January
2021

Global Financial Stability Update

Vaccines Inoculate Markets, but Policy Support Is Still Needed

The *Global Financial Stability Update* at a Glance

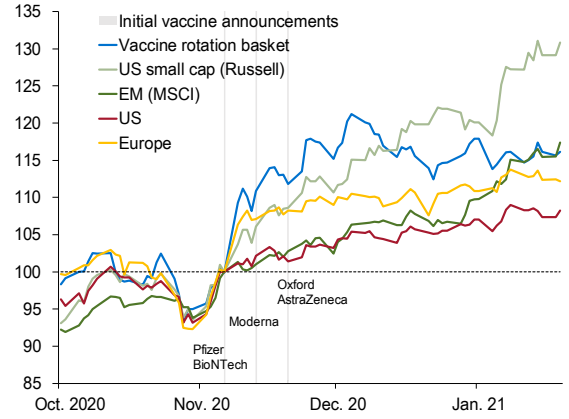
- Approval and rollout of vaccines have boosted expectations of a global recovery and lifted risk asset prices, despite rising COVID-19 cases and persistent uncertainties surrounding the economic outlook.
- Until vaccines are widely available, the market rally and the economic recovery remain predicated on continued monetary and fiscal policy support. Inequitable distribution of vaccines risks exacerbating financial vulnerabilities, especially for frontier market economies.
- An ongoing rebound of portfolio flows provides better financing options for emerging market economies facing large rollover needs in 2021.
- Policy accommodation has mitigated liquidity strains so far, but solvency pressures may resurface in the near future, especially in riskier segments of credit markets and sectors hit hard by the pandemic. Profitability challenges in the low-interest-rate environment may weigh on banks' ability and willingness to lend in the future.
- Policymakers should continue to provide support until a sustainable recovery takes hold as underdelivery may jeopardize the healing of the global economy. However, with investors betting on a persistent policy backstop and a sense of complacency permeating markets as asset valuations rise further, policymakers should also be prepared for the risks of a market correction.
- With monetary policy anticipated to remain accommodative in coming years, policymakers should contain rising vulnerabilities to avoid putting growth at risk in the medium term.

A Policy Bridge to the Vaccine

Financial markets have looked beyond the global resurgence of COVID-19 cases. Announcements and rollout of vaccines have boosted hopes of a global economic recovery in 2021 and pushed risk asset prices higher. The speed of the recovery will depend crucially on production, distribution networks, and access to vaccines. As discussed in the January 2021 *World Economic Outlook* (WEO) *Update*, continued monetary and fiscal support remain vital to lessen lingering uncertainties, build a bridge to the recovery, and ensure financial stability.

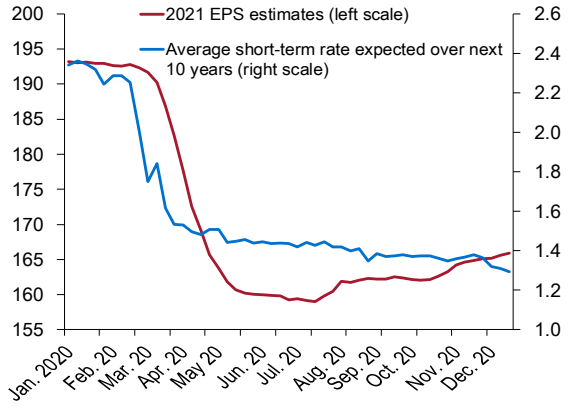
Risks to the baseline could threaten financial stability in some sectors and regions. A delay in the recovery would require prolonged accommodation, further fueling financial vulnerabilities. Uneven vaccine distribution and asynchronous recovery could imperil capital flows to emerging market economies, especially if advanced economies were to begin to normalize policy, and some countries could face daunting challenges. An asset price correction, should investors suddenly reassess growth prospects or the policy outlook, could interact with elevated vulnerabilities, creating knock-on effects on confidence and jeopardizing macro-financial stability.

Figure 1. Equity Market Performance
(Index; November 6, 2020 = 100)



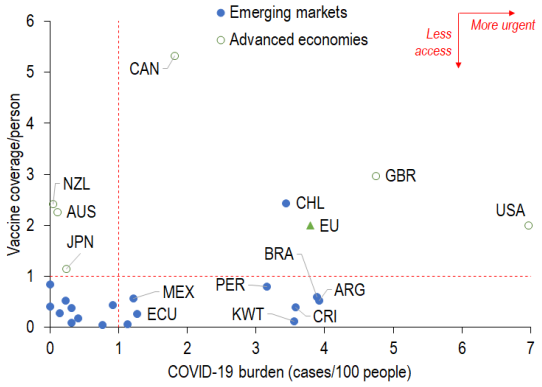
Sources: Bloomberg Finance L.P.; and IMF staff calculations.
Note: Vaccine rotation basket is an equal weighted index of US hotels and real estate and world airline equities. EM = emerging markets.

Figure 2. US Earnings Revisions and Rate Expectations
(US dollars a share, left scale; percent, right scale)



Source: IMF staff calculations.
Note: Earnings per share (EPS) based on Thomson Reuters Datastream IBES for the S&P 500; average expected short-term rates derived from Treasury bonds and Adrian, Crump, and Moench model.

Figure 3. COVID-19 Infections and Vaccine Preorders



Source: Duke Global Health Innovation Center.
Note: Vaccine preorders refers to confirmed doses as of January 19, 2021. EU = European Union. Data labels use International Organization for Standardization (ISO) country codes.

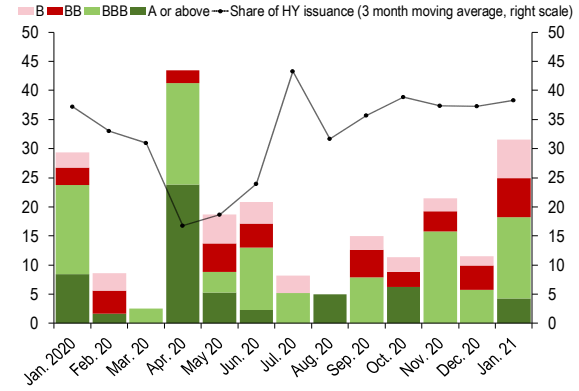
Finally, Some Good News

Announcements of earlier-than-anticipated effective COVID-19 vaccines have boosted market sentiment and paved the way for the global economic recovery. Industries such as airlines, hospitality, and consumer services rebounded in late 2020 as investors rotated into these previously battered sectors in search of value (Figure 1). Stock prices of smaller firms, including in clean energy, also benefitted. In advanced economies, investment-grade and high-yield corporate bond spreads have tightened sharply—close to or even below pre-February 2020 levels—while rates have reached record lows, as investors continue to reach for yield. Spreads of emerging market sovereign debt have exhibited a similar compression dynamic.

Financial markets have shrugged off the most recent softening in economic activity. The surge of COVID-19 infections and associated stringency measures since late 2020 have adversely affected economic activity in many countries, pointing to a possible slowdown in the fourth quarter (see the January 2021 WEO *Update*). Yet, despite persistent uncertainties surrounding the economic outlook, investors appear to remain confident about growth prospects in 2021, betting that continued policy support will offset any possible near-term disappointment. The much discussed disconnect between financial markets and the economy persists. Despite the recent rise in US long-end rates, market participants point to expectations of very low rates over coming years and upward revisions in earnings expectations since the vaccine announcements as justification for the market rally (Figure 2).

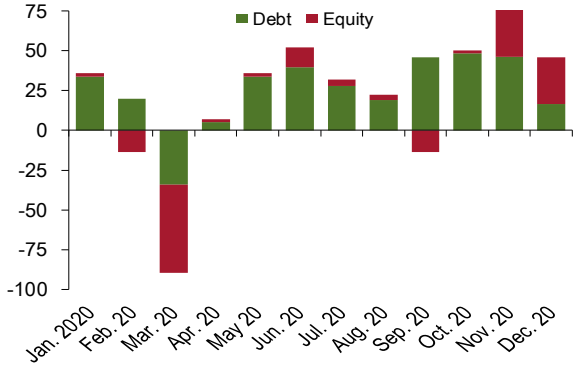
Vaccine access is likely to be uneven, and equitable distribution may take time. Many advanced economies, such as Canada, some European Union countries, the United Kingdom, and the United States, have prepurchased vaccines,

Figure 4. Emerging Market Sovereign Bond Issuance
(Billions of US dollars; share in percent)



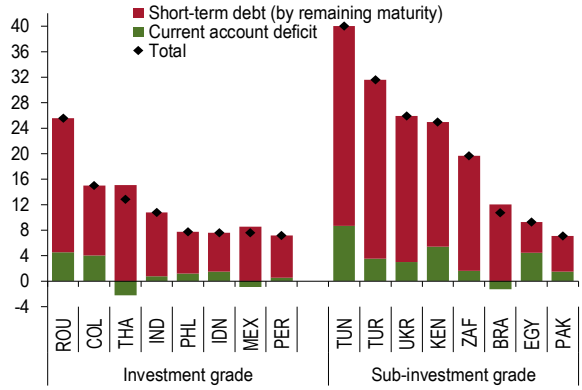
Sources: Bondradar; and IMF staff calculations.
Note: Refers to international hard currency bond issuance. January 2021 is partial data through January 20. HY = high yield.

Figure 5. Portfolio Flows to Emerging Markets
(US billions)



Sources: Institute of International Finance; and IMF staff calculations.

Figure 6. 2021 Gross External Financing Needs
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.
Note: Brazil, Romania, South Africa, Thailand, and Ukraine report intercompany lending in their gross external financing needs.

with large per capita coverage. By contrast, procurement of vaccine doses for emerging market and developing economies via direct negotiation or through the multilateral COVAX pillar lag significantly.[1] The need for access to vaccines is particularly urgent in countries where cases have accelerated recently or remain very high (Figure 3).

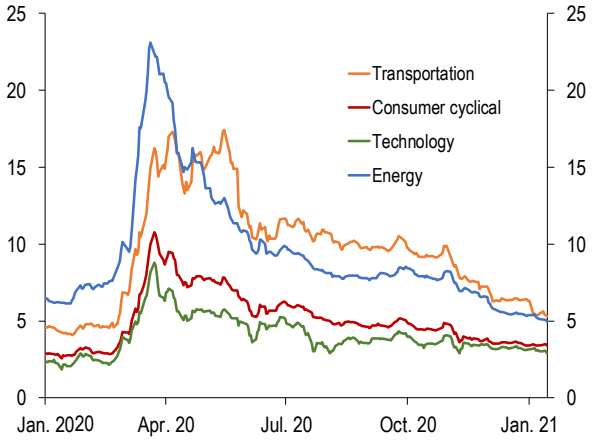
No Global Financial Crisis to Date: Don't Turn It into One!

Delayed access to comprehensive health care solutions could mean an incomplete global recovery and endanger the global financial system. With emerging market economies accounting for about 65 percent of global growth (about 40 percent excluding China) over 2017–19, delays in tackling the pandemic in such countries may bode ill for the global economy. Supply chain disruptions could affect corporate profitability even in regions where the pandemic is under control. And because growth is a crucial ingredient for financial stability, an uneven and partial recovery risks jeopardizing the health of the financial system.

Emerging markets have large financing needs. Large and persistent fiscal deficits in most emerging and frontier market economies are likely to persist in 2021, albeit to a smaller extent than in 2020. In the baseline WEO scenario of continued easy financial conditions, market financing will remain a significant source of funding, as it has been in recent months (Figure 4). The resumption of portfolio flows is central to the stability of many emerging market economies (Figure 5); retaining market access is essential. An uneven global economic recovery because of delayed health care and vaccine solutions may present a formidable challenge for emerging and frontier economies. With some countries already constrained by limited

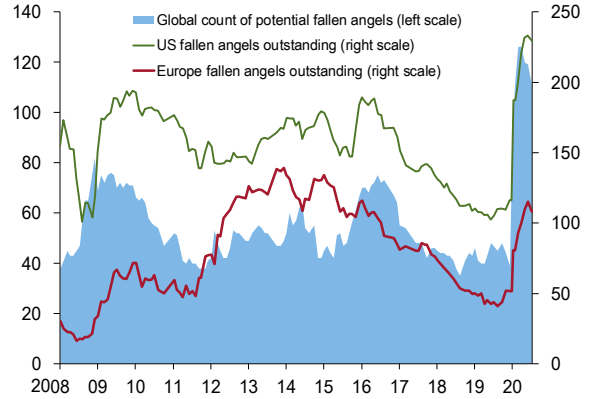
[1] COVAX—the vaccine-focused pillar of the Access to COVID-19 Tools Accelerator, a partnership of the World Health Organization, the European Commission, and France—is tasked with developing and providing innovative and equitable access to COVID-19 vaccines to all participating countries. It was launched in April 2020 in response to the pandemic, and it aims to make 2 billion doses available by the end of 2021.

Figure 7. US High-Yield Spreads
(Percent)



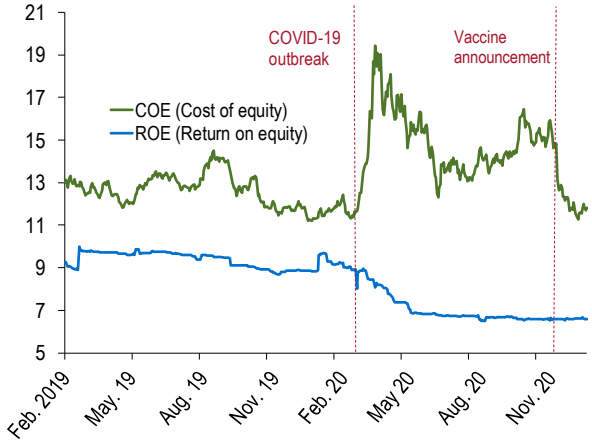
Sources: S&P Global; and IMF staff calculations.

Figure 8. Evolution of Potential "Fallen Angels"
(Count, left scale; US billions, right scale)



Sources: ICE BAML; S&P Global; and IMF staff calculations.
Note: See text for definition of "fallen angel" companies.

Figure 9. European Bank Performance Metrics
(Percent)



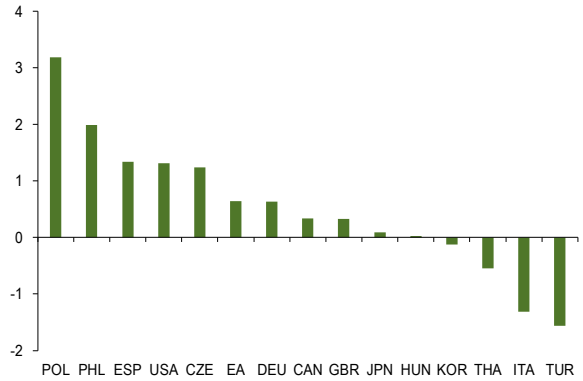
Sources: Bloomberg Finance L.P.; and IMF staff calculations.
Note: 2022 consensus EPS forecasts are used for the market-implied cost of equity, with consensus expectations used for ROE.

policy space, especially where access to capital markets is still not fully restored, the prospect of higher long-term rates in advanced economies as central banks find themselves closer to policy normalization may jeopardize the rollover of large external financing needs (Figure 6).

While solvency pressures have been limited so far, risks in the nonfinancial corporate sector remain. Reflecting unprecedented policy support, spreads have recovered almost entirely, even in the sub-investment-grade sector, although sectoral differences persist (Figure 7). Default rates at large firms have remained well below previous peaks, and bankruptcies among smaller firms have stayed low or even declined in some cases. However, challenges remain. For example, the number of potential "fallen angels" (that is, firms with a BBB minus rating and negative outlook) has tripled globally since the beginning of the pandemic, and in some jurisdictions (for example, the European Union and the United States) the potential for further downgrades is elevated (Figure 8). In China, defaults by state-owned enterprises in the last quarter of 2020 suggest that addressing financial vulnerabilities continues to be a priority. Ultimately, the health of the global corporate sector will depend critically on the evolution of the pandemic and on the extent and duration of policy support. Should investors reassess the prospects for economic growth and the outlook for monetary and fiscal policy, liquidity pressures, and the risk of such pressures morphing into insolvencies, may resurface,.

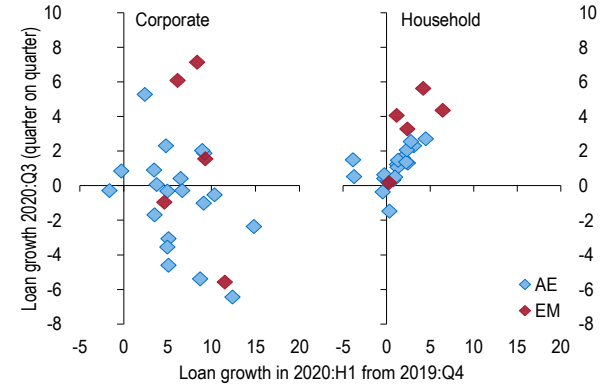
Household debt may rise, on the back of accommodative financial conditions. So far, strains in the household sectors have been mitigated by significant government support and relief programs as well as by declines in interest rates, which have reduced the debt service load. But poorer and marginalized households have been substantially more affected than others. This

Figure 10. Bank Lending Standards, Nonfinancial Firms
(Standard deviations from mean; higher is tighter; Q3 2020)



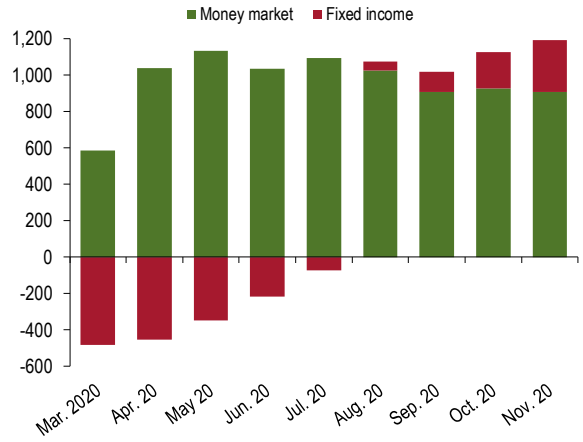
Sources: CEIC; Haver Analytics; and IMF staff calculations.

Figure 11. Bank Loan Growth
(Percent)



Sources: Haver Analytics; and IMF staff calculations.
Note: AE = advanced economy; EM = emerging market.

Figure 12. Flows into Global Investment Funds
(Billions of US dollars, cumulative since March 2020)



Source: Morningstar.

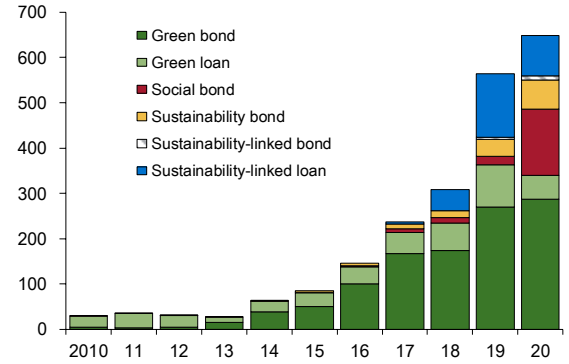
suggests that vulnerabilities are unevenly distributed among some households, and financial stress may rise if policy support is withdrawn too early or there is an incomplete economic recovery.

Banks have not been part of the problem so far. Banks entered the pandemic with a large amount of capital and high liquidity buffers and have shown resilience so far, and unprecedented policy support has helped maintain the flow of credit to households and firms. However, profitability challenges in the low-interest rate environment call into question banks' ability or willingness to continue to lend in coming quarters. Banks may be concerned about rising credit exposures and increasing nonperforming loans once policy support measures end, especially where the recovery may be delayed or incomplete. Banks may also face challenges in generating returns above the cost of equity amid continued compression of net interest margins, a development long evident in Japan and Europe (Figure 9). Underwriting standards for nonfinancial firms have tightened in some instances (Figure 10) and bank loan growth in many countries has remained low or slowed in recent months (Figure 11).

Inflows to investment funds have resumed on the back of improving market sentiment. The imperative to put cash to work in a buoyant market environment have driven investors to reach for yield. Between March and November 2020, fixed income funds registered cumulative inflows of about $280 billion, $230 billion of which poured in since the beginning of September (Figure 12). However, vulnerabilities in investment funds continue to be a concern: stretched asset valuations expose investment funds to the risk of a price correction, and liquidity and maturity mismatches remain largely unaddressed.[2]

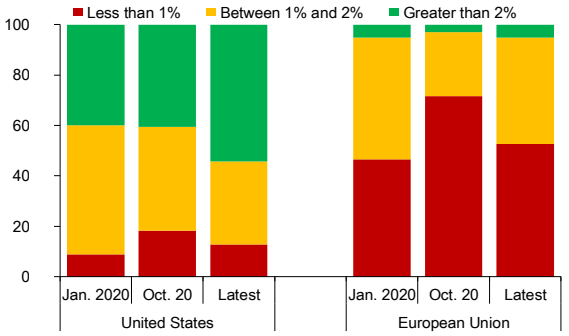
[2] See Chapter 1 of the October 2020 *Global Financial Stability Report* and the FSB holistic review.

Figure 13. Global Sustainable Debt Issuance
(Billions of US dollars)



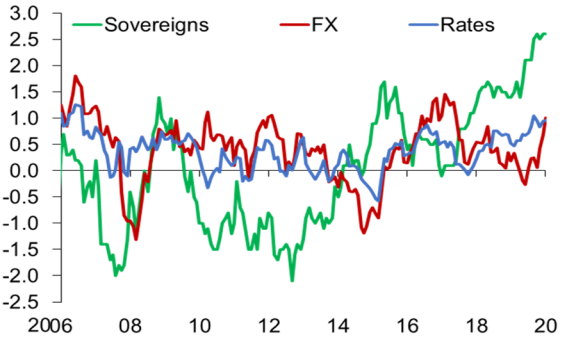
Sources: BloombergNEF; and IMF staff calculations.
Note: 2020 is partial data as of November 30.

Figure 14. Market-Implied Probability of Inflation Outcomes
(Percent, over five years)



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

Figure 15. Investor Positioning in Emerging Market Assets
(Reported investment position in excess of average in units of standard deviation)



Source: J.P. Morgan emerging markets client survey as of December 10, 2020. Note: FX = foreign exchange.

Capital markets are gaining importance as a source of funding to combat climate change and achieve social goals, and they can play a crucial role in greening the recovery. Greater awareness of the need for social spending, likely related to efforts to fight the pandemic, led to a very large increase in social bond issuance in 2020. Debtors have tapped into sustainable finance sources, with sustainable debt issuance in 2020 set to surpass the 2019 record at more than $650 billion (Figure 13).

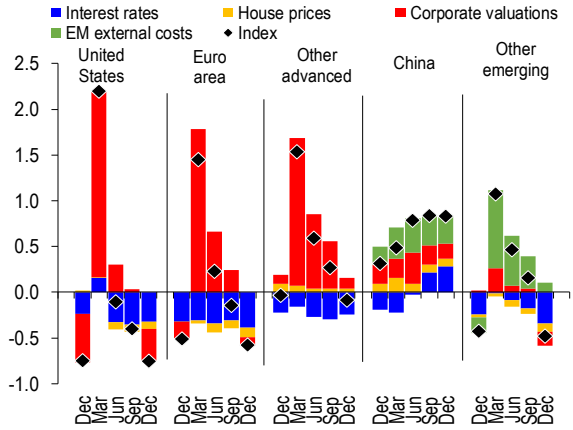
Once More Unto the Breach

Ongoing policy support remains necessary until a sustainable recovery takes hold to prevent the pandemic crisis from posing a threat to the global financial system. The global community should strive for multilateral cooperation in equitable vaccine development and delivery across the world to ensure an even and complete economic recovery. Policymakers should safeguard the progress made so far and build on the rollout of vaccines to return to sustainable growth. A bridge to the point where vaccines are widely available requires preserving monetary policy accommodation, ensuring liquidity support to households and firms, and keeping financial risks at bay.[3] Underdelivering on policy action risks jeopardizing the recovery, and the IMF and other multilateral institutions stand ready to provider further support should further downside risks materialize.

However, policymakers should also be cognizant of the risks of a market correction should investors suddenly reassess growth prospects or the policy outlook. With the recovery still nascent, and inflation still expected to be subdued, monetary policy is anticipated to remain accommodative for years to come

[3] See the October 2020 *Global Financial Stability Report* for a discussion of monetary, fiscal, and financial policies to support the recovery and the policy priorities once the pandemic is under control.

Figure 16. Financial Conditions Indices
(Standard deviations from mean)



Source: IMF staff calculations.
Note: Higher indicates tighter financial conditions. EM = emerging market. Series begins December 2019 and ends December 2020.

Note for all charts where applicable: Data labels use International Organization for Standardization (ISO) country codes.

(Figure 14). Asset valuations appear to be stretched in several markets. A sense of complacency permeating financial markets as investors seem to bet on a persistent policy backstop and uniform market views raise the risk of a price correction (Figure 15). A sudden sharp tightening of financial conditions from current very low levels—for example, as a result of a persistent increase in long-term interest rates—could be particularly pernicious should such tightening interact with financial vulnerabilities (Figure 16).

Financial stability risks are in check so far, but action is needed to address financial vulnerabilities exposed by the crisis.

Policymakers face an intertemporal policy trade-off between continuing to support the recovery until sustainable growth takes hold and addressing financial vulnerabilities that were evident before the pandemic or have emerged since it began. These include rising corporate debt, fragilities in the nonbank financial institutions sector, increasing sovereign debt, market access challenges for some developing economies, and declining profitability in some banking systems. Employing macroprudential policies to tackle these vulnerabilities is crucial to avoid putting growth at risk in the medium term.