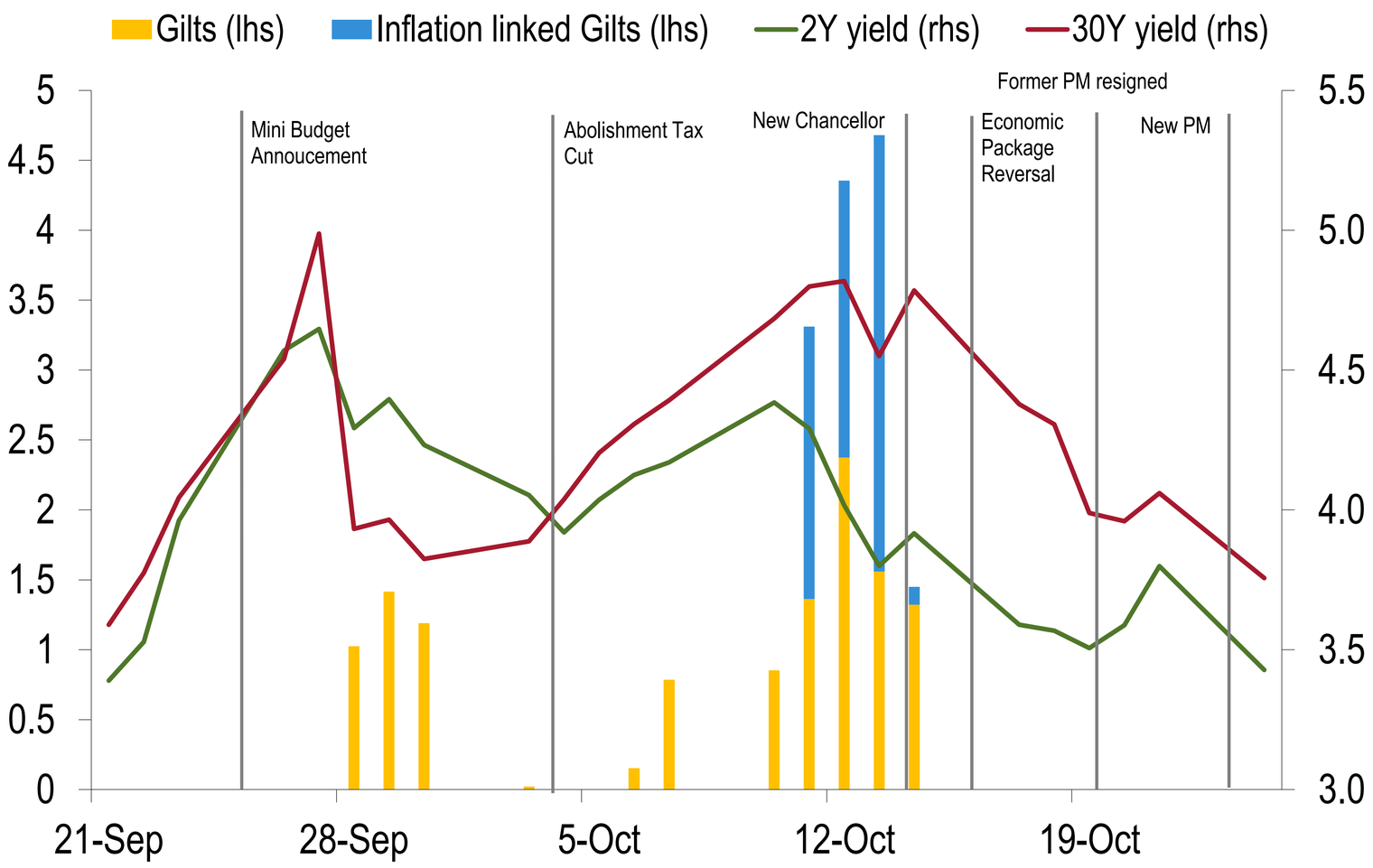
Option-Implied Distributions of Various Inflation Outcomes in the Euro Area, 1 year horizon
(Probability density)



Bank of England Intervened to Remedy Dysfunctional Gilt Market

Intraday Gilt Market Interventions of The Bank of England in September and October 2022

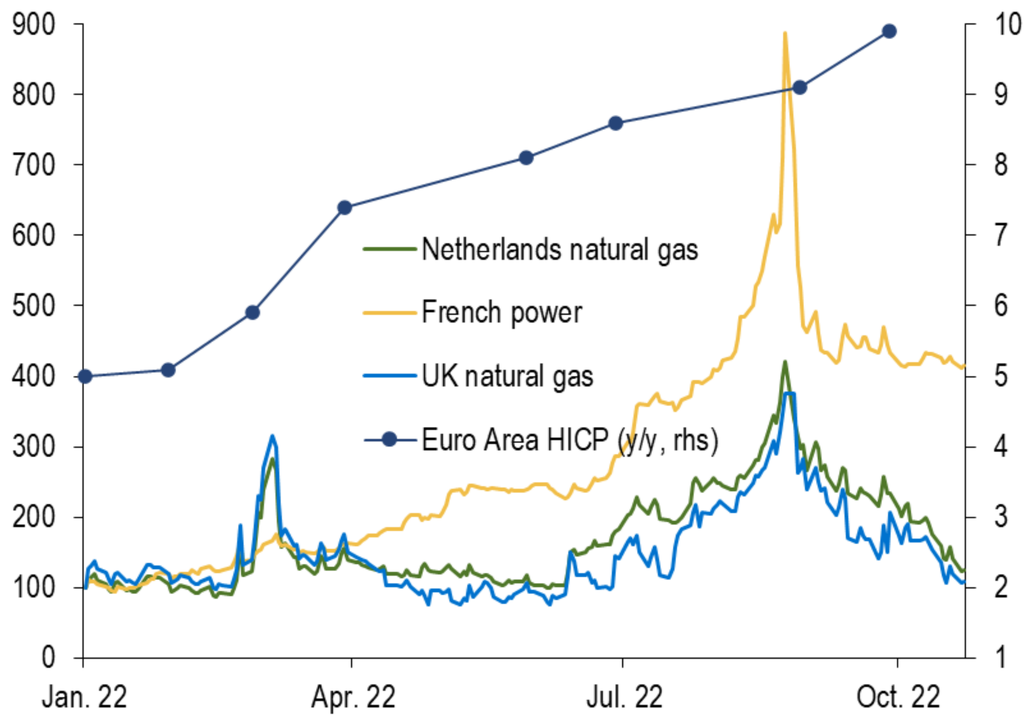
UK Gilt Yields
(Percent, basis points)



Euro Area Under Pressure from Energy Crisis and Fragmentation

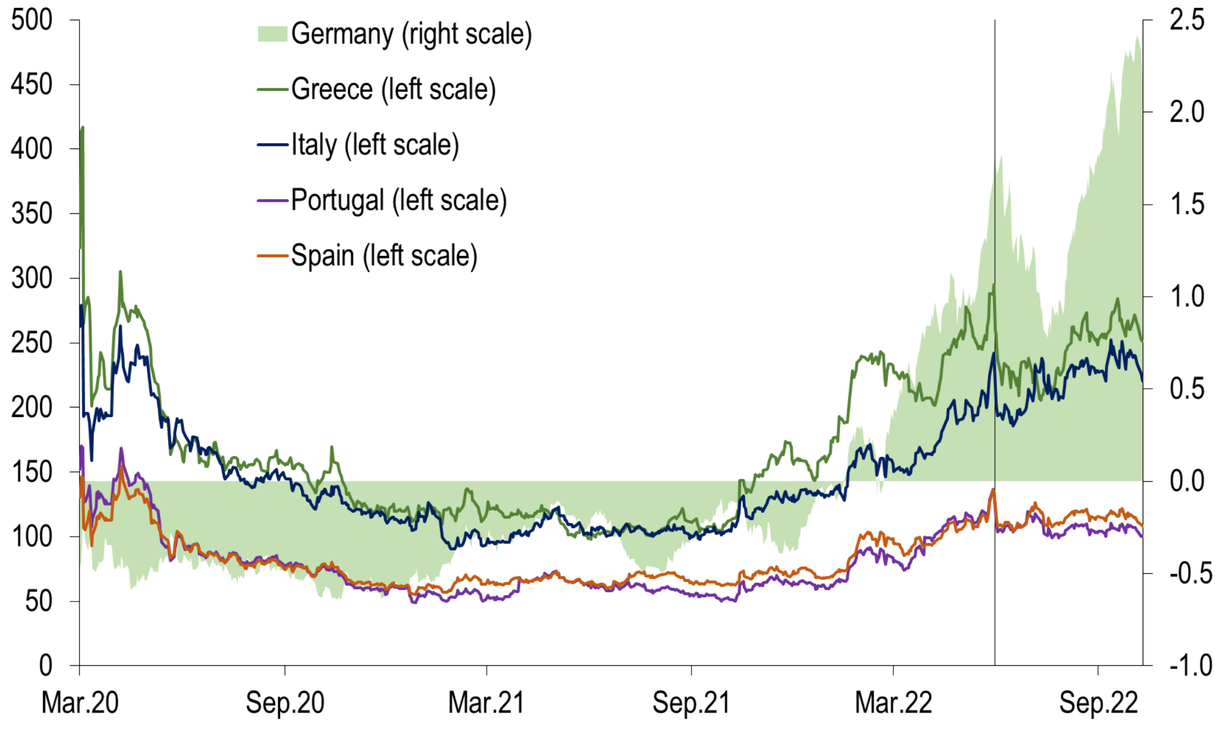
Rising energy prices threaten to tip the continent into recession

European Energy Prices and Headline Inflation
(Prices in Euro, left scale; percent, right scale)



Peripheral euro area sovereign yields have surged

German 10-Year Yields and Sovereign Spread
(Basis points, left scale; percent, right scale)

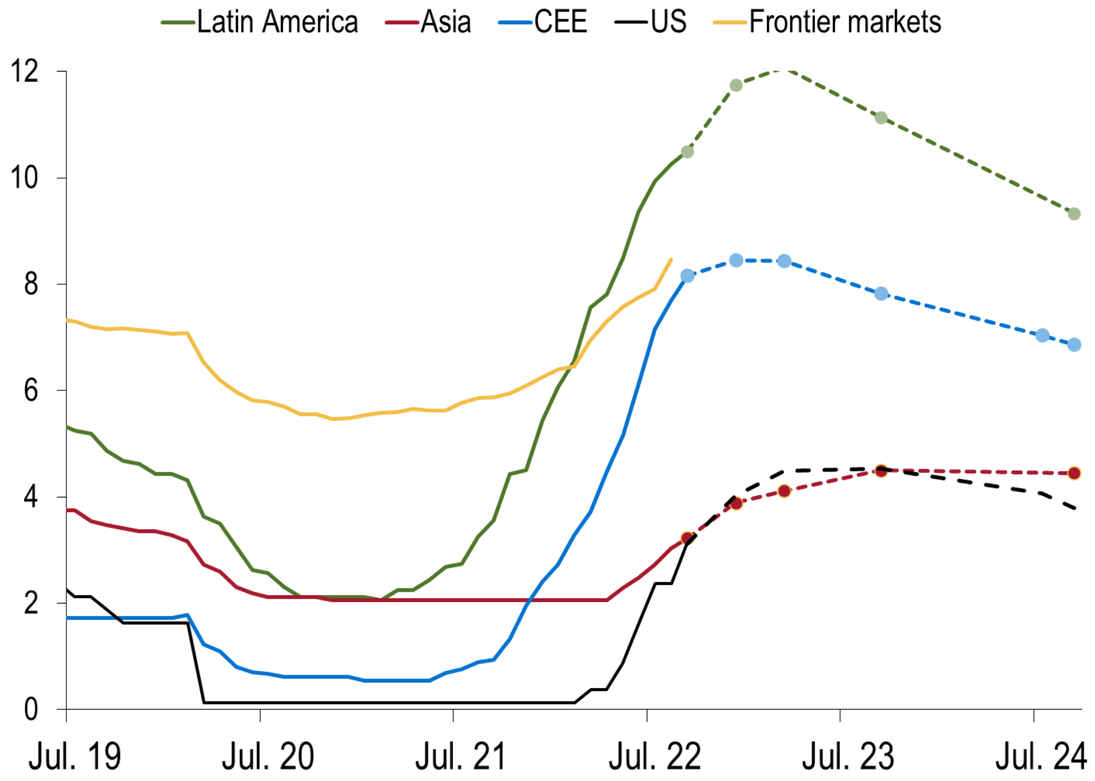


TPI announcement has helped to contain disorderly widening of spreads

EMs Appear Close to Easing, But Face Global Pressures

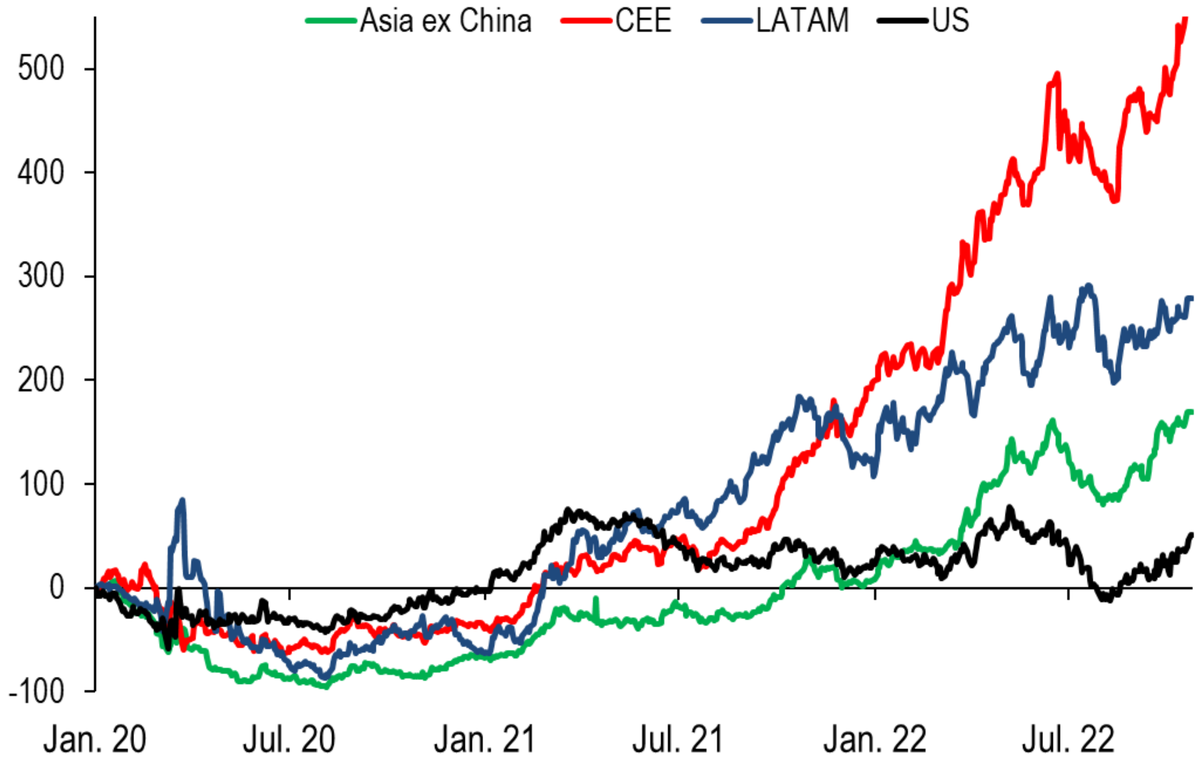
EMs are expected to begin easing in 2023…

Historical and Market-Implied Policy Rates across Regions
(Percent)



…but term premia remain elevated due to global uncertainty

Change in Five-year Term Premia since January 2020
(Basis points)

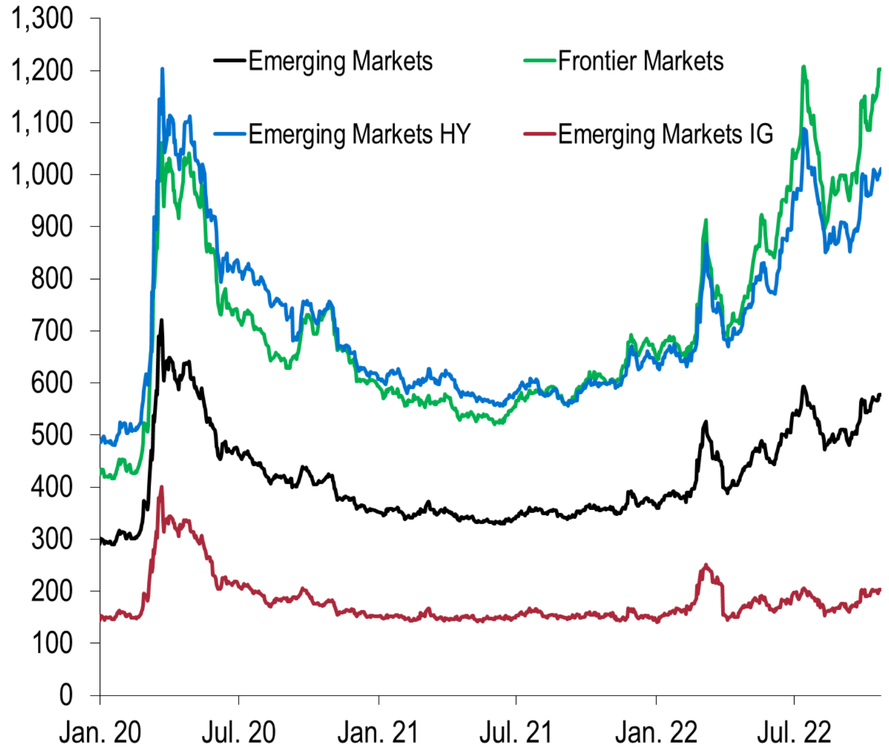


Note: CEE reflecting the average of Poland, Czech Republic and Hungary.

Serious Sovereign Debt Risks In Many Vulnerable EMDEs

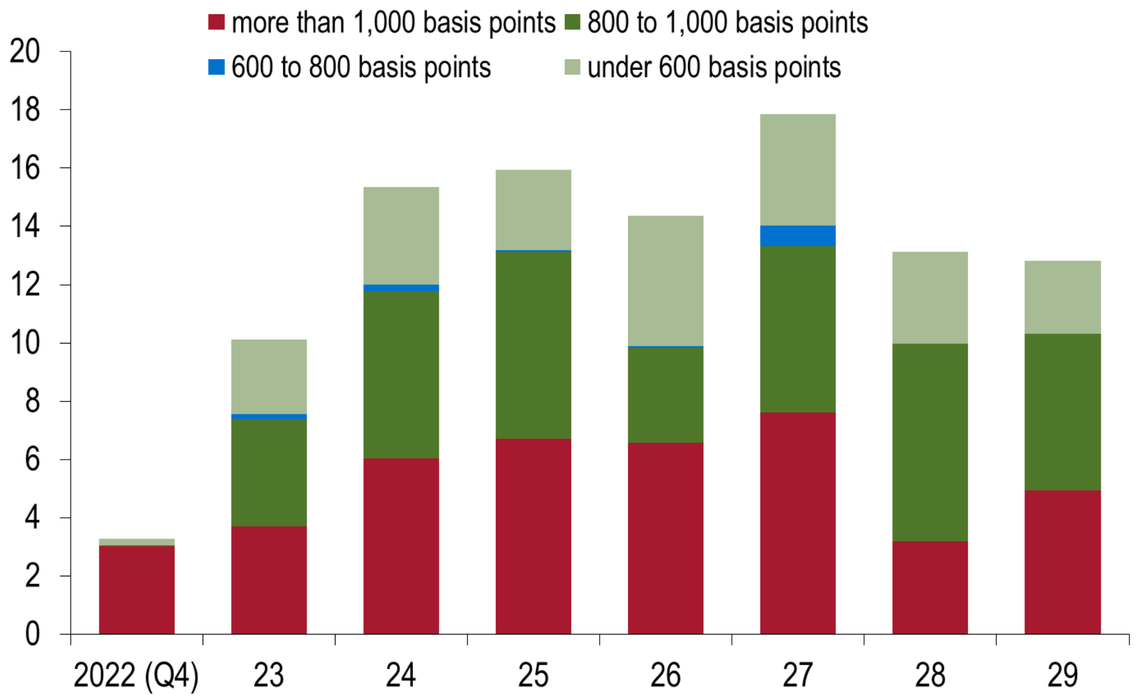
While large issuers have shown resilience, many lower-rated issuers now trade at distressed levels

Emerging market Sovereign Spreads
(Basis points)



Frontier markets face challenging re-financings, with ~20 names at high risk of (or already in) default

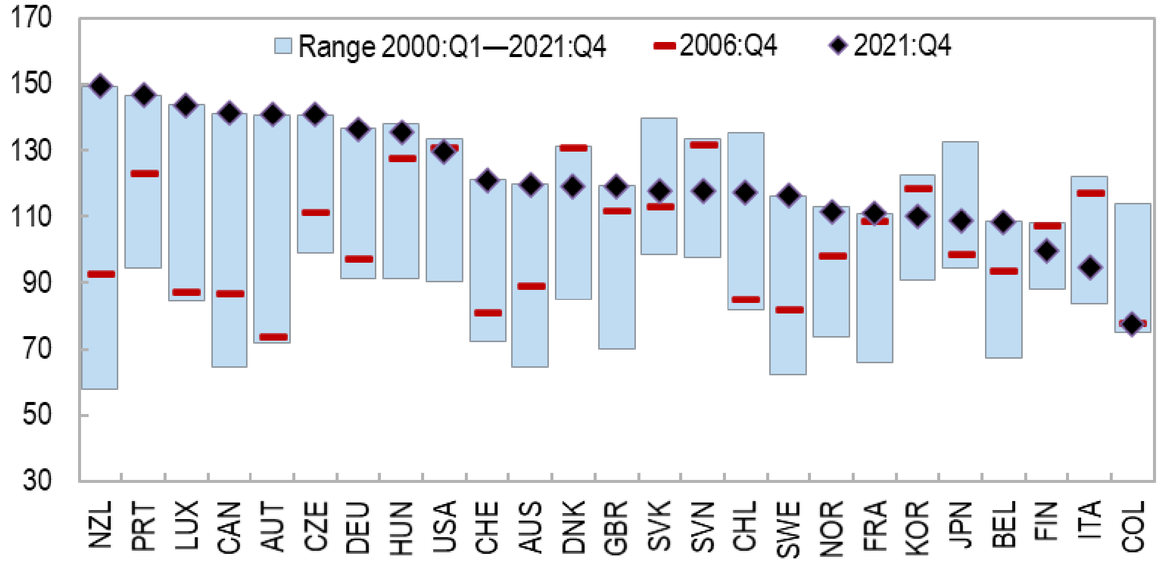
Hard- Currency Bond Maturities and Spreads
(Billions of US dollars)



Global Housing Markets May Come Under Pressure

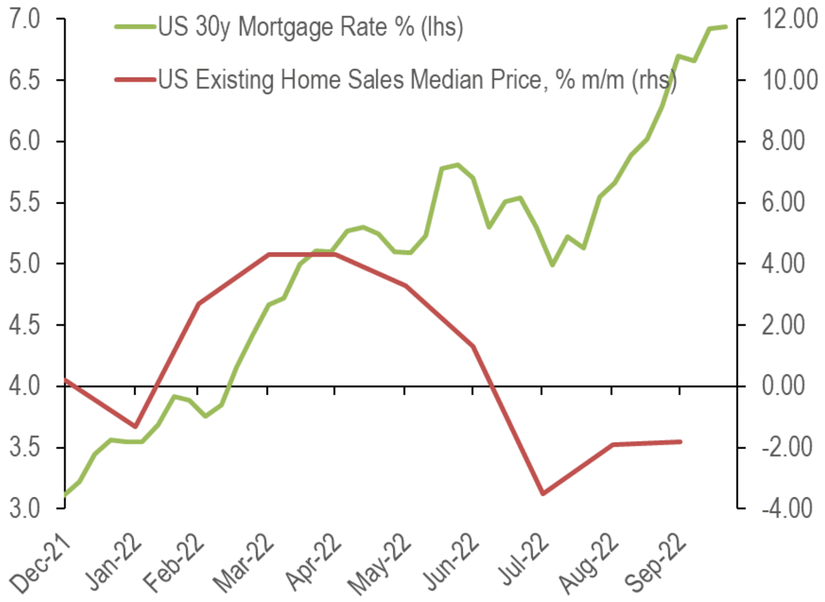
Stretched housing valuations relied on low rates to maintain affordability

Price-to-Income Ratio, 2000:Q1–21:Q4
(Index, 2015 = 100)



Prices are beginning to turn as mortgage rates back up dramatically

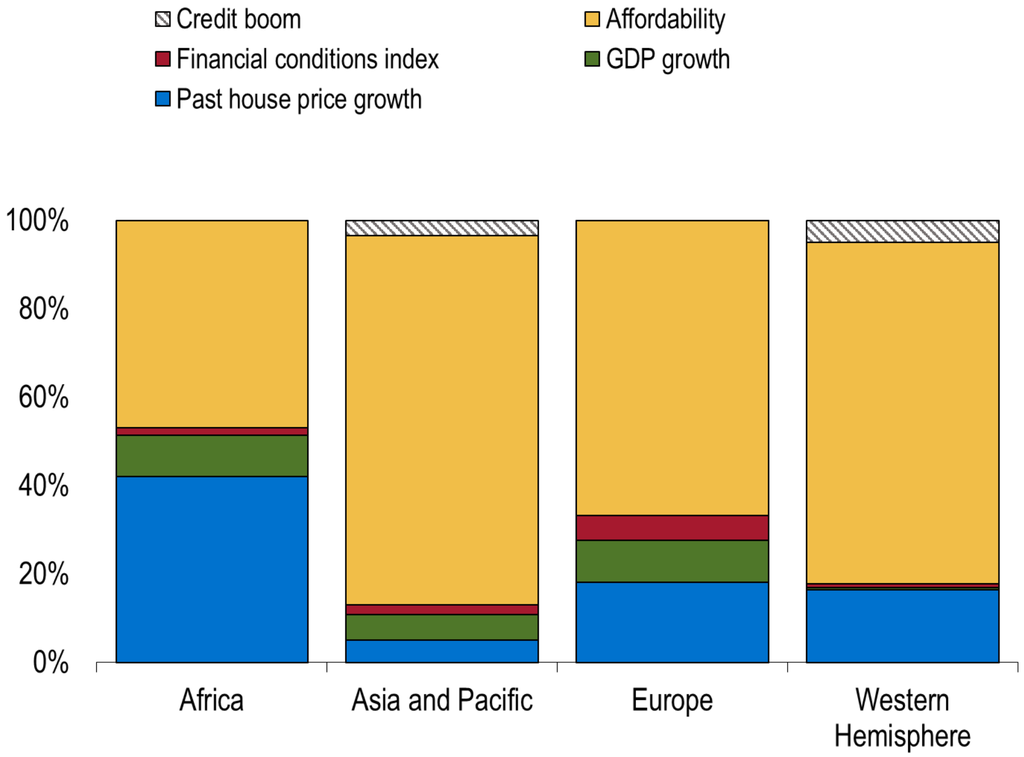
US 30y Mortgage rates and Home prices
(Percent)



House Price at Risk is Substantial, Especially for EMs

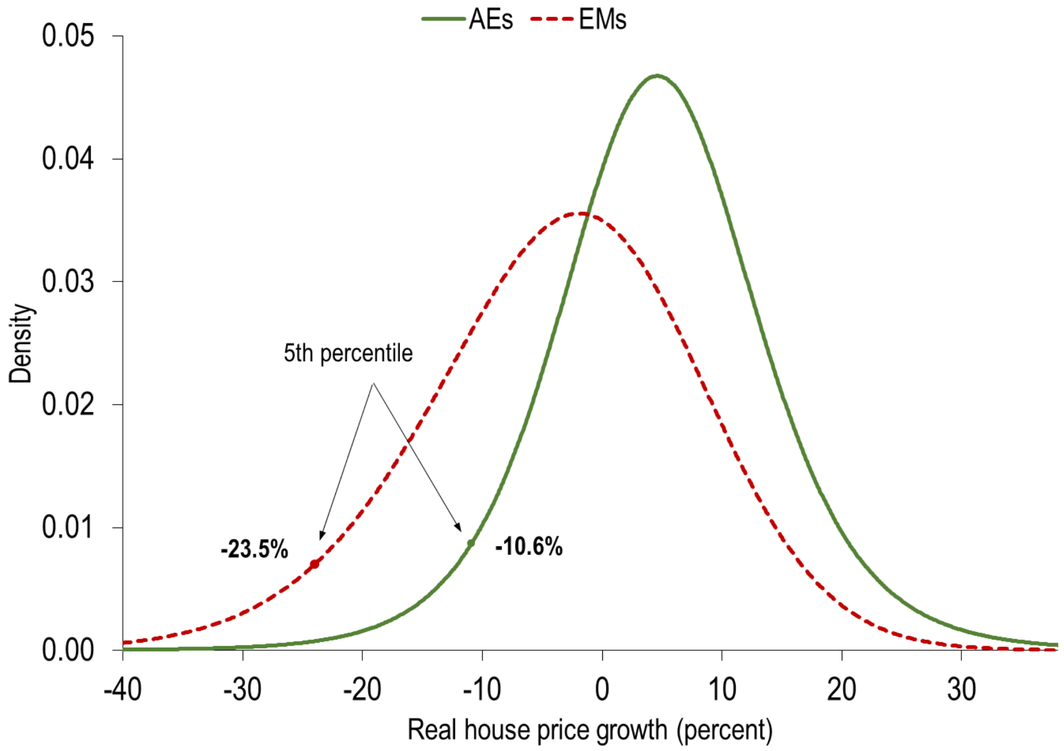
Affordability weighing on house prices

House Price at Risk Decomposition
(Percent, projected contribution, latest)



EM downside risks are elevated

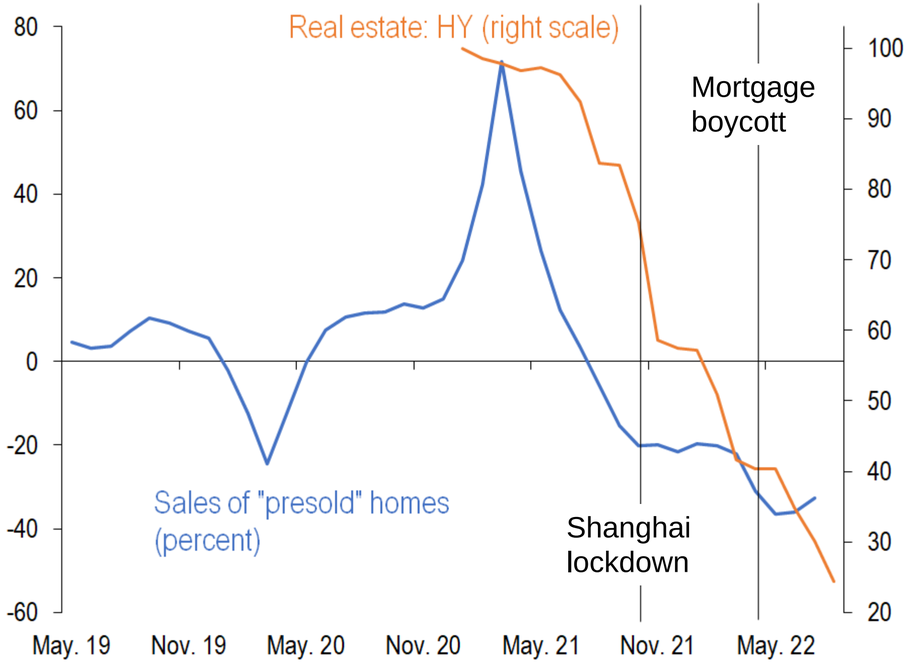
House- Price-at-Risk, Advanced Economies and Emerging Markets, Three Years Ahead
(Density; cumulative growth in percent)



In China, Housing Risks May Spread Far Beyond Property Developers

A stalled housing market has put developers into distress, threatening home completions

Residential Real Estate Sales and Property Developer Bonds
(Index, May 2021 = 100)

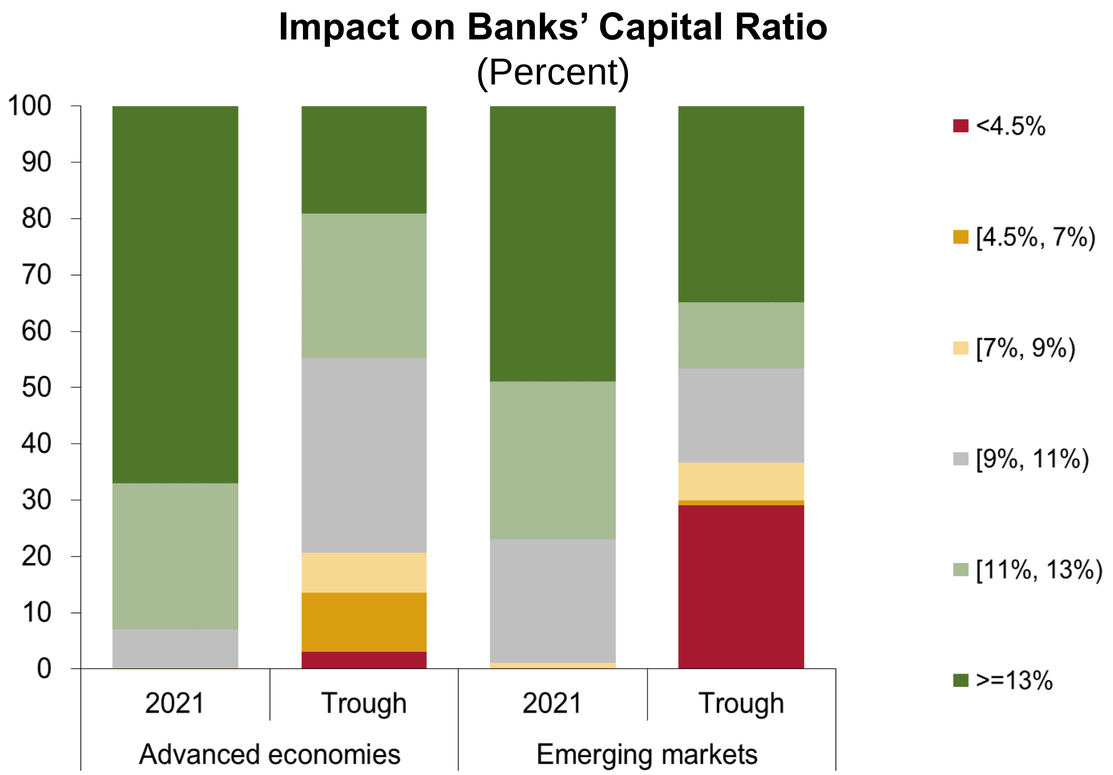


If pre-sold mortgages end up in default, many banks could face large losses

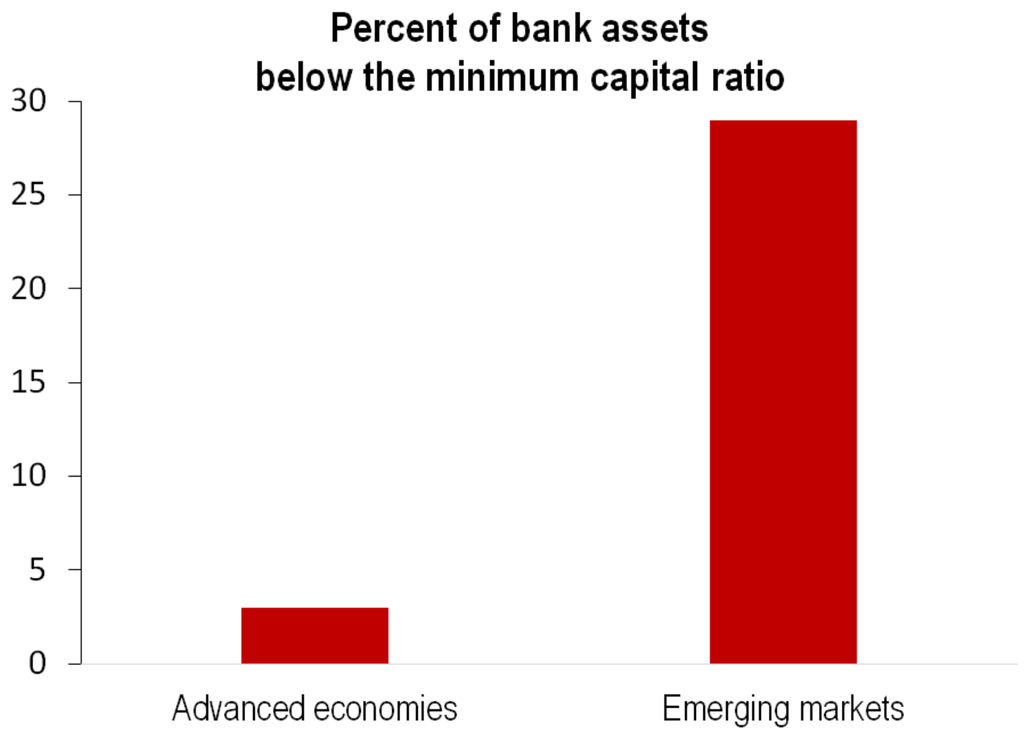
Banks: Potential Credit Losses Related to Real Estate Exposure
(Percent of total risk-weighted assets)

Global Banking Stress Tests Shows Some Weaknesses in EMs

Globally systemic banks and those in advanced economies seem largely resilient to adverse scenarios…



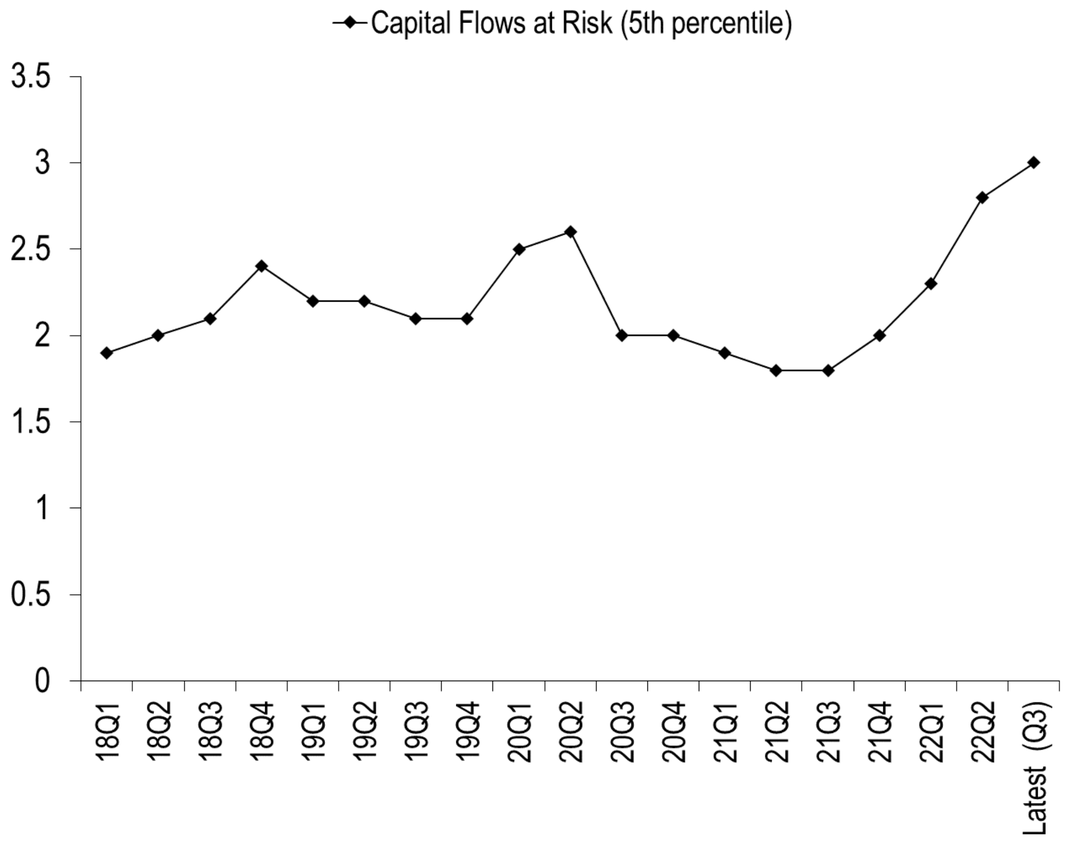
…but many EM banks face significant recapitalization needs under a stress test



Capital Flows at Risk and Growth at Risk Reach Multi Year Highs

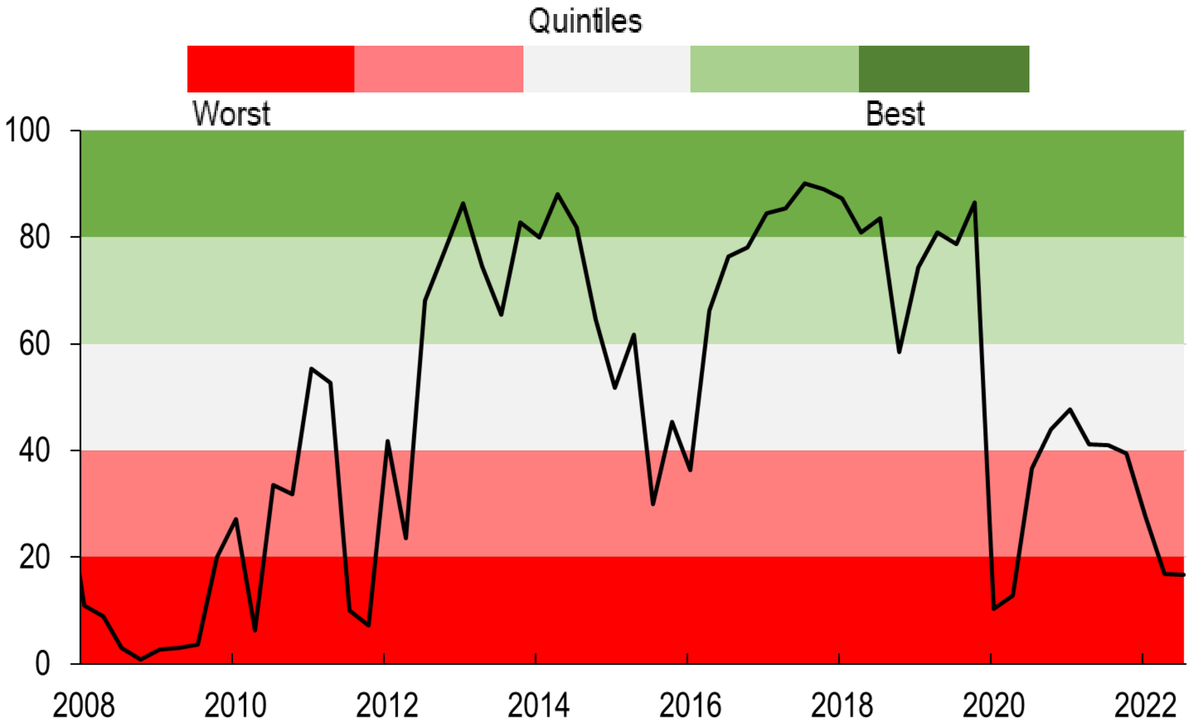
With high global rates and volatile capital markets, EMs face a risk of large outflows…

Capital Flows at Risk
(Probability density, percent, left scale; 5th percentile, percent of GDP)



…and growth downside risk is nearing peak 2020 levels

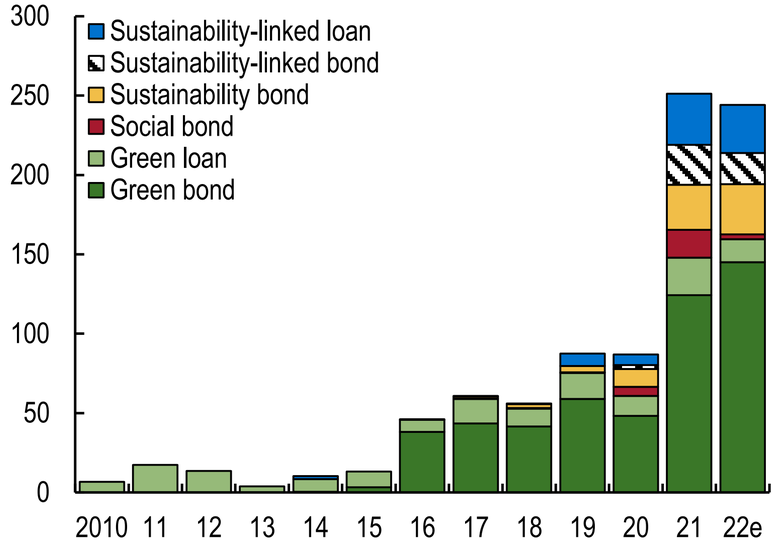
Near-Term Growth at Risk Forecasts
(Percentile rank)



The Market for Sustainable Finance in EMDEs is Growing

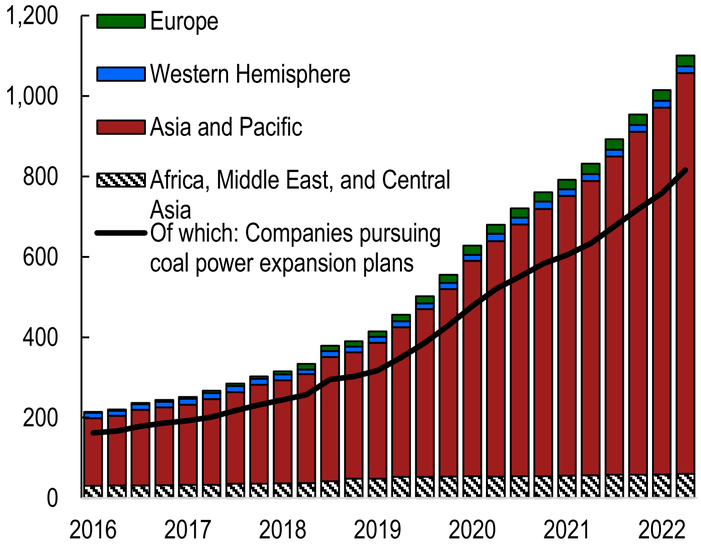
There has been a strong momentum in sustainable debt issuance in EMDEs…

Sustainable Instruments by Issuance Type
(Billions of US dollars; as of mid-2022)



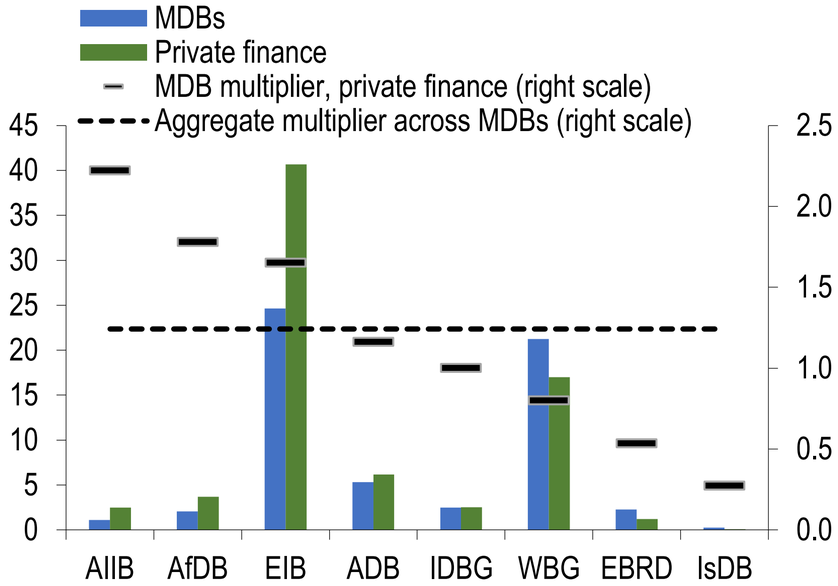
…while financing for fossil fuel firms in EMDEs is still rising rapidly.

EMDE-Domiciled Debt of Companies with Significant Role in Thermal Coal Value Chain
(Billions of US dollars)



MDBs have to play a key role in crowding in private finance.

MDB Climate Finance from Own Resources & Private Investors (private finance), 2020
(Billions of US dollars, left scale; ratio, right scale)



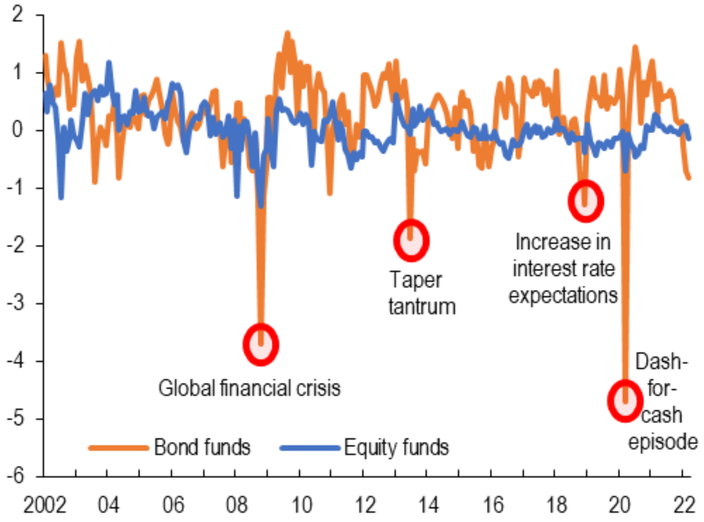
Note: ADB = Asian Development Bank; AfDB = African Development Bank; AIIB = Asian Infrastructure Development Bank; EBRD = European Bank for Reconstruction and Development; EIB = European Investment Bank; IDBG = Inter-American Development Bank Group; IsDB = Islamic Development Bank; MDB = multilateral development bank; WBG = World Bank Group.

But Several Challenges Will Need to be Overcome

Resilience of Open-End Investment Funds May Be Tested Again

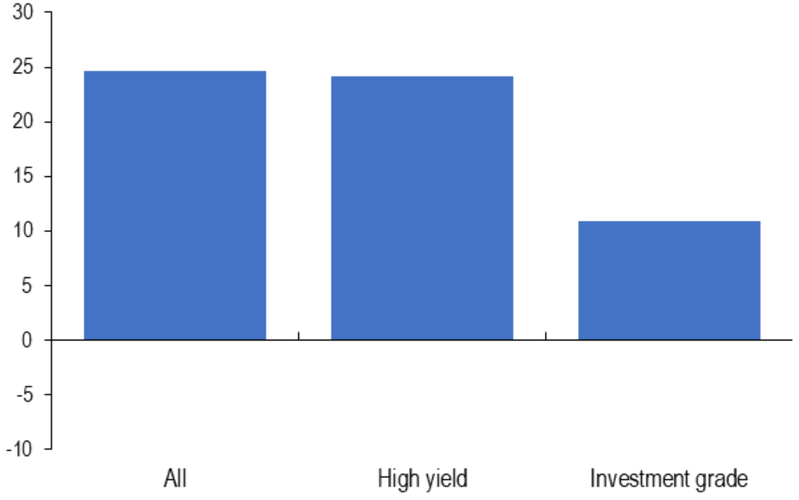
The March 20 market turmoil revealed vulnerabilities of open-end funds.

Monthly Net Flows
(Percent of lagged total net assets)



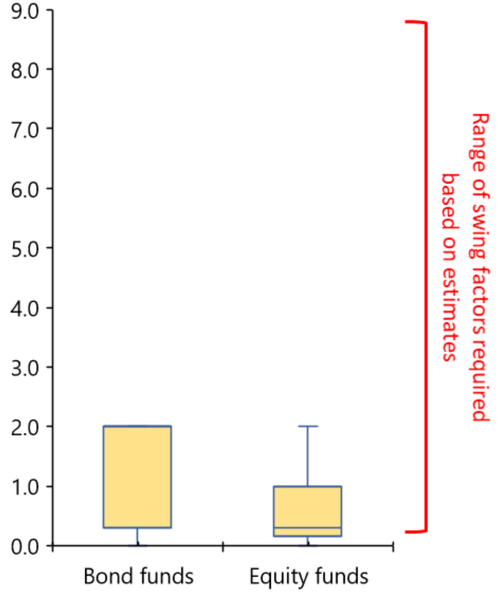
Corporate bonds held by less liquid funds have higher return volatility.

Effect of Vulnerability on Corporate Bond Return Volatility
(Percent of median volatility)



Swing pricing can mitigate fragilities, albeit often capped at levels that appear too low.

Maximum Downward Swing Factor among 200 Sample Funds
(Boxes cover the 25th–75th percentiles)



Effective liquidity management tools are key

Policy recommendations

Main policy priority: fight inflation, mitigate financial distortions

- Act resolutely to bring inflation credibly back to target in a timely way and avoid a de-anchoring of inflation expectations.
- Do not yield to pressure to ease monetary tightening, this will necessitate more painful policy actions in the future.
- Use Integrated Policy Framework to help avert crises, combining targeted foreign exchange interventions, capital flow measures, and other actions as needed to smooth exchange rate moves and reduce financial stability risks.
- In some cases, macroprudential policy adjustments and regulatory actions may be needed to avoid risks materializing.

Fiscal policy should protect the vulnerable while aiding the tightening monetary stance

- Targeted, temporary measures, should be deployed to cushion the impact of economic slowdown on the most vulnerable.
- Fiscal policy should tighten to support monetary policy where there is excess demand or inflation expectations are at risk of de-anchoring.
- For most countries, deficit reduction is appropriate, anchored in medium-term fiscal framework, esp. if there is little fiscal space or debt concerns are pressing.
- Policies should preserve price signals; attempts to control prices directly are fiscally costly and ultimately ineffective.
- Complement with structural policies to boost supply capacity in the long-term: education, childcare access, digitalization, infrastructure investment, pension reforms, supply chain resilience & pandemic preparedness.

Multilateral cooperation is urgently needed for crisis prevention and investment in the future

- More sovereigns in debt distress will require restructuring: urgently implement and broaden G-20 Common Framework.
- Ensure resilience of market functioning and maintain global liquidity amid tightening financial conditions. For many EMDEs, now is the time to apply for precautionary credit lines with the Fund.
- Prevent catastrophic climate change impact by accelerating green transition. Delays will magnify transition costs.
- Strengthen cooperation on common goods (e.g. climate policies, debt) to mitigate fragmentation risks. The Fund stands ready to deliver with existing and new tools: incl. SDR channeling, RST, RFI Food Shock Window.