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Financial Fragilities Along the Last Mile of Disinflation

Expectations that global disinflation is entering its „last mile" and monetary policy will be easing have driven up asset prices worldwide since the October 2023 Global Financial Stability Report. Many emerging markets have shown resilience, and some frontier economies have taken advantage of buoyant risk appetite to issue international debt. The global economy appears increasingly likely to achieve a soft landing, and cracks in the financial system exposed by high interest rates have not ruptured further. Near-term global financial stability risks have receded, according to the IMF's growth-at-risk framework. However, there are several salient risks along the last mile. Growing strains in the commercial real estate sector and signs of credit deterioration among corporates and in some residential housing markets could be exacerbated by adverse shocks. Stalling disinflation could surprise investors, leading to a repricing of assets and a resurgence of financial market volatility, which has been low despite considerable economic and geopolitical uncertainty. Beyond these more immediate concerns, other medium-term vulnerabilities are building, notably the continued accumulation of debt in both public and private sectors. Some governments may find it difficult to service debt in the future, whereas the private sector's leveraged exposures to financial assets may foretell elevated financial stability risks in the coming years.

Key words: central bank, monetary policy, financial market, financial institutions, stalling disinflation

Financial market sentiment has been buoyant since the October 2023 Global Financial Stability Report. Interest rates are down globally, on balance; stock markets are up substantially, especially in advanced economies; and corporate and sovereign borrowing spreads have narrowed notably. Capital inflows have resumed for many emerging markets, and some frontier and low-income countries have taken advantage of strong investor risk appetite to issue sovereign bonds after a lengthy hiatus. The continued easing of global financial conditions has been driven by growing confidence in a soft landing for the global economy against a backdrop of better-than-expected economic data in many parts of the world.

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The quest for disinflation seems to be entering the „last mile," with investors and central banks alike expecting monetary policy to ease in the coming quarters, considering that cumulative interest rate increases over the past two years are believed to have created monetary conditions sufficiently restrictive to bring inflation back to central banks' targets. That said, the disinflationary momentum has slowed more recently in a number of countries, raising the question of whether central banks in these countries will be able to deliver the extent of monetary easing currently expected by investors.

At the same time, cracks in the financial system— exposed during the tightening cycle by high interest rates—have not ruptured further. Major emerging markets have been resilient, and their financial and external sectors have proven strong throughout the interest rate upswing. Bank failures in Switzerland and the United States in March 2023 have not metastasized to other parts of the global financial system, and soundness indicators for most financial institutions point to continued resilience. With the global economy increasingly likely to achieve a soft landing and the financial system proving resilient, near-term financial stability risks have receded. According to the IMF's growth-at-risk (GaR) framework, downside risks to global growth in the coming year have declined, although they remain somewhat elevated from a historical perspective.

The last mile of disinflation, however, may be complicated by several near-term, salient financial fragilities. Stress in the commercial real estate (CRE) sector has become more acute, with more borrowers likely in trouble, and with a number of banks around the world being scrutinized by investors over CRE-related loan losses. Financial market volatility appears too low compared with the elevated levels of macroeconomic and geopolitical uncertainty and valuations of many risk assets are increasingly stretched, predicated on investor expectations for a relatively brisk monetary easing that may be tested by the bumps along the last mile. Upside inflationary surprises, for example, those driven by commodity price spikes and supply-chain disruptions, could challenge the benign disinflation narrative prevalent in markets and among policymakers.

A resurgence of volatility and a repricing of risk assets would lead to a sharp tightening in financial conditions and hasten the deterioration of the credit cycle, triggering adverse feedback loops. Beyond these more immediate concerns, other medium-term fragilities are building up along the last mile. Both public and private debt continue to accumulate in advanced economies and emerging markets. For governments, the vulnerabilities lie with the servicing of historically high sovereign debt in an environment of large fiscal deficits as real economic growth may fall below market expectations for real long-term interest rates, resulting in a „debt begets more debt" quandary (see the April 2024 World Economic Outlook projections).[1] While the level of debt is projected to change little in some countries, this challenge could be more acute for others with still-rising public debt. Elections to be held in a record number of countries in 2024 may also lead to fiscal „slippages".

Interest rates would then become increasingly sensitive to sovereign debt issuance strategies and to central bank quantitative tightening programs, posing a challenge for monetary policy to bring down inflation in the future. In some countries, banking sector health could be jeopardized by large exposures to sovereign debt. In addition, despite the recent improvement in credit market conditions, investor sentiment in China remains weak and may continue to weigh on the already distressed property and local government sectors. Further increases in financial vulnerabilities—especially higher debt—along with loose financial conditions could exacerbate downside risks to growth in the future (according to the IMF three-year-ahead GaR framework). With signs that reaching for yield is coming back amid expectations that interest rates will decrease in advanced economies in coming quarters, a rise in private financial and nonfinancial sector leverage could reemerge as a pressing financial stability concern.

Corporations, even lower-rated ones, are finding financing easier to obtain through traditional means such as corporate bond markets, as well as through new channels like private credit markets that are opaque to policymakers. Trading strategies that use leverage to boost returns, such as bond basis trades or exotic stock options linked to Chinese stocks, have been popular among investors seeking to increase their wager by borrowing. The excessive liquidity transformations that made the global financial crisis so severe could reappear, with open-end bond funds receiving large amounts of inflows in recent months and with illiquid asset classes such as private credit now being marketed to retail investors. In addition to increasing vulnerability in the financial system, faster credit growth stimulates aggregate demand, making disinflation more challenging.

This debt and leverage buildup is forging ahead even while the financial system is still tussling with the ongoing turning of the credit cycle, which could be hastened if the last mile turns out to be longer than expected. Many frontier and low-income countries are still experiencing financing stress, with little to no means of rolling over debt coming due. Around the world, more businesses and households are set to default as they continue to grapple with high interest rates and tighter bank lending standards. More brittle segments such as CRE and weaker banks are front and center in the battle against defaults. In the longer term, a reversal of financial globalization could reduce cross-border banking and investment flows, making the diversification of credit risk more challenging.

[1] https://mediacenter.imf.org/news/imf---world-economic-outlook-july-2024-update/s/6ae9bf9c-586c-4078-8e5c-90ace9de89b1

1. Monetary Policy and Financial Market Developments

The Expected Path of Monetary Policy Has Shifted Lower in Many Economies

Central banks have made notable progress in steering economies to steady disinflation, aided by positive supply-side improvements. Investors accordingly anticipate that major advanced economy central banks will pivot from monetary tightening to easing. Market pricing suggests multiple policy rate cuts over the course of this year. In the United States, evidence of still-significant labor market tightness and oscillating core inflation data releases have prompted the Federal Reserve to push back against market expectations of aggressive rate cuts, joining the chorus of the European Central Bank and the Bank of England.[2]

Market pricing currently indicates up to two rate cuts by the Federal Reserve, which are expected over the second half of the year, around three European Central Bank cuts by October, and one Bank of England cut by August. Japan remains an outlier, with markets pricing a gradual increase in the policy rate following the Bank of Japan's exit from long-standing negative interest rate policy and other unconventional measures on the back of its judgment that an achievement of the price stability target came into sight.[3]

The Bank of Japan's announcement did not elicit major market reactions as investors had reportedly anticipated these changes. In many emerging markets, policy expectations are also lower. As inflation has slowed, expectations of future inflation have fallen in the euro area but have risen some for the United States since the start of the year. Core inflation remains above central bank targets in most countries, leaving the global economy susceptible to inflationary shocks (for example, shocks arising from supply-chain disruptions). Pricing from inflation option markets reflects this uncertainty, with evidence signaling increased investor disagreement about future US inflation levels, expected over the next five years. Predicted odds of inflation moving below or above 2 percent over the next five years are almost the same.

Analysts' forecast surveys for the end of 2024 suggest that disagreement over the most likely inflation outcomes in the United States has increased since the October 2023 Global Financial Stability Report. Forecasts for real GDP reflect that expected US growth is meaningfully higher than euro area growth but is coupled with higher uncertainty. Looking ahead, uncertainty about the path of expected policy

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2 Gopinath, Gita, and Jeremy C. Stein, *Banking, Trade, and the Making of a Dominant Currency*, Working paper, Harvard University, Cambridge, MA, 2018. Gourinchas, P, Rey, H Sauzet, M, *The International Monetary and Financial System*, NBER Working Paper No. 25782, 2019.

3 https://www.nbcnewyork.com/news/business/money-report/bank-of-japan-hikes-rates-for-the-first-time-in-17-years-abolishes-yield-curve-control/5237674/?os=io...sxj9oul9%3Fno_journeys%3Dtrue&ref=app

rates remains elevated. Interest rate option prices indicate that the most likely level of the federal funds rate has declined and is now more or less consistent with the level of the median projection for 2024 in the Federal Reserve's latest Summary of Economic Projections. For the euro area, the distribution of policy rate outcomes has also shifted leftwards since the October 2023 Global Financial Stability Report, reflecting an increasingly tepid growth outlook coupled with moderating inflation.

That said, uncertainty around the most likely outcome for the policy rate has narrowed marginally relative to October 2023 for the United States, whereas it has widened some for the euro area. From a longer-term historical perspective, uncertainty about rates—proxied by swaption-implied volatility for one-year rates, one year forward—remains elevated compared with the average before the COVID-19 pandemic,[4] say, for both jurisdictions, albeit having compressed in recent months.

Longer-Term Interest Rates Have Declined Globally

Global long-term interest rates have declined, on net, since the October 2023 Global Financial Stability Report, driven in both advanced economies and major emerging markets by both the lower expected path of policy rates (as discussed previously) and a compression of the term premium—compensation required by investors to bear interest-rate risk over long-maturity bonds.

In the United States, term premiums have gyrated notably since the October 2023 Global Financial Stability Report. In September and October of 2023, an upward revision to the federal government's fiscal deficit and softer demand from traditional Treasury buyers such as banks and foreign reserve managers, weighed on US Treasury securities. The 10-year Treasury yield approached 5 percent at one point, driven by a term premium increase of around 70 basis points as the sell-off that started in mid-September 2023 intensified. More specifically, a higher real risk premium component of the term premium—capturing fiscal and economic uncertainty—drove up the term premium.[5] Subsequent announcements that Treasury securities issuances were lower than investor expectations helped ease pressure on the real risk premium. That said, the current level of real risk premiums across future horizons remains elevated compared with the end of the previous tightening cycle in January 2019 (Blinder 2023)[6], as well as to the average after the global financial crisis. Such gyrations

[4] International Monetary Fund (IMF), Commercial Real Estate: Financial Stability Risks during the COVID-19 Crisis and beyond. In *Global Financial Stability Report* (Chapter 2), Washington, DC, April 2021.

[5] Acemoglu, D, Johnson, S, Robinson, J, and Thaichar, Y, oen, Institutional Causes, Macroeconomic Symptoms: Volatility, Crises and Growth, *Journal of Monetary Economics*, Vol. 50, January, pp. 49–123, 2003.

[6] For more details, see the box entitled „Euro area bank deposit costs in a rising interest rate environment", *Financial Stability Review*, ECB, May 2023.

in the term premium have had global implications, as spillovers from US term premiums to those in other advanced economies and emerging markets have steadily risen in recent years. The premiums reached a new high after US fiscal concerns in late 2023, according to the percent of variation methodology in Diebold and Yilmaz (2009). Co-movements among global longer-term interest rates could remain pronounced in the future.

Asset Prices Have Rallied on the Basis of Buoyant Sentiment and Optimism about Earnings

Global equity markets have experienced broad-based rallies since the October 2023 Global Financial Stability Report, with the largest gains in Japan and the United States. By contrast, Chinese stocks have significantly underperformed, reflecting tepid economic performance as property market downturns remain a drag (see the section „Chinese Asset Prices Face a Difficult Turnaround amid Weak Sentiment").[7] European and US corporate bond markets have moved in sympathy with the stock market rally, with borrowing spreads narrowing considerably for both investment-grade and high-yield issuers.

Market expectations for a soft landing have been a major tailwind for asset prices. In the United States, this has led to positive earnings prospects for the corporate sector, driven by the mega technology stocks known as the Magnificent 7. These stocks have experienced high price-to-earnings ratios accompanied by investor optimism about medium-term earnings prospects. In recent months, earnings optimism and the stock price rally have spread more widely through the market, as reflected by price appreciation of the Russell 2000 index since October 2023.

A standard discounted cash flow model (Bank of England 2017; IMF 2019)[8] suggests that the rise in the overall S&P 500 index appears to have been driven, almost in equal parts, by improved earnings projections and investors' stronger risk appetite. That said, companies with strong margin power, mostly in the information technology and materials sectors, have outperformed companies with weak margin power. Companies with weak margin power have traditionally been more sensitive to inflation, but despite inflation having fallen from its peak in June 2022, recovery by these companies has been sluggish thus far. Even crypto markets—which have proven sensitive to risk sentiment—have rallied. Bitcoin prices have surpassed $70,000 for the first time in history, boosted by the recent approval of spot Bitcoin exchange-traded products. On the back of the crypto recovery rally, market capitalization of crypto assets surpassed $2.79 trillion in March 2024. If expectations of a soft landing and continued

7 Bloomberg Finance L. P; and IMF staff calculations. Note: AE = advanced economies; GFSR = Global Financial Stability Report; EMs = emerging markets

8 International Monetary Fund (IMF), „Online Annex 1.1. Technical Note." *In Global Financial Stability Report*, Washington, DC, April 2019.

disinflation no longer remain the baseline for investors, then overall, any optimism in earnings projections and buoyant risk sentiment could abruptly reverse, dragging stock prices down.[9]

Financial Conditions Have Eased, But Bank Lending Standards Have Tightened in Some Countries

Supported by investor optimism about a soft landing, lower long-term yields, and rallies in stock and corporate bond markets, financial conditions have eased, especially in advanced economies in most regions. In emerging markets, modest volatility in exchange rates in recent quarters has translated into a lower price of external financing risk, also modestly easing financial conditions. In China, financial conditions have eased slightly but remain somewhat tight by historical standards, as risk sentiment is weighed down by growth and property sector issues. In contrast with financial conditions, which summarize the price of risk in capital markets, bank lending standards—measuring banks' willingness to lend—tightened sequentially in much of 2022 and 2023, especially in advanced economies, amid concerns about deteriorating bor rower risk profiles, expectations of economic slowdowns, and reductions in banks' risk tolerance.

More recently, tentative signs indicate that the tightening in lending standards has stabilized in Brazil, the euro area, and the United States. Historically, tighter standards appear to portend an ebbing of credit growth over the next year in some countries, most notably the United States, although this connection is more tenuous in others, including Brazil, Japan, and the Philippines, as other factors such as the strength of loan demand and banking sector soundness attenuate the effect of lending standards on loan growth.

With global financial conditions having eased and credit growth having changed little since the October 10 2023 Global Financial Stability Report, estimates based on the IMF's GaR framework suggest that downside risks to global growth for 2024 have receded some what, with the balance of risks to growth forecast to be broadly symmetrical.[10] Downside risk—specifically as measured by the GaR metric4—suggests that with 5 percent probability, global growth over 2024 could fall below + 0.7 percent, although that is an improvement compared with the level in October 2023, which stood at just below 0 percent. From a historical perspective, the current level of fore cast downside risk for the near term is still marginally elevated.[11]

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9 Bank of England; Bloomberg Finance L. P; European Central Bank; Federal Reserve; ICE Bank of America; and IMF staff calculations.

10 Jensen, Henrik, Ivan Petrella, Søren Hove Ravn, and Emiliano Santoro, Leverage and Deepening Business-Cycle Skewness, *American Economic Journal: Macroeconomics 12* (1): 245–81, 2020.

11 Gourinchas, P, Rey, H Sauzet, M, The International Monetary and Financial System, *NBER Working Paper* No. 25782, 2019.

Zaključak

Čini se da su globalni napori da se inflacija vrati na cilj ušli u posljednju milju, budući da su povoljna kretanja na strani ponude i pooštravanje monetarne politike, čini se, obuzdali pritiske cijena. Ipak, pritisci na baziČnu inflaciju i plate i dalje su povišeni u mnogim ekonomijama, a ostaje značajna neizvjesnost u pogledu budućih kretanja inflacije. Neravnine na putu — prije svega zastoj dezinflatornog procesa — mogu iznenaditi investitore koji su sve više uvjereni da je bitka protiv inflacije već dobijena i da će niske stope ponovo prevladati. Sa ekonomskim rastom i napretkom u smanjenju inflacije, koji se razlikuju po regionima i zemljama, stav monetarne politike treba da odražava okolnosti specifične za zemlju. U ekonomijama koje još uvijek bilježe stalnu inflaciju, centralne banke ne bi trebale prerano popuštati kako bi kasnije izbjegle nazadovanje.

Centralne banke bi takođe trebalo da se suprotstave previše optimističnim očekivanjima investitora za ublažavanje monetarne politike. Tamo gdje je napredak u smanjenju inflacije dovoljno evidentan da sugeriše da se inflacija održivo kreće prema ciljevima, centralne banke bi trebalo da postepeno pređu na neutralniji politički stav. U oba slučaja, jasna komunikacija ostaje ključna za izbjegavanje neopravdane volatilnosti na tržištima. Smanjenje bilansa centralnih banaka do sada je bilo uredno. Ali centralne banke treba da pažljivo prate sva moguća pitanja funkcionisanja tržišta, koristeći širok spektar indikatora koji obuhvataju uslove likvidnosti i stope finansiranja na tržištima novca, dok budu spremne da se pozabave stresovima na tržištu ako je potrebno. Vlasti bi trebalo da budu posebno usmjerene na moguće rizike od neravnomjerne raspodjele likvidnosti i rezervi centralne banke među bankama. Kreatori politike treba da jasno saopšte ciljeve i korake za uklanjanje likvidnosti, naglašavajući spremnost da se koriste svi drugi dostupni alati za podršku likvidnosti.

Jasna i pravovremena komunikacija je posebno ključna ako se procijeni da su prilagođavanja neophodna kao odgovor na promjene makroekonomskih izgleda ili kretanja na finansijskom tržištu, te ako se kvantitativni proces pooštravanja nastavi nakon što centralne banke počnu snižavati svoje kamatne stope. S obzirom na to da državni dug i deficiti ostaju veći nego što su bili prije pandemije COVID-19, investitori bi mogli zahtijevati veće oročene premije, a time i prinose, kako bi zadržali državni dug i u naprednim ekonomijama i na tržištima u razvoju. Vlasti treba da pažljivo prate promjenjivu strukturu baze potražnje za državnim obveznicama i procijene potencijalne rizike povezane sa ovom promjenom. U Sjedinjenim Državama, Komisija za vrijednosne papire i berzu nedavno je usvojila pravila koja nalažu centralni kliring na trezorskim tržištima, kako bi se poboljšala njihova otpornost i transparentnost.

Ključno je nastaviti razvijati pravila za pristup klirinškoj kući i evaluirati potencijalne transakcijske troškove, kako bi se u potpunosti ostvarile prednosti ove mjere. Fiskalno prilagođavanje može podržati posljednju milju deinflacije, jer centralne banke preduzimaju korake kako bi postigle utvrđene ciljeve inflacije.

Fiskalna prilagođavanja bi se prvenstveno morala fokusirati na obnovu zaštitnih sredstava, smanjenje oročenih premija i obuzdavanje rasta duga. Tempo i sastav prilagođavanja treba da zavise od snage agregatne tražnje i raspoloživog fiskalnog prostora. U okviru budžetskih ograničenja, vlade bi trebalo da preispitaju prioritete potrošnje kako bi zaštitile najugroženije populacije. Da bi se pratile ranjivosti u CRE sektoru, potrebna je kontinuirana budnost kako bi se potencijalni rizici finansijske stabilnosti sveli na minimum. Da bi se osigurala otpornost bankarskog sistema i informirale odluke u vezi sa adekvatnošću kapitalnih bafera za CRE izloženosti, vlasti bi trebalo da sprovedu vježbe stresnog testiranja koje uključuju scenarije velikog pada cijena CRE. Ovi stresni testovi bi uključili manje banke sa materijalnom izloženošću CRE-ovima. Supervizori bi takođe trebalo da pregledaju pretpostavke vrednovanja CRE banaka i osiguraju da su rezervacije adekvatne.

Postoji hitna potreba da se smanje sistemski rizici vezani za CRE koji proizilaze iz nebankarskih finansijskih institucija, osiguravanjem djelotvornosti alata za upravljanje likvidnošću, uzimajući u obzir ograničenja finansijske poluge i poboljšavajući prikupljanje podataka. CRE fondovi bi trebali otkupljivati dionice manje učestalosti i zahtijevati duge otkazne periode ili periode poravnanja. U zavisnosti od dalje analize, vlasti bi takođe trebalo da razmotre zahtjev da takvi fondovi budu strukturisani kao zatvoreni fondovi. Vlasti bi trebalo da nastave da grade tamponove kako bi se zaštitile od budućih gubitaka u finansijskom sektoru i da bi podržale davanje kredita kroz periode stresa. Na primjer, vlasti mogu povećati kontraciklične zaštitne rezerve kapitala ili sektorske zaštitne rezerve za sistemski rizik, ako to okolnosti dozvoljavaju. Takvi baferi bi se mogli osloboditi ako bi se naprezanja, kao što su povećane zadane vrijednosti, materijalizovala.

Da bi se izbjegli prociklični efekti, podizanje zaštitnog sloja mora biti uslovljeno odsustvom znakova da je kredit već ograničen adekvatnošću kapitala banaka. U Kini, da bi se trajno poboljšalo povjerenje i ublažili dezinflatorni pritisci, potrebne su prilagodljive makroekonomske politike, zajedno sa strukturnim i protržišnim reformama, kako bi se podstakla kratkoročna aktivnost, ublažili rizici i osigurala glatka tranzicija ka kvalitetnijem i uravnoteženijem rastu na srednji rok. Politike imovinskog sektora, posebno, trebalo bi prioritet daju dovršavanju stambenih objekata i blagovremenom restrukturisanju investitora u problemima. Dodatno ublažavanje monetarne politike, posebno kroz niže kamatne stope, i preusmjeravanje javnih rashoda na domaćinstva, moglo bi podstaći kratkoročni oporavak, dok su potrebne sveobuhvatne fiskalne reforme kako bi se osigurala održivost finansija lokalne samouprave i spriječila negativna prelivanja na širu ekonomiju. Vlasti su postigle napredak u smanjenju rizika u nebankarskom finansijskom sektoru, ali dodatne mjere za poboljšanje upravljanja rizikom likvidnosti i dospijeća, kao i za zatvaranje regulatornih i podataka, mogle bi pomoći u obuzdavanju budućih sistemskih rizika. Za bankarski sektor je od ključnog značaja da se striktno sprovodi prudencijalna politika, uključujući postepeno ukidanje mjera odricanja i održavanje adekvatnih zaštitnih sredstava koji apsorbuju gubitke, kako bi se ojačali napori vlasti da restrukturiraju slabe banke i zaštite rizike finansijske stabilnosti. Vlasti treba da nastave pažljivo da prate razvoj tržišta kapitala, kako bi se izbjeglo prelivanje na širi finansijski sistem.

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Finansijske krhkosti duž posljednje milje dezinflacije

Očekivanja da globalna dezinflacija ulazi u „posljednju milju" i da će monetarna politika biti popuštena, povećala su cijene imovine širom svijeta od izvještaja o globalnoj finansijskoj stabilnosti iz oktobra 2023. Mnoga tržišta u nastajanju pokazala su otpornost, a neke pogranične ekonomije iskoristile su veliku sklonost riziku da izdaju međunarodni dug. Čini se da je sve veća vjerovatnoća da će globalna ekonomija postići meko slijetanje, a pukotine u finansijskom sistemu izložene visokim kamatnim stopama nisu dalje izbile. Kratkoročni rizici globalne finansijske stabilnosti su se povukli, prema MMF-ovom okviru za rast pod rizikom. Međutim, postoji nekoliko značajnih rizika duž zadnje milje. Rastući pritisak u sektoru komercijalnih nekretnina i znaci pogoršanja kredita među preduzećima i na nekim tržištima stambenih nekretnina mogli bi biti pogoršani negativnim šokovima. Odugovlačenje dezinflacije moglo bi iznenaditi investitore, što bi dovelo do promjene cijena imovine i ponovnog izbijanja volatilnosti finansijskog tržišta, koja je bila niska uprkos značajnoj ekonomskoj i geopolitičkoj neizvjesnosti. Osim ovih neposrednih zabrinutosti, rastu i druge srednjoročne ranjivosti, posebno kontinuirano nagomilavanje duga u javnom i privatnom sektoru. Nekim vladama će možda biti teško da servisiraju dug u budućnosti, dok izloženost privatnog sektora finansijskoj imovini može predvidjeti povećane rizike finansijske stabilnosti u narednim godinama.

Ključne riječi: centralna banka, monetarna politika, finansijsko tržište, finansijske institucije, zastoj dezinflacije