Dangerous undercurrents threaten global economy: IMF

In the 10 years since the global financial crisis, regulatory frameworks have been enhanced and the banking system has become stronger, but new vulnerabilities have emerged, and the resilience of the global financial system has yet to be tested. Over the past six months, global financial conditions have marginally tightened and the divergence between advanced and emerging market economies has grown. The global economic expansion continues, providing an opportunity to strengthen balance sheets and rebuild buffers, but growth appears to have peaked in some major economies.

With rising U.S. interest rates and a stronger dollar, as well as the intensification of trade tensions, a number of emerging market economies have experienced a reversal in portfolio flows. Beyond 2019, growth in most advanced economies is expected to be held back by slow labor force growth and weak labor productivity. In emerging market and developing economies, growth is projected to remain relatively robust, although income convergence toward advanced economy levels would likely be less favorable for countries undergoing substantial fiscal adjustment, economic transformation, or conflicts.

While financial conditions in advanced economies remain broadly accommodative, an inflation surprise could lead to an abrupt tightening of monetary policy and to an intensification of market pressures across a broader range of countries.

Priorities for low-income developing countries include building resilience, lifting potential growth, improving inclusiveness, and making progress toward the 2030 Sustainable Development Goals, while commodity exporters should also prioritize economic diversification.

Financial Conditions in Advanced and Emerging Market Economies Are Diverging

Financial conditions in advanced economies have remained accommodative, while conditions have tightened in emerging markets.

- In the United States, the Federal Reserve has raised its policy rate 25 basis points since April, marking the seventh hike in the tightening cycle, reflecting growing confidence in the economic outlook.
- In the euro area and other major advanced economies, financial conditions have remained relatively easy primarily because of still-accommodative monetary policies and strong global risk appetite and despite political uncertainty.
- In China, financial conditions have remained broadly stable, with an easing in monetary policy largely offsetting the impact of external pressures. China's equity markets have weakened on rising trade tensions.
- In other systemically important emerging market economies, a combination of country-specific political or policy uncertainties and worsening external financing conditions have led to a significant tightening of financial conditions, particularly in

more vulnerable economies, though on aggregate, financial conditions are still broadly accommodative relative to historical levels.

Emerging Markets: Key Risks and Vulnerabilities

Risks	Vulnerabilities	Buffers
Faster monetary policy normalization in advanced economies • Strong US dollar • Rising interest rates	**High leverage**	**Sound policy frameworks**
Political risks • Trade tensions • Policy uncertainty	**Large external financing needs**	**Foreign exchange reserves**
Contagion	**Short-term foreign currency debt**	**Fiscal buffers**
-	**Flighty investors**	**Deep and liquid markets**
-	**Trade exposures**	**Strong local investors base**

Source: PHD Research Bureau, data compiled from IMF Global Financial Stability Report October 2018

Foreign Investors, Domestic Investor Base, and Market-Liquidity

	Foreign Investors		**Domestic Investor Base**			
Country	**Debt**	**Equity**	**Mutual funds**	**Insurance**	**Pension funds**	**Banks assets**
	% GDP 2018:Q1	% GDP 2018:Q1	% GDP 2017	% GDP 2016	% GDP 2016	% GDP 2017
China	3	6	14	20	1	308
India	4	6	12	17	1	75
Indonesia	16	11	3	4	2	57
Malaysia	29	26	60	20	60	188
Philippines	8	17	2	8	4	101
Thailand	9	29	30	22	6	186

Source: PHD Research Bureau, data compiled from IMF Global Financial Stability Report October 2018

In Asia, despite substantial progress in financial deepening since the early 2000s, foreign exchange liquidity remains low compared to the size of the economy or of the local debt market (including in China, India, and Indonesia), while in some cases the size of their domestic mutual, insurance, and pension funds is also among the lowest.

In India, the Financial Stability and Development Council is a coordinating entity for macro prudential policy, and hard powers are left to the individual supervisors. Soft powers include informing the relevant hard-power agency and the public of potential risks. Gross public debt has increased substantially in Brazil in recent years and remains elevated in India.

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