

World Economic and Financial Surveys

Global Financial Stability Report

Vulnerabilities, Legacies, and Policy Challenges **Risks Rotating to Emerging Markets**

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OCT **15**



I N T E R N A T I O N A L M O N E T A R Y F U N D

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Editor's Note

(October 1, 2015)

- In Figure 1.11, the scale of the horizontal axis in the panel labeled Advanced Economies (bottom left) has been corrected.
- In Figure 2.2.1 (Box 2), the description within the figure has been reworded for clarity.

ASSUMPTIONS AND CONVENTIONS

The following conventions are used throughout the *Global Financial Stability Report* (GFSR):

- . . . to indicate that data are not available or not applicable;
- to indicate that the figure is zero or less than half the final digit shown, or that the item does not exist;
- between years or months (for example, 2014–15 or January–June) to indicate the years or months covered, including the beginning and ending years or months;
- / between years or months (for example, 2014/15) to indicate a fiscal or financial year.

“Billion” means a thousand million.

“Trillion” means a thousand billion.

“Basis points” refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to $\frac{1}{4}$ of 1 percentage point).

If no source is listed on tables and figures, data are based on IMF staff estimates or calculations.

Minor discrepancies between sums of constituent figures and totals shown reflect rounding.

As used in this report, the terms “country” and “economy” do not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

Further Information and Data

This version of the GFSR is available in full through the IMF eLibrary (www.elibrary.imf.org) and the IMF website (www.imf.org).

The data and analysis appearing in the GFSR are compiled by the IMF staff at the time of publication. Every effort is made to ensure, but not guarantee, their timeliness, accuracy, and completeness. When errors are discovered, there is a concerted effort to correct them as appropriate and feasible. Corrections and revisions made after publication are incorporated into the electronic editions available from the IMF eLibrary (www.elibrary.imf.org) and on the IMF website (www.imf.org). All substantive changes are listed in detail in the online tables of contents.

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PREFACE

The *Global Financial Stability Report* (GFSR) assesses key risks facing the global financial system. In normal times, the report seeks to play a role in preventing crises by highlighting policies that may mitigate systemic risks, thereby contributing to global financial stability and the sustained economic growth of the IMF's member countries.

The current report finds that, despite an improvement in financial stability in advanced economies, risks continue to rotate toward emerging markets. The global financial outlook is clouded by a triad of policy challenges: emerging market vulnerabilities, legacy issues from the crisis in advanced economies, and weak systemic market liquidity. With more vulnerable balance sheets in emerging market companies and banks, firms in these countries are more susceptible to financial stress, economic downturn, and capital outflows. Recent market developments such as slumping commodity prices, China's bursting equity bubble, and pressure on exchange rates underscore these challenges. The prospect of the U.S. Federal Reserve gradually raising interest rates points to an unprecedented adjustment in the global financial system as financial conditions and risk premiums "normalize" from historically low levels alongside rising policy rates and a modest cyclical recovery. The report also examines the factors that influence levels of liquidity in securities markets, as well as the implications of low liquidity. Currently, market liquidity is being supported by benign cyclical conditions. Although it is too early to assess the impact of recent regulatory changes on market liquidity, changes in market structure, such as larger holdings of corporate bonds by mutual funds, appear to have increased the fragility of liquidity. Finally, the report studies the growing level of corporate debt in emerging markets, which quadrupled between 2004 and 2014. The report finds that global drivers have played an increasing role in leverage growth, issuance, and spreads. Moreover, higher leverage has been associated with, on average, rising foreign currency exposures. It also finds that despite weaker balance sheets, firms have managed to issue bonds at better terms as a result of favorable financial conditions.

The analysis in this report has been coordinated by the Monetary and Capital Markets (MCM) Department under the general direction of José Viñals, Financial Counsellor and Director. The project has been directed by Peter Dattels and Dong He, both Deputy Directors, as well as by Gaston Gelos and Matthew Jones, both Division Chiefs. It has benefited from comments and suggestions from the senior staff in the MCM Department.

Individual contributors to the report are Ali Al-Eyd, Adrian Alter, Nicolas Arregui, Serkan Arslanalp, Luis Brandão-Marques, Antoine Bouveret, Peter Breuer, John Caparusso, Yingyuan Chen, Martin Čihák, Fabio Cortes, Reinout De Bock, Martin Edmonds, Selim Elekdag, Jennifer Elliott, Michaela Erbenova, Brenda González-Hermosillo, Tryggvi Gudmundsson, Fei Han, Sanjay Hazarika, Geoffrey Heenan, Eija Holttinen, Hibiki Ichiue, Etibar Jafarov, Mustafa Jamal, Bradley Jones, David Jones, William Kerry, Oksana Khadarina, Ayumu Ken Kikkawa, John Kiff, Suchitra Kumarapathy, Raphael Lam, Frederic Lambert, Sheheryar Malik, Win Monroe, Machiko Narita, Evan Papageorgiou, Vladimir Pillonca, Jean Portier, Shaun Roache, Luigi Ruggerone, Christian Saborowski, Luca Sanfilippo, Tsuyoshi Sasaki, Kate Seal, Nobuyasu Sugimoto, Narayan Suryakumar, Shamir Tanna, Laura Valderrama, Constant Verkoren, Francis Vitek, Jeffrey Williams, Kai Yan, and Jinfan Zhang. Magally Bernal, Carol Franco, Juan Rigat, and Adriana Rota were responsible for word processing.

Joe Procopio from the Communications Department led the editorial team and managed the report's production with support from Michael Harrup and Linda Kean and editorial assistance from Lucy Scott Morales, Sherrie Brown, Gregg Forte, Linda Long, Lorraine Coffey, Shannon Mann, EEI Communications, and AGS.

This particular edition of the GFSR draws in part on a series of discussions with banks, securities firms, asset management companies, hedge funds, standards setters, financial consultants, pension funds, central banks, national treasuries, and academic researchers.

This GFSR reflects information available as of September 18, 2015. The report benefited from comments and suggestions from staff in other IMF departments, as well as from Executive Directors following their discussion of the GFSR on September 21, 2015. However, the analysis and policy considerations are those of the contributing staff and should not be attributed to the IMF, its Executive Directors, or their national authorities.

EXECUTIVE SUMMARY

Financial stability has improved in advanced economies

Financial stability has improved in advanced economies since the April 2015 *Global Financial Stability Report*. This progress reflects a strengthening macrofinancial environment in advanced economies as the recovery has broadened, confidence in monetary policies has firmed, and deflation risks have abated somewhat in the euro area.

The Federal Reserve is poised to raise interest rates as the preconditions for liftoff are nearly in place. This increase should help slow the further buildup of excesses in financial risk taking. Partly due to confidence in the European Central Bank's (ECB's) policies, credit conditions are improving and credit demand is picking up. Corporate sectors are showing tentative signs of improvement that could spawn increased investment and economic risk taking, including in the United States and Japan, albeit from low levels.

Risks continue to rotate toward emerging markets, amid greater market liquidity risks

Despite these improvements in advanced economies, emerging market vulnerabilities remain elevated, risk appetite has fallen, and market liquidity risks are higher. Although many emerging market economies have enhanced their policy frameworks and resilience to external shocks, several key economies face substantial domestic imbalances and lower growth, as noted in the October 2015 *World Economic Outlook* (WEO). Many emerging market economies relied on rapid credit creation to sidestep the worst impacts of the global crisis. This increased borrowing has resulted in sharply higher leverage of the private sector in many economies, particularly in cyclical sectors, accompanied by rising foreign currency exposures increasingly driven by global factors. This confluence of borrowing and foreign currency exposure has increased the sensitivity of these economies to a tightening of global financial conditions (see Chapter 3).

As emerging market economies approach the late stage of the credit cycle, banks have thinner capital cushions, while nonperforming loans are set to rise

as corporate earnings and asset quality deteriorate. In China, banks have only recently begun to address the growing asset quality challenges associated with rising weaknesses in key areas of the corporate sector. These developments in emerging market banking systems stand in contrast to those in advanced economies, where banks have spent the past few years deleveraging and repairing balance sheets, raising capital, and strengthening funding arrangements.

Against a challenging backdrop of falling commodity prices and weaker growth, several emerging market sovereigns are at greater risk of losing investment-grade ratings in the medium term. Pressures on sovereign ratings could intensify if contingent liabilities of state-owned enterprises—with a large and rising share of emerging market corporate bond issuance—have to be assumed by the sovereign, for example, from firms in the oil, gas, and utility sectors.

Policymakers confront a triad of challenges

The baseline outlook for financial stability, consistent with the October 2015 WEO, is characterized by continuing cyclical recovery, but with weak prospects for medium-term growth in both advanced economies and emerging markets. In advanced economies, improvements in private balance sheets and continued accommodative monetary and financial conditions have spurred a cyclical recovery, but the handover to higher levels of self-sustaining growth is incomplete. Emerging markets face substantial challenges in adjusting to the new global market realities from a position of higher vulnerability.

Successful normalization of financial and monetary conditions would bring macrofinancial benefits and considerably reduce downside risks. This report analyzes the prospects for normalization according to three scenarios: the baseline, an upside scenario of successful normalization, and a downside scenario characterized by disruptions in global asset markets. Against this backdrop, the global financial outlook is clouded by a triad of broad policy challenges in evidence over the past several months:

- *Emerging market vulnerabilities*—As examined in the WEO, growth in emerging markets and developing economies is projected to decline for the fifth year in a row. Many emerging markets have increased their resilience to external shocks with increased exchange rate flexibility, higher foreign exchange reserves, increased reliance on FDI flows and domestic-currency external financing, and generally stronger policy frameworks. But balance sheets have become stretched thinner in many emerging market companies and banks. These firms have become more susceptible to financial stress, economic downturn, and capital outflows. Deteriorating corporate health runs the risk of deepening the sovereign-corporate and the corporate-bank nexus in some key emerging markets. China in particular faces a delicate balance of transitioning to more consumption-driven growth without activity slowing too much, while reducing financial vulnerabilities and moving toward a more market-based system—a challenging set of objectives. Recent market developments, including slumping commodity prices, China’s bursting equity and margin-lending bubble, falling emerging market equities, and pressure on exchange rates, underscore these challenges.
- *Legacy issues from the crisis in advanced economies*—High public and private debt in advanced economies and remaining gaps in the euro area architecture need to be addressed to consolidate financial stability, and avoid political tensions and headwinds to confidence and growth. In the euro area, addressing remaining sovereign and banking vulnerabilities is still a challenge.
- *Weak systemic market liquidity*—This poses a challenge in adjusting to new equilibria in markets and the wider economy. Extraordinarily accommodative policies have contributed to a compression of risk premiums across a range of markets including sovereign bonds and corporate credit, as well as a compression of liquidity and equity risk premiums. While recent market developments have unwound some of this compression, risk premiums could still rise further. Now that the Federal Reserve looks set to begin the gradual process of tightening monetary policy, the global financial system faces an unprecedented adjustment as risk premiums “normalize” from historically low levels alongside rising policy rates and a modest cyclical recovery. Abnormal market conditions will

need to adjust smoothly to the new environment. But there are risks from a rapid decompression, particularly given what appears to be more brittle market structures and market fragilities concentrated in credit intermediation channels, which could come to the fore as financial conditions normalize (see Chapter 2). Indeed, recent episodes of high market volatility and liquidity dislocations across advanced and emerging market asset classes highlight this challenge.

Strong policy actions are needed to ensure “successful normalization”

The relatively weak baseline for both financial stability and the economic outlook leaves risks tilted to the downside. Thus, ensuring successful normalization of financial and monetary conditions and a smooth handover to higher growth requires further policy efforts to tackle pressing challenges. These should include the following:

- Continued effort by the Federal Reserve to provide clear and consistent communication, enabling the smooth absorption of rising U.S. rates, which is essential for global financial health.
- In the euro area, more progress in strengthening the financial architecture of the common currency to bolster market and business confidence. Addressing the overhang of private debt and bank nonperforming loans in the euro area would support bank finance and corporate health, and boost investment.
- Rebalancing and gradual deleveraging in China, which will require great care and strong commitments to market-based reforms and further strengthening of the financial system.
- More broadly, addressing both cyclical and structural challenges in emerging markets, which will be critical to underpin improved prospects and resilience. Authorities in emerging markets should regularly monitor corporate foreign currency exposures, including derivatives positions, and use micro- and macroprudential tools to discourage the buildup of excessive leverage and foreign indebtedness.
- Safeguarding against market illiquidity and strengthening market structures, which are priorities, especially in advanced economies’ markets.
- Ensuring the soundness and health of banks and the long-term savings complex (for example, insurers and pension funds), which is critical, as highlighted in the April 2015 GFSR.

With bold and upgraded financial policy actions detailed in the report, policymakers can help deliver a stronger path for growth and financial stability, while avoiding downside risks. Such an upside scenario would benefit the world economy and raise global output 0.4 percent above the baseline by 2018. Further growth-enhancing structural reforms, detailed in the WEO, could bring additional support to growth and stability, beyond the benefits detailed here.

Possible shocks or policy missteps could lead to a global asset market disruption

Without the implementation of policies to ensure successful normalization, potential adverse shocks or policy missteps could trigger an abrupt rise in market risk premiums and a rapid erosion of policy confidence. Shocks may originate in advanced or emerging markets and, combined with unaddressed system vulnerabilities, could lead to a global asset market disruption and a sudden drying up of market liquidity in many asset classes. Under these conditions, a significant—even if tempo-

rary—mispricing of assets may ensue, with negative repercussions on financial stability (see Chapter 2).

In such an adverse scenario, substantially tighter financial conditions could stall the cyclical recovery and weaken confidence in medium-term growth prospects. Low nominal growth would put pressure on debt-laden sovereign and private balance sheets, raising credit risks. Emerging markets would face higher global risk premiums and substantial capital outflows, putting particular pressure on economies with domestic imbalances. Corporate default rates would rise, particularly in China, raising financial system strains, with implications for growth. These events would lead to a reappearance of risks on sovereign balance sheets, especially in Europe's vulnerable economies, and the emergence of an adverse feedback loop between corporate and sovereign risks in emerging markets. As a result, aggregate global output could be as much as 2.4 percent lower by 2017, relative to the baseline. This implies lower but still positive global growth.

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IMF EXECUTIVE BOARD DISCUSSION SUMMARY

The following remarks were made by the Chair at the conclusion of the Executive Board's discussion of the World Economic Outlook, Global Financial Stability Report, and Fiscal Monitor on September 21, 2015.

Executive Directors broadly shared the assessment of global economic prospects and risks. They noted that global growth remains modest and uneven across countries and regions, while financial market volatility has increased in recent months. Downside risks to the global outlook have risen, with emerging market and developing economies particularly exposed to the declining commodity prices and tighter global financial conditions. Directors observed that persistent weak growth in advanced economies and the fifth consecutive year of growth declines in emerging market economies reflect both country-specific developments and common forces of a medium- and long-term nature. Forceful policy action on all fronts, as well as enhanced international cooperation, has become more crucial than ever to reverse this trend and promote stronger, more balanced global growth.

Directors broadly concurred that, in advanced economies, the foundations for a modest recovery in 2015–16 are still intact, while financial stability has generally improved. They noted that a sustained recovery in the euro area, a return to positive growth in Japan, and continued robust activity in the United States are positive forces, although increased market volatility may pose financial stability challenges in the near term. Medium-term prospects remain subdued, reflecting unfavorable demographics, weak productivity growth, and high unemployment, as well as legacy issues from the crisis—including high indebtedness, low investment, and financial sector weakness. A key risk is a further decline of already-low growth that could turn into near stagnation, especially if slower growth in emerging market economies dampens global demand. In this context, persistent below-target inflation could become more entrenched.

Directors noted that the overall outlook for emerging market and developing economies is generally

weakening, reflecting tighter global financial conditions, China's transition toward consumption-driven sustainable growth, a weaker commodity market outlook, and geopolitical tensions. However, growth prospects differ considerably across countries. Emerging market economies are vulnerable to shifts in exchange rates and a reversal of capital flows. Meanwhile, further declines in commodity prices could weaken the outlook for commodity exporters. While China's transition and the ensuing slowdown have long been anticipated, a sharper-than-expected growth decline, if it materialized, could generate considerable spillovers and risks for other countries.

Directors acknowledged that the global financial outlook is clouded by increased emerging market vulnerabilities, legacy issues from the crisis in advanced economies, and concerns about weak market liquidity. They noted in particular high corporate leverage and foreign-currency exposures in emerging market economies, headwinds from balance sheet weaknesses in advanced economies, and remaining gaps in the euro area financial architecture. In the context of rising policy rates, the global financial system may see adjustment as financial conditions tighten and risk premiums rise from historically low levels. Directors recognized that interest rate normalization in the United States driven by robust activity will benefit the world economy and also reduce uncertainty—and hence should take place in a timely, data-dependent manner.

Directors underscored that raising both actual and potential output continues to be a policy priority, requiring mutually reinforcing measures for demand support and structural reforms. They concurred that the main policy recommendations are appropriate, although the right balance of policy mix will vary from country to country. A collective effort is needed to boost trade growth, avoid trade protectionist

measures, refrain from competitive devaluations, and reduce the persistent global imbalances.

Directors agreed with the policy priorities for full employment and stable inflation in advanced economies. Accommodative monetary policy remains essential, particularly in Japan and the euro area, while efforts should continue, where needed, to enhance policy transmission and address financial system risks through continued balance sheet repair and macro-prudential policies. Fiscal policy should remain prudent, yet flexible and growth friendly, anchored in sound medium-term strategies. Countries with fiscal space and sizable output gaps or significant current account surpluses should ease their fiscal stance in the near term, especially by increasing investment in high-quality, high-return infrastructure projects. Structural reforms should aim to strengthen labor force participation and trend employment, facilitate labor market adjustment, tackle legacy debt overhang, and lower barriers to entry in product markets, especially in services.

Directors recognized that emerging market and developing economies in general are now better prepared for the current, less favorable environment—with stronger fundamentals, buffers, and policy frameworks. Nevertheless, they face a difficult trade-off between supporting demand and reducing vulnerabilities. The scope for further easing macroeconomic policies varies considerably across countries, depending on the extent of economic slack and inflationary pressures and fiscal space, as well as external, financial, and fiscal vulnerabilities. Directors agreed that exchange rate flexibility, where feasible, in the context of a well-specified policy framework, can help absorb external shocks. They stressed that, in many countries, structural reforms are urgently needed to raise productivity and remove bottlenecks to production.

Directors concurred that, in a more difficult external environment, developments in low-income countries should be given particular attention. Many of these countries are commodity exporters whose initial conditions have already been strained, fiscal and external balances are deteriorating, and absorptive capacity is limited. Appropriate policy advice and adequate financial assistance from development partners, includ-

ing the Fund, will be essential to support low-income countries in their adjustment efforts and advancement toward the Sustainable Development Goals. Their priorities generally include economic diversification, domestic revenue mobilization, and financial sector deepening.

Directors highlighted the importance of preserving financial stability, safeguarding against market illiquidity, and maintaining confidence in policymaking. For advanced economies, priorities should include continued clear and effective communication of monetary policy intentions, and a comprehensive strategy to tackle nonperforming loans and complete the financial architecture in the euro area. Liquidity conditions, especially for nonbanks, should be closely monitored, and market structure solutions to liquidity shortages should be explored. Completing the global financial regulatory reform agenda requires further progress on implementation, finalization of outstanding reforms, and addressing emerging risks.

Directors emphasized the need to address both cyclical and structural challenges in emerging market economies. They agreed that policymakers should rely on micro- and macro-prudential tools to discourage the buildup of excessive leverage, strengthen provisioning by banks, and improve regulations on credit quality classification. Foreign-currency exposures warrant special attention and the reform of corporate insolvency regimes should continue. Rebalancing and deleveraging in China will require a careful pacing and sequencing of market-based reforms, a further strengthening of the financial system, and strong implementation of the reform agenda.

Directors noted that lower oil prices present both opportunities and challenges. In many oil-importing countries, lower oil prices have eased the burden on monetary policy and created some fiscal policy space. Exporters of oil and other commodities with worsening terms of trade will need to adjust public spending in the face of lower commodity-related revenue. These countries should also continue to upgrade their fiscal policy frameworks and provide a longer-term anchor to guide policy decisions. Reforms of energy subsidies and taxation remain an important priority for many countries.

THREE SCENARIOS FOR FINANCIAL STABILITY

Financial Stability Overview

During the past six months financial stability has improved in advanced economies, but risks continue to rotate toward emerging markets amid a lower risk appetite and higher market and liquidity risks. In advanced economies, growth is gaining traction, and monetary policy normalization is approaching in the United States. Despite these improvements in advanced economies, emerging market vulnerabilities remain elevated. Several key emerging market economies face substantial domestic imbalances, and growth projections have been downgraded, leaving financial stability risks tilted to the downside. The possibility of a global asset market disruption, whereby market risk premiums would decompress in a disorderly way and spread financial contagion, remains heightened. Such a scenario could derail the recovery and delay or stall monetary policy exits. In contrast, “successful normalization”—featuring gradually rising risk premiums, orderly balance sheet adjustments, and renewed financial and corporate health—will require concerted policy action.

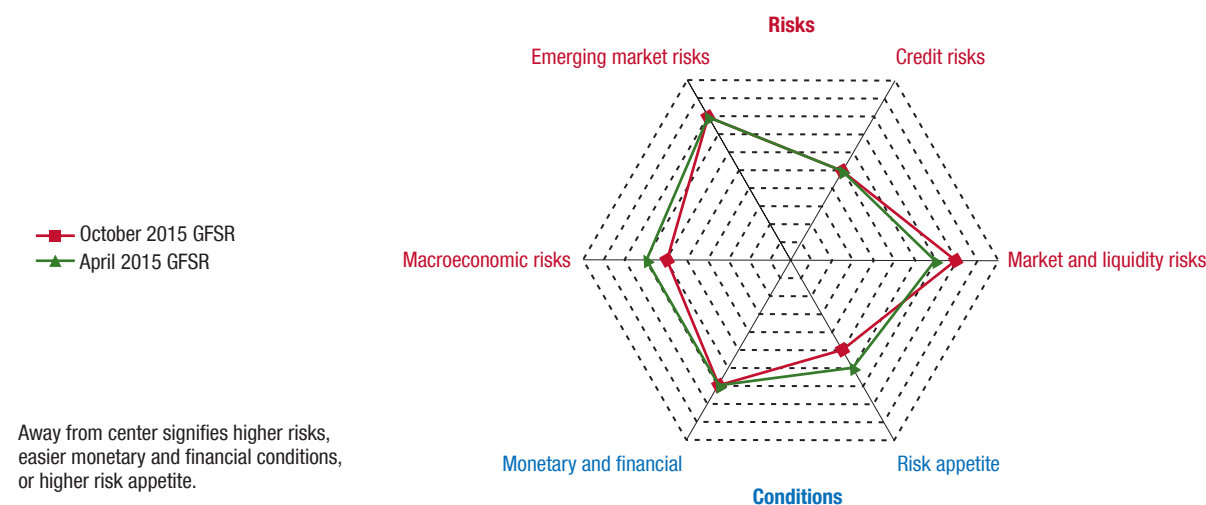
Financial stability has improved modestly in advanced economies since the April 2015 *Global Financial Stability Report* (GFSR), as shown in the Global Financial Stability Map (Figure 1.1) and its components (Figure 1.2). Risks continue to rotate from advanced economies to emerging markets and from banking to nonbanking sectors, keeping *emerging market risks* elevated, while *market and liquidity risks* continue to increase, in an environment of lower *risk appetite*.

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Financial stability has improved in advanced economies

Macroeconomic risks have declined as the economic recovery in advanced economies has broadened. Deflation fears peaked in early 2015 and confidence in monetary policies has since increased (Figure 1.3, panels 1 and 2), as reflected in improved cyclical economic data in advanced economies. The following developments allow for cautious optimism about near-term stability and growth:

- *The U.S. recovery has resumed, and wage and price inflation pressures remain subdued.* Improving labor market performance is boosting hopes of sustainable consumer and household support for the recovery, as noted in the October 2015 *World Economic Outlook* (WEO). With the output gap closing, the Federal Reserve is nearer to raising its monetary policy rate above the zero bound. This action will mark the beginning of a move away from the long period of extraordinary monetary accommodation and the first step toward normalizing monetary and financial conditions. It will also help reduce the pockets of both excess financial risk taking and corporate leverage—as flagged in previous issues of the GFSR—that have arisen as a result of the highly accommodative monetary policies of recent years.
- *The policies of the European Central Bank (ECB) are taking hold and euro area credit conditions are easing.* Signs are growing that the ECB’s unconventional monetary policy is starting to work. For example, the portfolio rebalancing channel sent asset prices higher, narrowed spreads, and boosted the nonbank supply of credit. Policies aimed at strengthening the banking system have bolstered confidence as well as safety, and credit supply and demand have risen. The market’s expected time remaining before the commencement of ECB policy normalization has halved to 2½ years, but has recently edged up amid increased turmoil in global markets (Figure 1.3, panel 2). Market reactions to developments in Greece have been muted so far, reflecting the strength of European firewalls, the ECB’s commitment and actions, and the declining importance of systemic linkages associated with Greece.

Figure 1.1. Global Financial Stability Map: Risks and Conditions

Source: IMF staff estimates.

Note: GFSR = *Global Financial Stability Report*.

- *The Japanese economy is expected to continue to recover, despite a setback in the second quarter.* Tentative signs are emerging that corporate investment plans are firming, helping improve the outlook for wage and price inflation. The Bank of Japan's quantitative and qualitative monetary easing has improved financial conditions, increasing equity prices and leading to a modest increase in bank lending. However, market-based inflation expectations remain below the Bank of Japan's inflation target.

Easy monetary and financial conditions and improvements in private balance sheets in advanced economies have spurred the cyclical recovery, but the transition to self-sustaining growth is incomplete. The financial stability outlook is characterized by continuing cyclical recovery, but prospects for medium-term growth are weak, as noted in the October 2015 WEO. In the United States, earlier measures to repair bank balance sheets have helped boost credit growth, and economic risk taking is rising, but from low levels (Figure 1.4). In Japan, investment is slowly recovering from very low levels as the availability of credit has increased with the improvement in banking system health. The level of euro area real investment still remains below that of 2008, and the outlook for medium-term growth is decidedly weak.

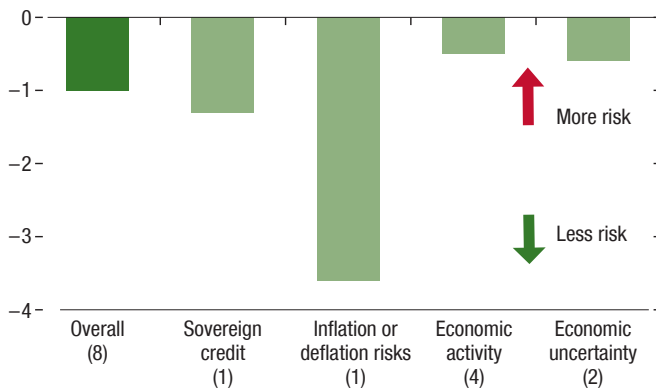
Risks continue to rotate from advanced economies to emerging markets

Emerging market risks remain elevated. Several key emerging market economies face substantial domestic imbalances, and growth projections have been downgraded. Although the quality of bank assets appears robust, many emerging market economies are at late stages in their credit cycles, leaving them more vulnerable to an economic downturn and a likely tightening of external financial conditions as the Federal Reserve prepares to raise policy rates for the first time since 2006 (see also Chapter 3).

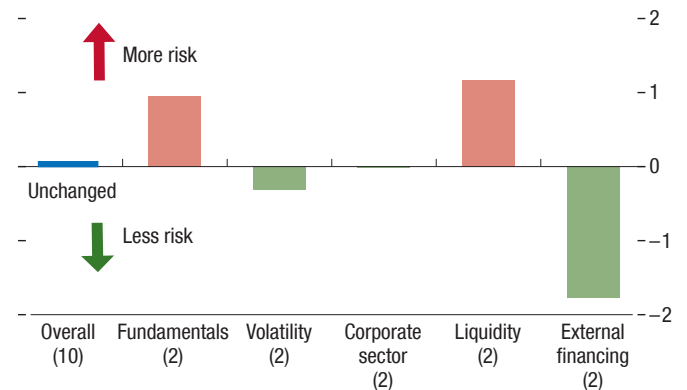
China faces a delicate balance of transitioning to more consumption-driven growth without activity slowing too much, addressing rising financial and corporate sector vulnerabilities, and making the transition toward a more market-based financial system that discourages the buildup of imbalances. Recent market developments underscore the complexity of these challenges, as well as potentially stronger spillovers from China. A gradual growth slowdown is inevitable in the process of reining in vulnerabilities, but the recent weaker-than-expected economic indicators and exchange rate depreciation raised concerns about corporate indebtedness (particularly in foreign currency), while banks are reporting higher credit costs and rising nonperforming loans, albeit from low levels. Although China has substantial buffers to deal with shocks—including official foreign reserves well exceeding private sector external debt—

Figure 1.2. Global Financial Stability Map: Components of Risks and Conditions
(Notch changes since the April 2015 Global Financial Stability Report)

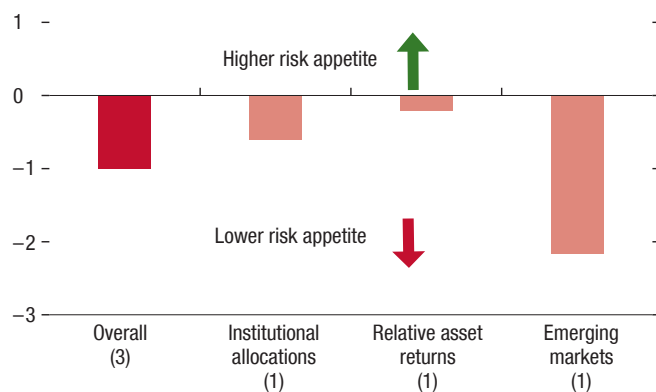
1. Macroeconomic risks are lower, mainly from improved signs of recovery in advanced economies.



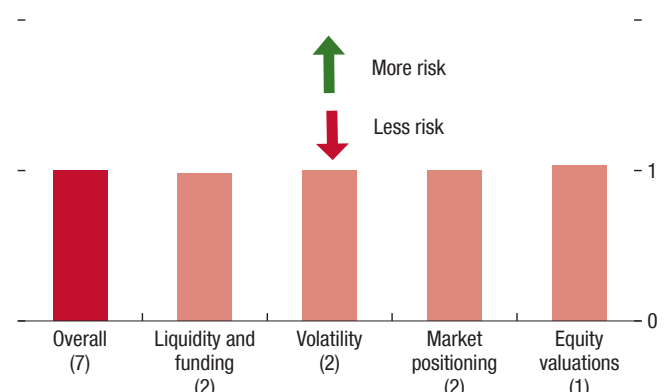
2. Emerging market risks are unchanged but elevated. External conditions, including current account balances, have improved, but liquidity has weakened and credit ratings have deteriorated.



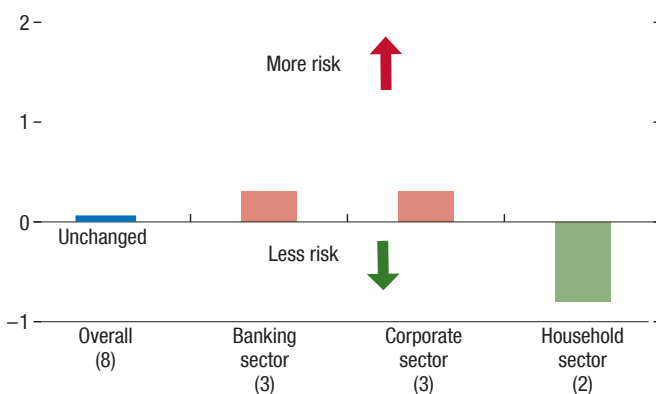
3. Risk appetite has decreased, primarily as a result of substantial outflows from emerging markets, although the allocation to, and performance of, riskier assets have declined somewhat.



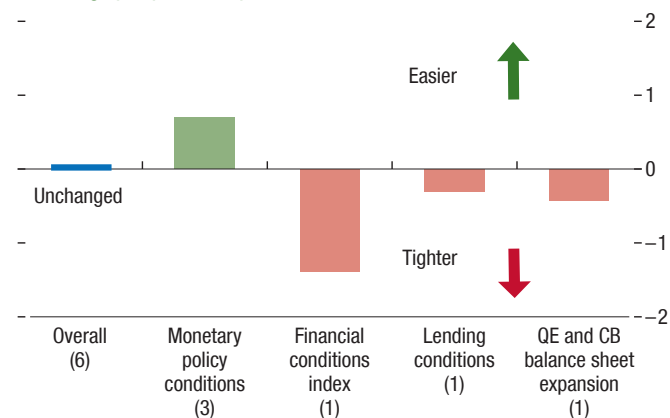
4. Market and liquidity risks have increased following a broad worsening of market conditions. Liquidity is weaker and volatility higher following the deterioration in markets and downturn in sentiment.



5. Credit risks are unchanged although their composition has shifted. Banking valuations have deteriorated and corporate defaults have increased. Household credit risks have decreased.



6. Monetary and financial conditions are unchanged, as real interest rates remain very low and central bank balance sheets are at highly expansionary levels.

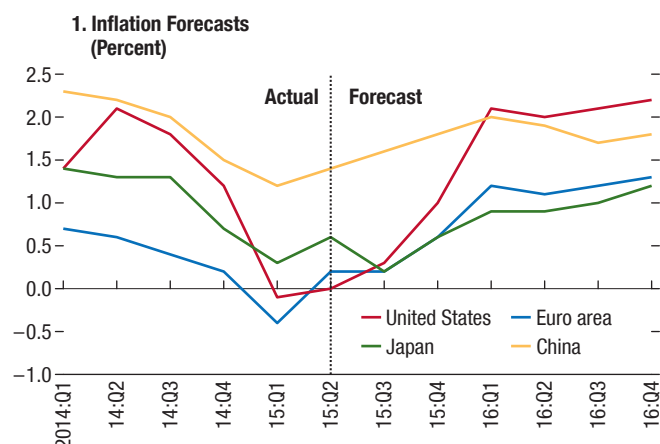


Source: IMF staff estimates.

Note: Changes in risks and conditions are based on a range of indicators, complemented by IMF staff judgment (see Annex 1.1 in the April 2010 *Global Financial Stability Report* and Dattels and others [2010] for a description of the methodology underlying the Global Financial Stability Map). Overall notch changes are the simple average of notch changes in individual indicators. The number below each label indicates the number of individual indicators within each subcategory of risks and conditions. For lending conditions, positive values represent slower pace of tightening or faster easing. CB = central bank; QE = quantitative easing.

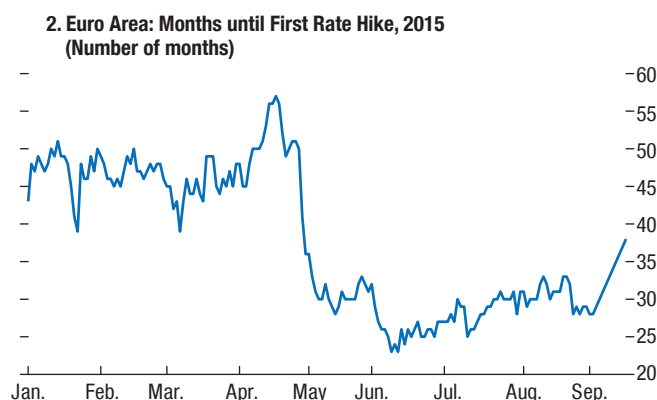
Figure 1.3. Inflation, Monetary Policy, and Policy Rate Normalization

Headline inflation is projected to gradually rise in advanced economies...



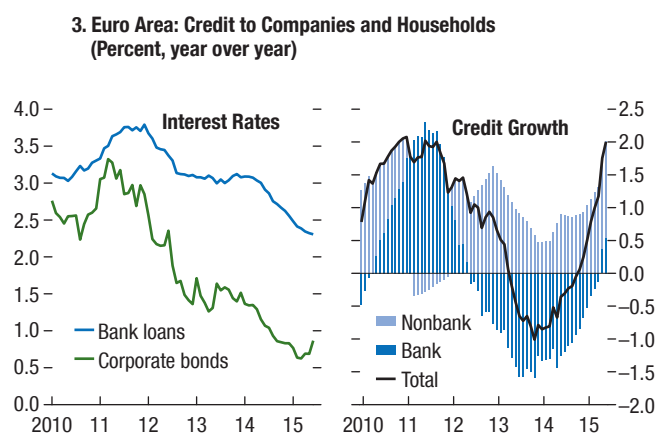
Sources: Bloomberg, L.P.; and IMF staff calculations.
 Note: Headline inflation (Japan adjusted for value-added tax).

...and markets have shifted from pessimism to cautious optimism.



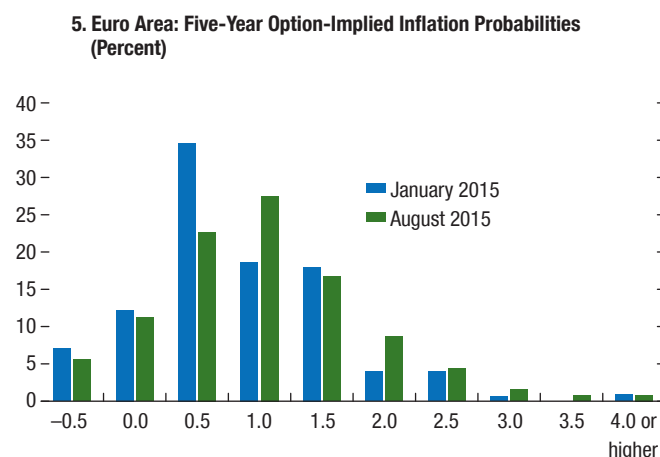
Source: Citigroup.

Euro area credit conditions are easing...



Sources: European Central Bank; Haver Analytics; and IMF staff calculations.

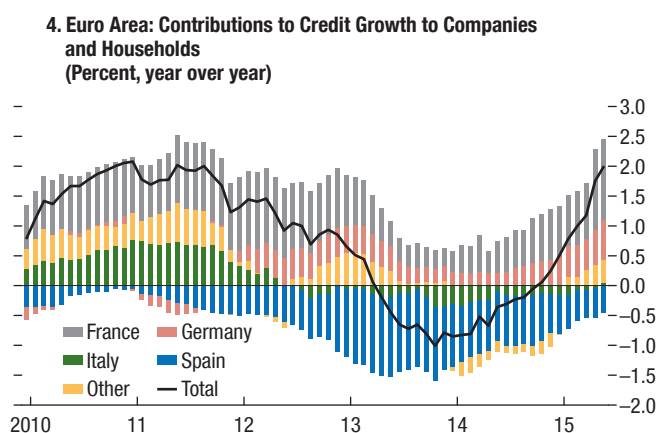
But deflation risks remain in the euro area...



Source: IMF staff calculations.

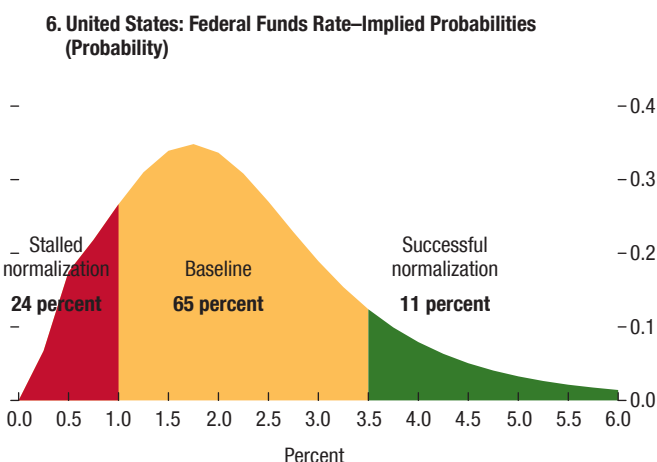
Note: The probabilities are constructed by creating a "butterfly" portfolio that pays out if inflation takes a specific value or range. The options involved are inflation caps and floors that protect the buyer against high and low inflation, respectively. Each x-axis label refers to midpoint probability.

...as quantitative easing and bank reform begin to revive credit.



Sources: European Central Bank; Haver Analytics; and IMF staff calculations.

...and full monetary policy normalization is not guaranteed, even in the United States.

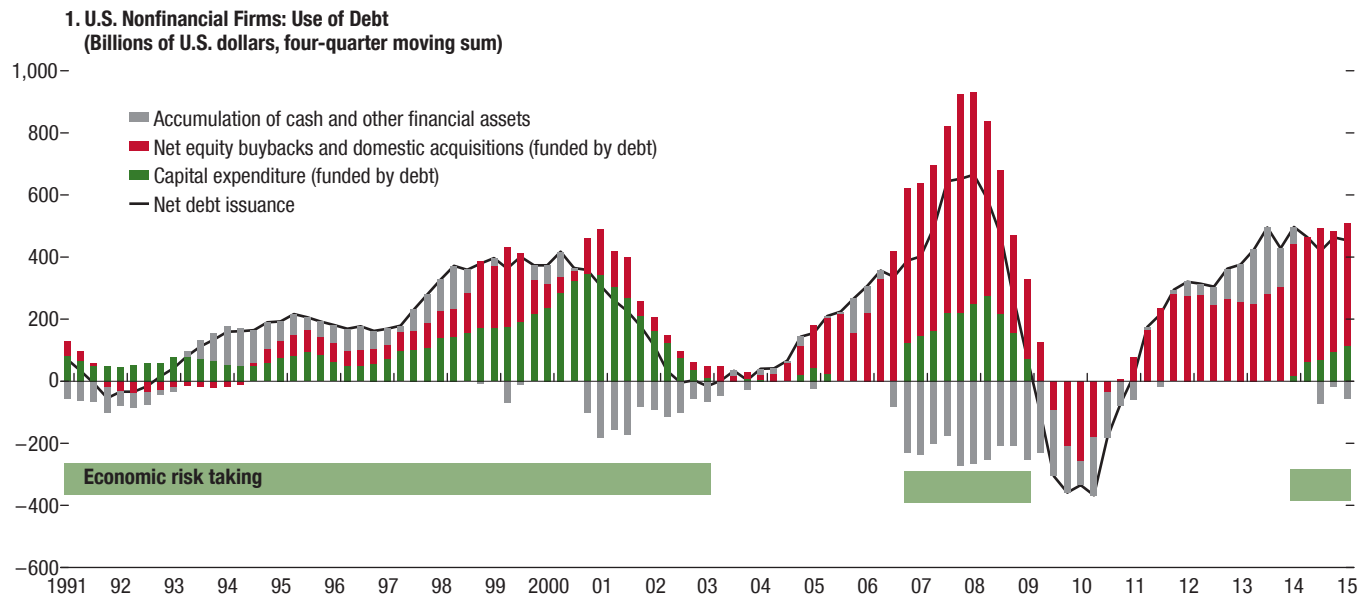


Source: IMF staff calculations.

Note: For this calculation, the market pricing of options expiring in August 2017 on three-month swaps was used to determine the probability that market participants are placing on a stalled normalization. The calculation assumes that the difference between the three-month swap rate and the effective federal funds rate would remain relatively stable, at 15 basis points.

Figure 1.4. Economic Risk Taking Remains Weak in Advanced Economies

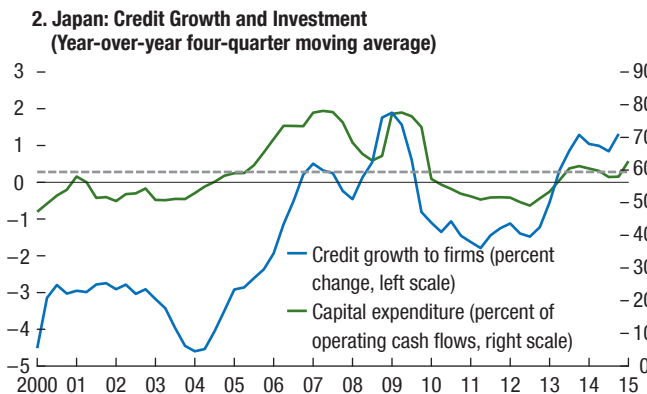
In the United States, easier policies have spurred only tentative signs of economic risk taking.



Sources: Federal Reserve; and IMF staff estimates.

Note: Capital expenditure (funded by debt) is equal to capital expenditures minus internal funds. Net equity buybacks consist of the sum of buybacks, after deducting any new issues that companies make to finance their own businesses, and when employees exercise their options. Episodes when debt issuance finances capital expenditures are identified as common risk taking.

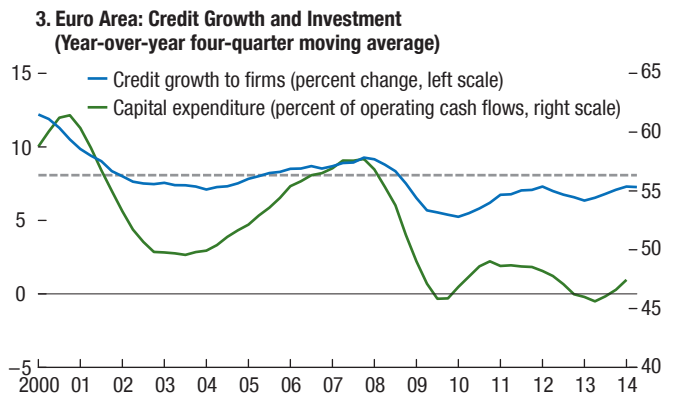
Investment in Japan is rising from low levels...



Sources: Bank for International Settlements; Japan, Ministry of Finance (Quarterly Report of Incorporated Enterprises Statistics); and IMF staff estimates.

Note: The dashed line represents the historical average since 2000.

...but remains subdued in the euro area.



Sources: Bank for International Settlements; European Central Bank; and IMF staff estimates.

Note: The dashed line represents the historical average since 2000.

what has been perceived as unconventional official policy interventions to stem volatility in Chinese equities and the exchange rate have weakened market confidence in a smooth resolution of these challenges. The consequences for emerging market economies of weaker economic performance and increased policy uncertainty in China

could be significant. Further softening of Chinese demand for commodities and investment goods would undermine growth in emerging market economies, while a weaker Chinese exchange rate would affect external competitiveness. These concerns have started to manifest in market prices, crystallizing the rotation of financial

market risks toward emerging market economies, as discussed in this and previous GFSRs (Figure 1.5).

The risks of tipping into the downside are driven by disruptions in global asset markets

Potential near-term adverse shocks in the presence of system vulnerabilities could prematurely halt the rise in U.S. interest rates, degrade financial stability, and stall the economic recovery. Shocks could originate in advanced economies—possibly owing to greater spillovers from Greece to the euro area and international markets—or emerging markets, for example, from greater-than-expected spillovers from China. These shocks could further exacerbate the negative influence of the medium-term forces at play, including ongoing low productivity growth, crisis legacies in advanced economies (high public and private debt and low investment), and ongoing adjustment in emerging market economies after the postcrisis boom in credit and growth and the turn of the commodity cycle (see the October 2015 WEO).

Disruptions in global asset markets would erode public confidence in policy, eliminate market optimism, and generate an abrupt rise in market risk premiums. A rise in equity risk premiums would push global equities down, while credit spreads would widen as default risk increases. The tightening of overall financial conditions and decline in confidence would worsen the outlook along with prospects for investment and consumption.

Financial contagion could surface should asset price movements be amplified by low market liquidity and fragile market structures. Balance sheet commitments by dealers have shrunk dramatically, and smaller trade sizes and reduced market making have had a negative impact on liquidity across markets. These developments raise the risk of volatility and mark-to-market losses during stress periods, while higher asset market correlations and embedded leverage in derivatives positions create the potential for cross-market contagion. An analysis of corporate debt trading indicates how liquidity stress could put pressure on corporate earnings of highly leveraged companies, as discussed in the section “Global Policy Challenges” and in Chapter 2.

Many emerging markets are in the late stage of the credit cycle, and are highly vulnerable to this downside scenario because their balance sheets have become more stretched and more susceptible to market stress and

shocks. Oversupply and concerns about slowing growth in China have been the primary drivers for the recent slump in commodity prices, with relatively tepid growth in advanced economies also weighing on prices. Investor concerns have focused on commodity-exporting emerging markets (Brazil, Chile, Malaysia, Russia, and South Africa), whose currencies so far this year have declined between 5 and 25 percent against the dollar, while their equity indices have generally tracked declines of global commodity prices. The capital positions of a number of emerging market banks—until recently, stronger than those of their advanced economy peers—have been weakening. Borrowers’ rising leverage and increasingly strained balance sheets suggest that their credit costs will probably rise (Chapter 3).

Policies are needed to ensure successful normalization

Successful normalization of financial and monetary conditions would bring macrofinancial benefits and considerably reduce downside risks. This report analyzes the prospects for normalization according to three scenarios: the baseline, an upside scenario of successful normalization, and a downside scenario characterized by disruptions in global asset markets (Table 1.1). This analysis points to structural problems and incomplete postcrisis policy initiatives that open the way for shocks to halt normalization. It also models the downside and upside scenarios to indicate the scale of costs and benefits at stake.

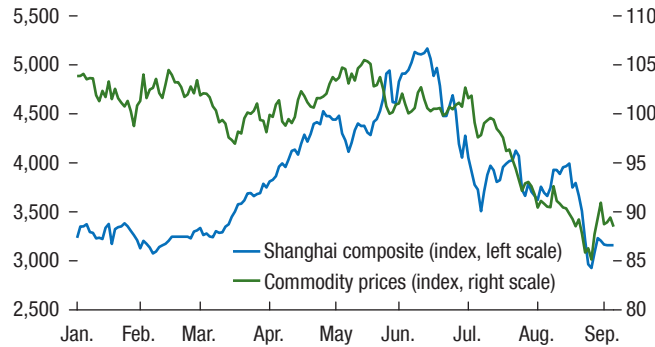
The decline during the past six months in market-implied probabilities of below-target inflation in the euro area (Figure 1.3, panel 5) has not been large enough to vanquish elevated risks of euro area recession and deflation. In the United States, market data suggest a notable risk that an initial tightening by the Federal Reserve could stall, bringing about a loss of momentum in economic activity. More precisely, the market-implied expectation is of a nearly 25 percent chance that the central bank will tighten fewer than four times by the end of 2017. Similarly, the market-implied probability of achieving a more rapid tightening to a higher terminal policy rate consistent with a stronger economy is also relatively low. The inference is that attaining monetary normalization in the United States could prove challenging, possibly owing to global factors.

A concerted, collective effort and strong policy action (Table 1.1) can help ensure continued improvement in prospects for financial stability by reducing the

Figure 1.5. Locus of Risks Shifting toward Emerging Markets

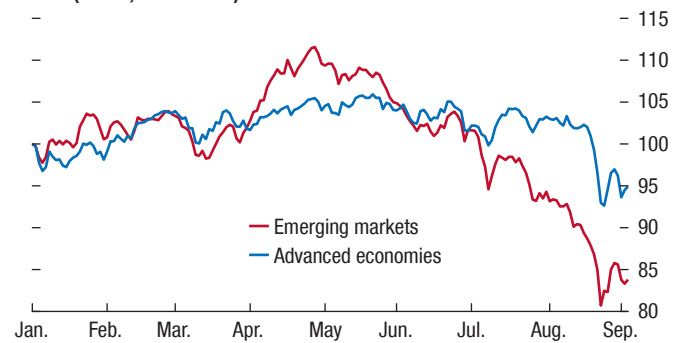
Negative sentiment on China has hurt commodities and Chinese equities...

1. Commodities and Chinese Stock Prices, 2015



...adding to pressures, particularly on emerging market equities...

**2. Global Equities, 2015
(Jan. 1, 2015 = 100)**



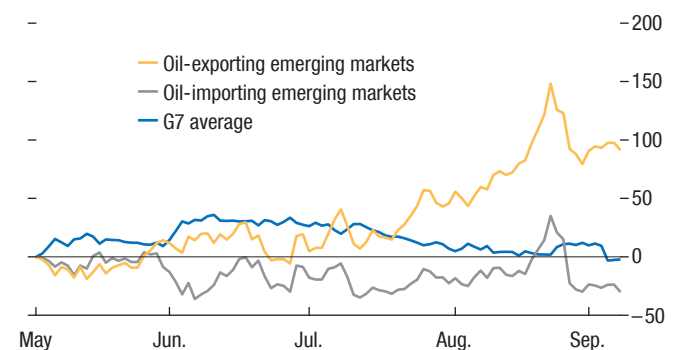
...and weakening emerging market currencies.

**3. Trade-Weighted Foreign Exchange, 2015
(Jan. 1, 2015 = 100)**



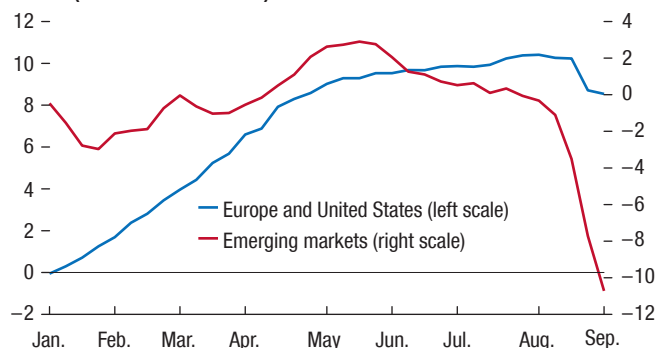
Sovereign yields for commodity exporters have been hurt the most...

**4. Sovereign Bond Yield Changes since April 30, 2015
(Cumulative change in basis points)**



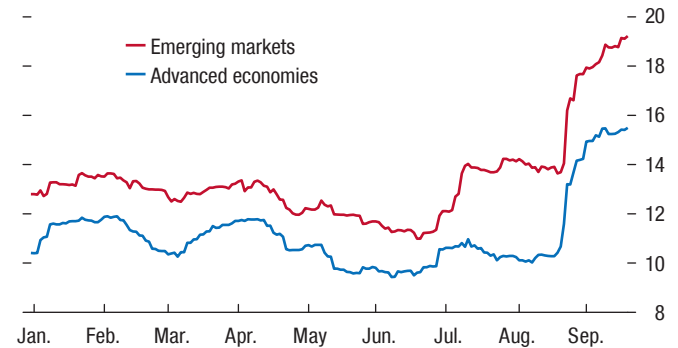
...contributing to persistent outflows from emerging markets...

**5. Cumulative Bond Fund Flows, 2015 (Exchange-Traded Funds and Mutual Funds)
(Billions of U.S. dollars)**



...and rising volatility.

**6. Historical Equity Volatilities, 2015
(Percent, 90-day window)**



Sources: Bloomberg, L.P.; EPFR Global; Morgan Stanley; Morgan Stanley Capital International; and IMF staff calculations.
Note: G7 = Group of Seven.

Table 1.1. Three Scenarios for Financial Stability

Global Asset Market Disruption	Baseline	Successful Normalization
<ul style="list-style-type: none"> • Loss of confidence in policies • Growth declines • Delayed or stalled monetary normalization • Abrupt decompression of risk premiums amplified by low market liquidity • Credit cycle downturns in most emerging markets, along with disorderly deleveraging 	<ul style="list-style-type: none"> • Current policies • Mediocre growth • Only partial handover from financial risk taking to economic risk taking • Asynchronous monetary normalization in systemic advanced economies 	<ul style="list-style-type: none"> • Policy implementation complete • Higher medium-term growth driven by improved fundamentals • Handover from financial risk taking to economic risk taking • Smooth and converging monetary normalization in systemic advanced economies • Smooth decompression of risk premiums • Emerging market resilience, orderly deleveraging

Source: IMF staff.

Note: For calibration of the scenarios and the underlying methodology, see Annex 1.2.

downside risks and achieving successful normalization of financial conditions. Policies must provide for more resilient market liquidity, address legacy problems, contribute to economic risk taking, and anchor optimism for medium-term financial stability and growth. This would be aided by a smooth market response to the rise in the U.S. policy rate. In the euro area, the necessary measures include cleaning up impaired bank and nonbank balance sheets. Complementary policies include strengthening prudential supervision, reforming insolvency procedures, and developing distressed-debt markets. In China, and in emerging markets more broadly, policies for orderly deleveraging must be implemented. The scenario and policy recommendations are discussed in the final section, “Policies for Successful Normalization.”

Global Policy Challenges

Policymakers face a triad of challenges relating to crisis legacies in advanced economies, vulnerabilities in emerging market economies, and systemic market liquidity concerns. If these challenges are mishandled, they could materialize as significant risks to financial stability.

The world is facing a triad of challenges

The global outlook remains clouded by three broad policy challenges in evidence during the past several months (Figure 1.6):

- *Emerging markets’ vulnerabilities*—Many emerging markets have increased their resilience to external shocks with increased exchange rate flexibility, higher foreign exchange reserves, increased reliance on FDI flows and domestic-currency external

Figure 1.6. Triad of Global Policy Challenges

Source: IMF staff.

financing, and generally stronger policy frameworks. But company and bank balance sheets are now stretched thinner in many emerging markets, making some of these economies more susceptible to financial stress, economic downturn, and capital outflows. China in particular faces a delicate balance of transitioning to more consumption-driven growth without activity slowing too much, addressing rising financial and corporate sector vulnerabilities, and making the transition to a more market-based system that discourages the buildup of imbalances—a challenging set of objectives. Recent market developments, including slumping commodity prices, China’s bursting equity and margin-lending bubble, falling emerging market equities, and pressure on exchange rates, underscore these challenges.

- *Legacy issues from the crisis in advanced economies*—In particular, high public and private debt in advanced economies and remaining gaps in the euro area architecture need to be addressed to consolidate

financial stability and avoid political tensions and headwinds to confidence and growth. In the euro area, addressing remaining sovereign and banking vulnerabilities is still a challenge.

- *Weak systemic market liquidity*—This poses a challenge in adjusting to new equilibria in markets and the wider economy. Extraordinarily accommodative policies contributed to a compression of risk premiums across a range of markets, including sovereign bonds and corporate credit, as well as a compression of liquidity and equity risk premiums. Risk premiums remain below historical levels in the U.S. Treasury market, as the Federal Reserve looks set to begin the gradual process of tightening monetary policy (Figure 1.2.1). As such, the global financial system faces an unprecedented adjustment as risk premiums “normalize” from low levels alongside rising policy rates, amid a modest global cyclical recovery. The challenge will be for abnormal market conditions to adjust smoothly to the new environment. However, there are risks from a rapid decompression, particularly given what appear to be more brittle market structures and market fragilities concentrated in credit intermediation channels, which could come to the fore as financial conditions normalize (see Chapter 2). Indeed, recent episodes of high market volatility and liquidity dislocations across advanced economy and emerging market asset classes highlight this challenge.

Other potential global risks and repercussions can be subsumed under this triad, including from the recent marked fall in global commodity prices or a flare-up of geopolitical tensions. Policy challenges in China and Greece are used here to illustrate the potential risks posed by vulnerabilities in emerging markets and legacy issues in advanced economies, respectively, and to illustrate how such shocks could combine with a “bumpy” exit in the United States and be amplified through existing market fragilities.

Emerging markets are in the late stages of the credit cycle

Emerging market and advanced economies’ credit cycles have diverged since the global financial crisis (Figure 1.7). Advanced economies have spent the past few years traversing a sharp downturn and painful balance sheet deleveraging and repair. But some

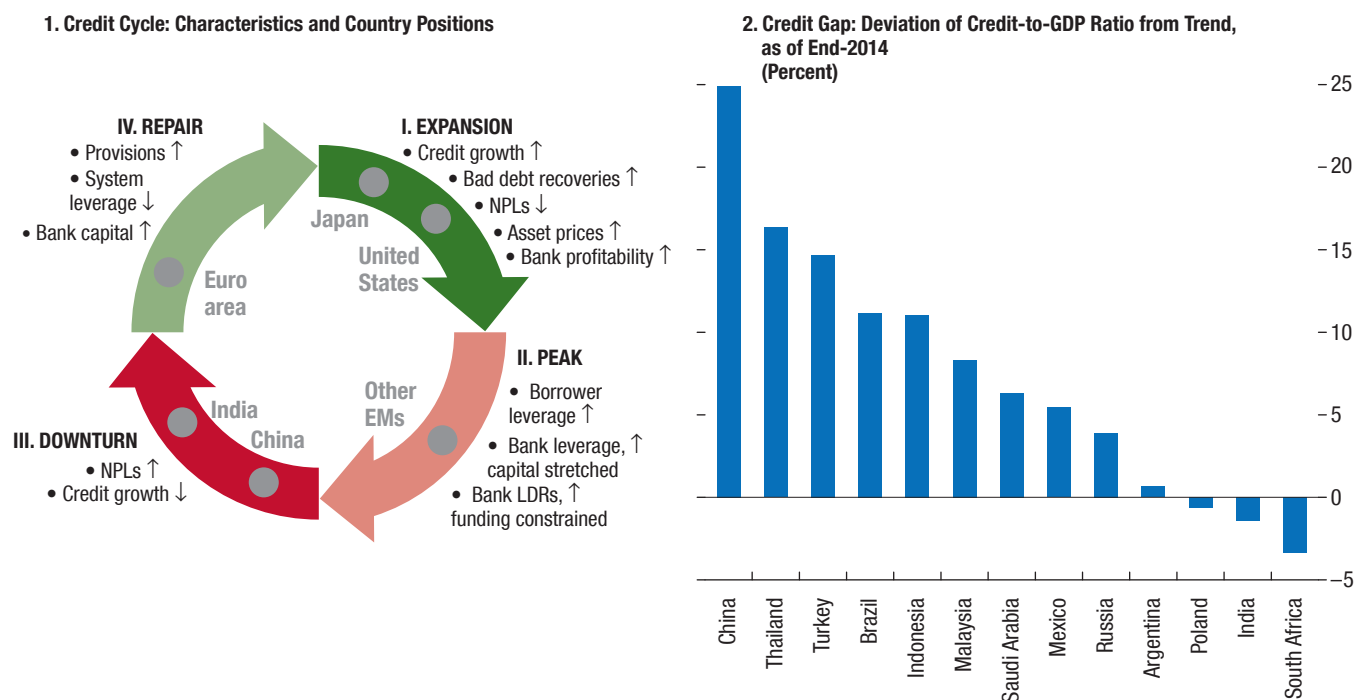
countries, including Japan and the United States, are now in the early phases of a new cycle. In contrast, key emerging market economies relied on rapid credit creation to sidestep the worst impacts of the global crisis. This strategy has resulted in sharply higher leverage of the private sector in many emerging market economies.

A measure of the credit cycle is the “credit gap,” or deviation of current credit growth from the long-term trend. China’s credit gap is elevated compared with that in recent history (Figure 1.7, panel 2). Although the recent deceleration of credit growth is ultimately beneficial, the process of reducing excess credit creation may impose significant stress on borrowers. Brazil, Thailand, and Turkey also have large credit gaps, while eastern European economies continue to deleverage. India’s credit expansion, although relatively more moderate, has not prevented high formation of new stressed loans. Recent decelerations in credit growth signal that many emerging market economies are now close to their cycle peaks and approaching the downturn phase.

Rapidly rising leverage (Figure 1.8, panel 1) and falling corporate profitability across emerging markets, particularly since 2010, have left corporate sectors in a number of economies with stretched debt-servicing capacity (Figure 1.8, panel 2). Reflecting the late stage of the credit cycle, emerging market firms, especially in the “weak tail” of the corporate sector, are vulnerable to downside risks (Figure 1.8, panel 3). The share of nonperforming loans in emerging market banks continues to rise and now exceeds the improving levels in advanced economy banks (Figure 1.8, panel 4). Household leverage is also high in some emerging markets, but household borrowing is a small portion of total borrowing across virtually all emerging markets. Public sector leverage is generally low both in absolute terms and relative to advanced economy peers.

Recent currency and commodity price weaknesses could exacerbate stresses

The deterioration of emerging market companies’ financial health suggested by historically high debt-to-EBITDA ratios ignores two additional risk factors that have become much more severe in recent months: external and foreign currency borrowing, and borrower cash flows linked to weakening commodity prices. Emerging

Figure 1.7. The Credit Cycle

Sources: Bank for International Settlements; Bankscope; IMF, World Economic Outlook database; national authorities; and IMF staff calculations.

Note: Credit cycles describe the consequences of credit growth on economic growth, asset quality, and leverage. In expansion, borrower profits and asset quality are robust, but high credit growth also increases banks' and borrowers' leverage. Leverage in banks and borrowers then peaks, followed by a contraction or slowdown in credit growth, downturn in asset quality, and rising nonperforming loans (NPLs). The process culminates in balance sheet repair and recapitalization, which sets the stage for a new credit cycle. The credit gap is calculated using a one-sided Hodrick-Prescott filter with a smoothing parameter of 400,000. EM = emerging market; LDR = loan-to-deposit ratio.

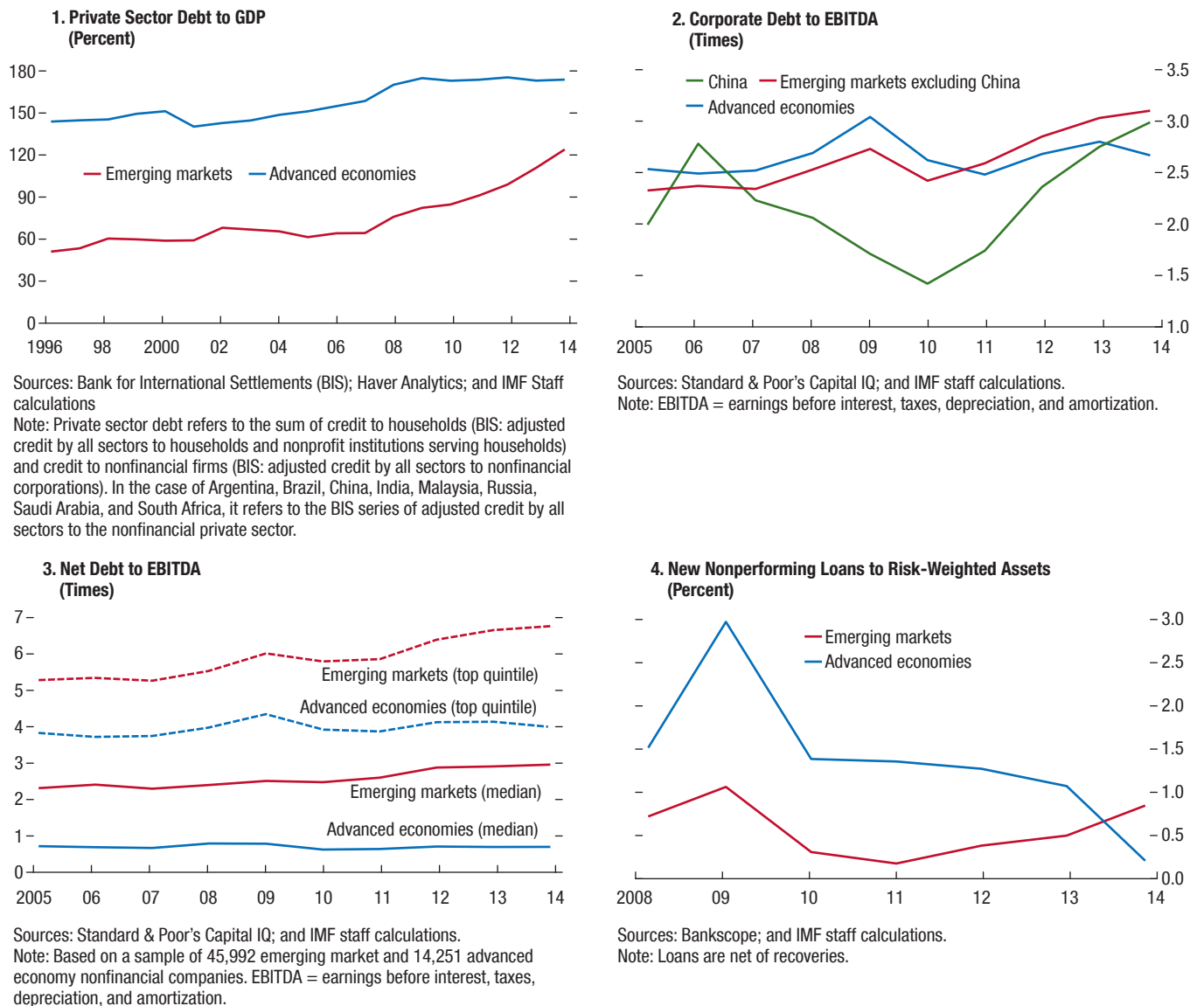
market companies face two related but distinct risks associated with foreign currency borrowing—liquidity risk and exposure to foreign exchange losses. Companies that borrow externally face the risk that lenders could decline to roll over funding as conditions deteriorate. Liquidity risk affects countries with high external debt *irrespective of the currency composition*. In addition, the bulk of external borrowing is denominated in foreign currencies (Figure 1.9 panel 1), usually U.S. dollars, which gives rise to the risk that a borrower's operating cash flow could decline relative to its repayment obligations if there were to be a depreciation.

In addition, commodity firms whose cash flows are under pressure from sharply declining product prices make up a disproportionately large segment of emerging market corporate borrowers (particularly large listed firms). As shown in Figure 1.9, panel 2, deteriorating cash flows during the past few years have driven a sharp increase in the debt-to-EBITDA ratio and erosion of interest coverage ratios. Figure 1.9, panel 3 shows the borrowings of commodity producers relative to all listed

firms, distinguishing between energy producers and metals and mining firms. Economies whose firms display both high external and foreign currency borrowings and high exposure to commodity prices are particularly at risk of rising defaults and banking system losses.

Emerging market banks' balance sheets have yet to reflect late-cycle asset quality deterioration

Banking system capital dynamics differ between advanced and emerging market economies (Figures 1.10 and 1.11). Capital ratios in most advanced economy banking systems have improved during the past five years, mainly through a combination of very low credit growth and modest profitability. Despite their more robust profitability, emerging market systems' much faster new asset growth has absorbed essentially all of the retained earnings and new capital raised during the past five years. In systems with already apparent asset quality and earnings issues, emerging market banks' capital adequacy may be at risk.

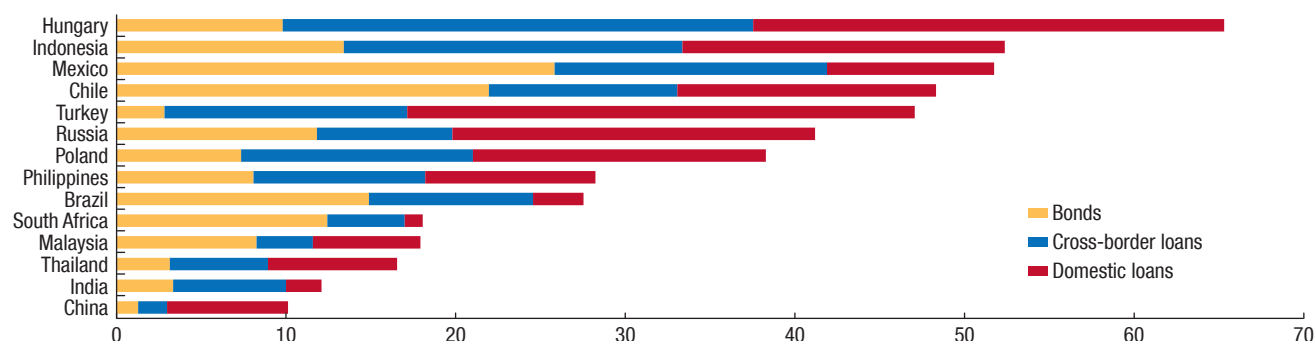
Figure 1.8. Credit Growth, Corporate Leverage, and New Nonperforming Bank Loans

As emerging market economies approach the late stage of the credit cycle, banks have thinner capital cushions relative to advanced economy banks, and nonperforming loans are set to rise as corporate earnings and asset quality deteriorate. In China, banks have only recently begun to address the growing asset quality challenges associated with rising weaknesses in key areas of the corporate sector. Banks are doing this in part by accelerating charge-offs, which rose quickly to about 26 percent of gross nonperforming loans in 2014. Chinese banks will need to enhance loss-absorbing buffers if they are to meet the likely challenges from the exit of nonvi-

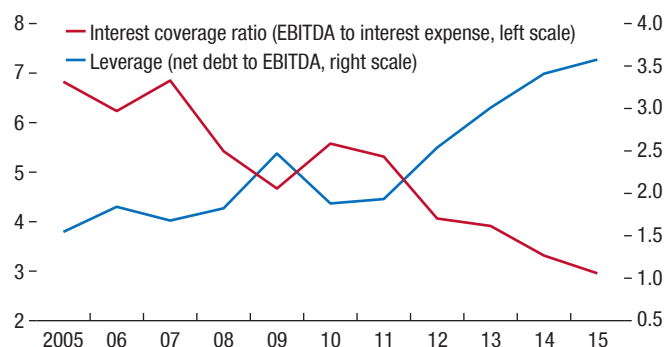
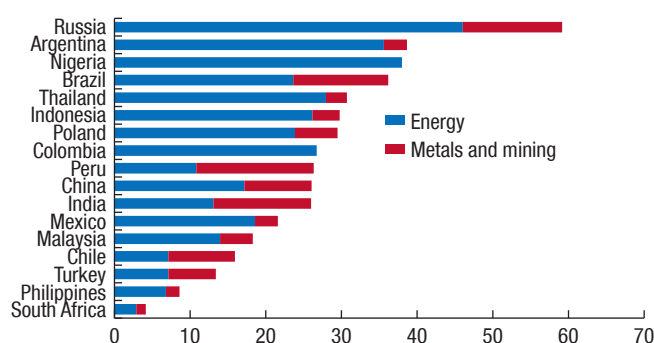
able firms in industries with overcapacity and excessive indebtedness (Figure 1.12). Increasing these buffers will require raising additional capital, because higher provisioning and lower profitability will hinder the ability of banks to generate internal capital.

Erosion in bank funding can amplify the effects of a credit cycle downturn

Rapid credit growth also underlies a significant increase in emerging market banks' loan-to-deposit ratios during the past eight years. Their loan-to-

Figure 1.9. Emerging Market Companies: Exposure to Dollar Strength and Commodity Prices**1. Foreign Currency Nonfinancial Corporate Debt
(Percent of total corporate debt, 2014:Q4)**

Sources: Bank for International Settlements (BIS); Bloomberg, L.P.; CEIC; IMF, Monetary and Banking database; and IMF staff calculations
 Note: Bonds include securities issued abroad and are as of September 2015 (Bloomberg). Cross-border loans are for the nonbank sector. We approximate cross-border loans denominated in foreign currency using the level of cross-border loans for each country denominated in specific currencies as reported in the bank for International Settlements international banking statistics. Indian domestic loans are as of 2013:Q3.

**2. Energy and Metals and Mining: Debt to EBITDA and
Interest Coverage Ratios
(Median)****3. Borrowings of Commodity Producers
(Percent of total corporate debt)**

Sources: Standard & Poor's Capital IQ; and IMF staff calculations.

Note: The sample includes 442 energy firms and 660 metals and mining firms from 18 emerging markets. Other sources include loans, money market instruments, trade credits, and bonds. EBITDA = earnings before interest, taxes, depreciation, and amortization; FX = foreign currency. In panel 3, the numerator is the outstanding debt of energy and metals and mining companies in the sample; and the denominator is the aggregate debt of the sample of firms.

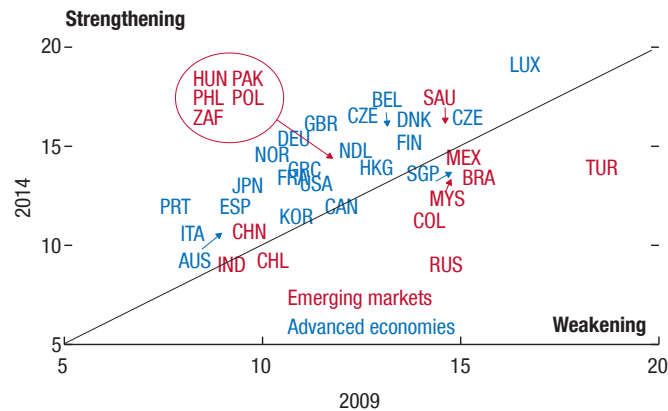
deposit ratios are now converging with those of advanced economy banks, whose funding positions have improved in the same period (Figure 1.13, panel 1). Emerging market banks have historically relied heavily on deposits, which are a stable, low-cost source of funding that has been a cornerstone of their performance and stability (Figure 1.13, panel 2). But funding positions in some countries are now approaching statutory ceilings (domestic liquidity regulations or the Basel III liquidity requirements) or an “economic” ceiling that is effectively set by banks’ access to funding at a reasonable cost. This deterior-

ation in funding positions is a further constraint on banks’ ability to underwrite the credit needed to drive growth.

Can China avoid destabilizing markets while achieving its objectives?

China is aiming to make the transition to a new growth model and a more market-based financial system to reduce vulnerabilities inherited from the old system, while safeguarding financial stability. Reflecting the inherent difficulty in smoothly engineering this transi-

Figure 1.10. Banking System Average Regulatory Tier 1 Ratio
(Percent of risk-weighted assets)



Source: IMF, Financial Soundness Indicators.

Note: Data labels in the figure use International Organization for Standardization (ISO) country codes.

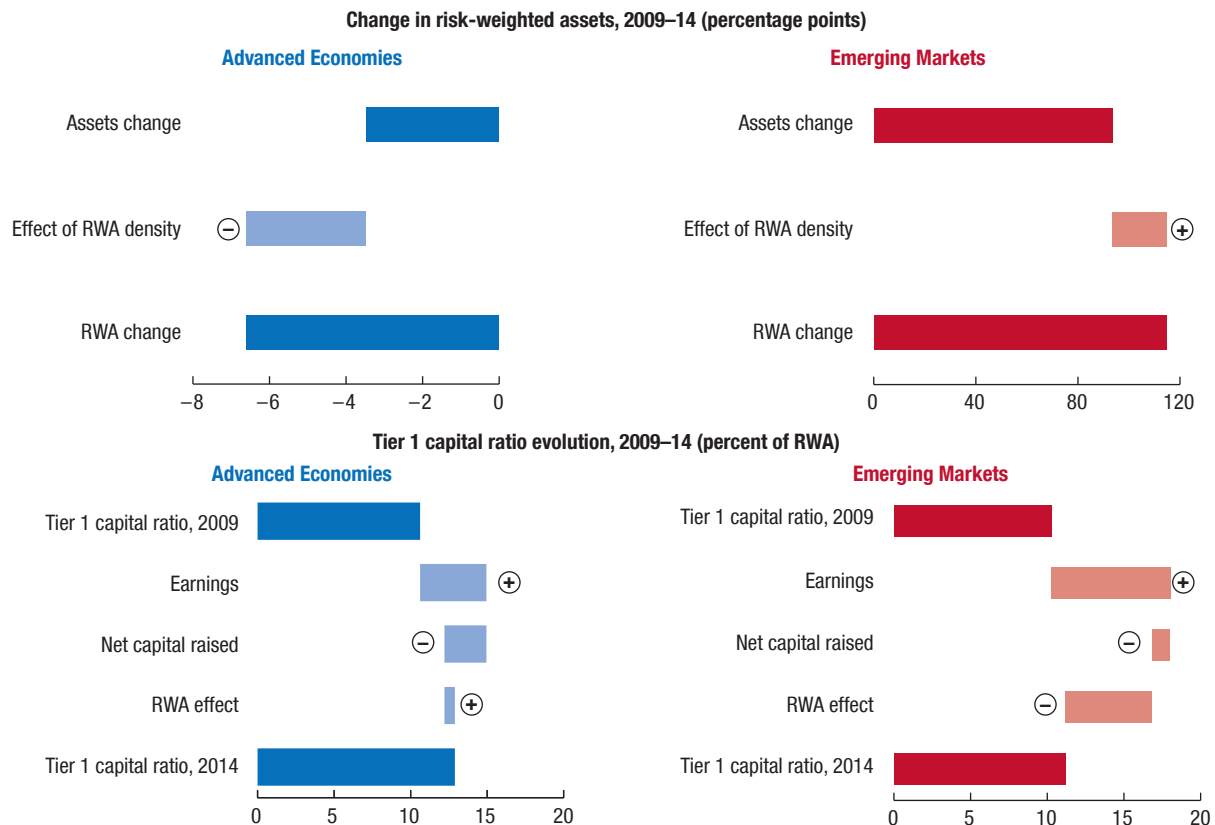
tion, global financial markets have become more sensitive to changes in China's economic and financial conditions and policies. Spillovers from higher equity market volatility and recent exchange rate policy shifts, against the background of more uncertain Chinese growth prospects, have affected commodity prices, currencies, and other asset prices, especially in emerging markets.

A deeper Chinese equity market would help facilitate needed deleveraging by providing an avenue for firms to raise equity capital and reduce reliance on banks. However, progressive relaxation of rules on margin borrowing to buy equities, a perception of official support for rising equity prices, and shortcomings in supervision created the conditions for a debt-fueled rally that pushed valuations to bubble territory by June 2015 (Box 1.1 and Figure 1.1.1, panels 1 and 2). The subsequent correction in

Figure 1.11. Bank Capital and Asset Changes

Advanced economy banks have on balance deleveraged and raised new capital...

...while emerging market banks have used their strong profitability to increase lending.



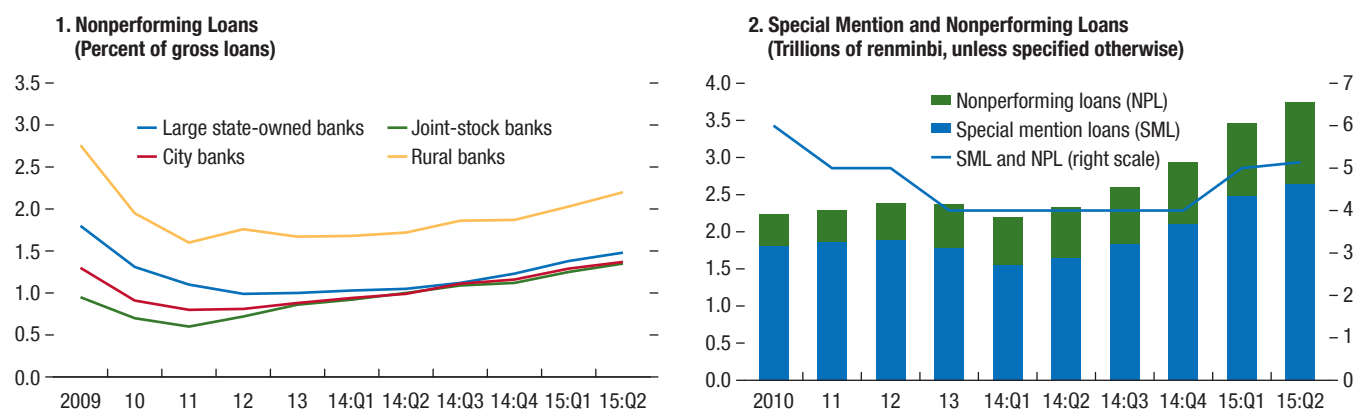
Sources: Bankscope; and IMF staff calculations.

Note: The earnings and net capital in the two lower panels are expressed in 2014 risk-weighted assets (RWA). RWA density = RWA/total assets. The top panels include 512 advanced economy banks and 222 emerging market economy banks. The lower panels include 1,356 advanced economy banks and 576 emerging market economy banks. The plus/minus symbols indicate that the impact increase/decrease the relevant measure by the size of the bar.

Figure 1.12. Chinese Banks: Asset Quality Challenges

China's slowing economic and credit growth reveals a gradual deterioration in asset quality, albeit from low levels...

...reflected in rising nonperforming and special mention loans.

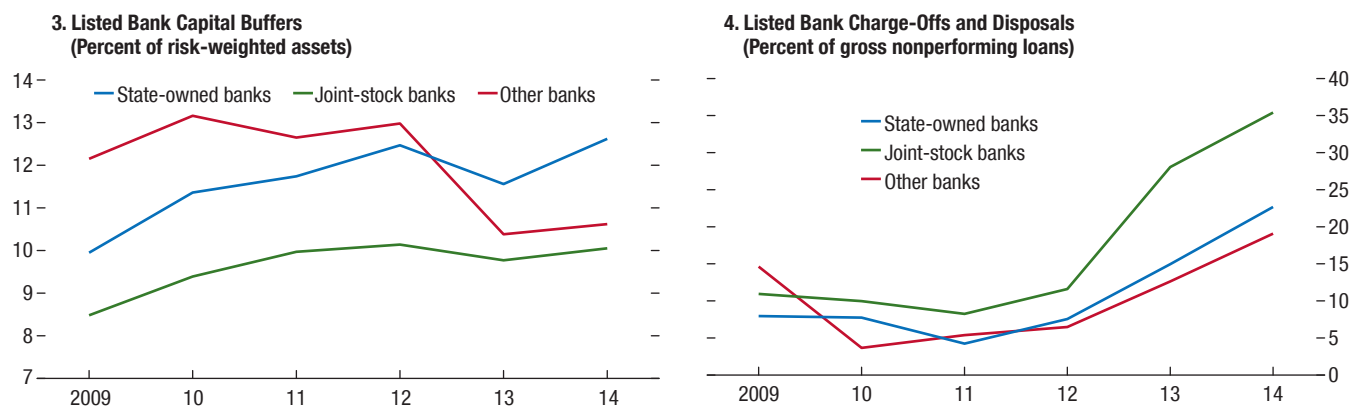


Sources: CEIC; and China Banking Regulatory Commission.

Sources: CEIC; and China Banking Regulatory Commission.

Deteriorating asset quality will contribute to an erosion of loss-absorbing buffers.

Banks are selling an increasing proportion of nonperforming loans.



Sources: Wind Info Co.; and IMF staff calculations.

Sources: Wind Info Co.; and IMF staff calculations.

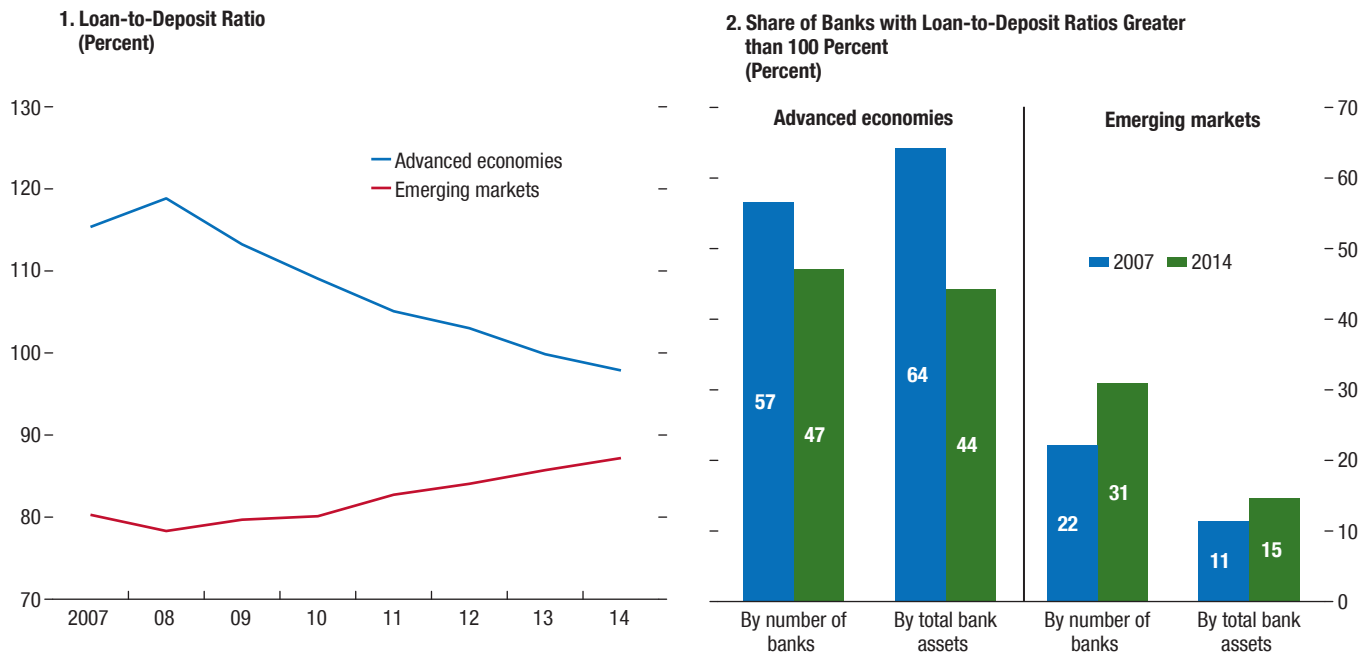
Note: Capital buffers are defined as Tier 1 capital plus provisions less nonperforming loans. The sample of listed banks refers to 22 listed banks with combined assets of 55.8 trillion renminbi at the end of 2015:Q1, which accounts for 79 percent of the commercial banking system's gross loans.

Note: Gross nonperforming loans are calculated as the sum of previous nonperforming loans and gross flows (net increase and charge-offs). The sample covers 18 listed Chinese banks.

equity prices was fueled by a self-reinforcing dynamic of margin calls and forced selling, prompting heavy-handed official efforts to arrest precipitous price declines. Although equities have had limited systemic implications in China (partly because of limited wealth effects), actions to stem price declines have created uncertainty about the direction and consistency of policy.

Increased flexibility of the renminbi exchange rate would facilitate more market-based decision making, including by encouraging better risk management by Chinese companies and households. The announcement

on August 11 by the People's Bank of China of a new mechanism to determine the daily reference rate (or central parity of the ± 2 percent trading band) of the onshore renminbi (CNY) exchange rate versus the U.S. dollar was a significant move in this direction. However, the timing of the decision came as a surprise to markets and introduced greater exchange rate uncertainty, with the CNY depreciating by 3 percent versus the U.S. dollar in the first three days, similar to moves in offshore renminbi trading. The exchange rate subsequently stabilized, including with the help of periodic

Figure 1.13. Evolution of Bank Funding

Sources: Bankscope; and IMF staff calculations.

official intervention and enhanced communication, but exchange rate expectations remain fragile, and weakness has spread through commodity and emerging economy currency markets (Figure 1.14, panels 1 and 2).

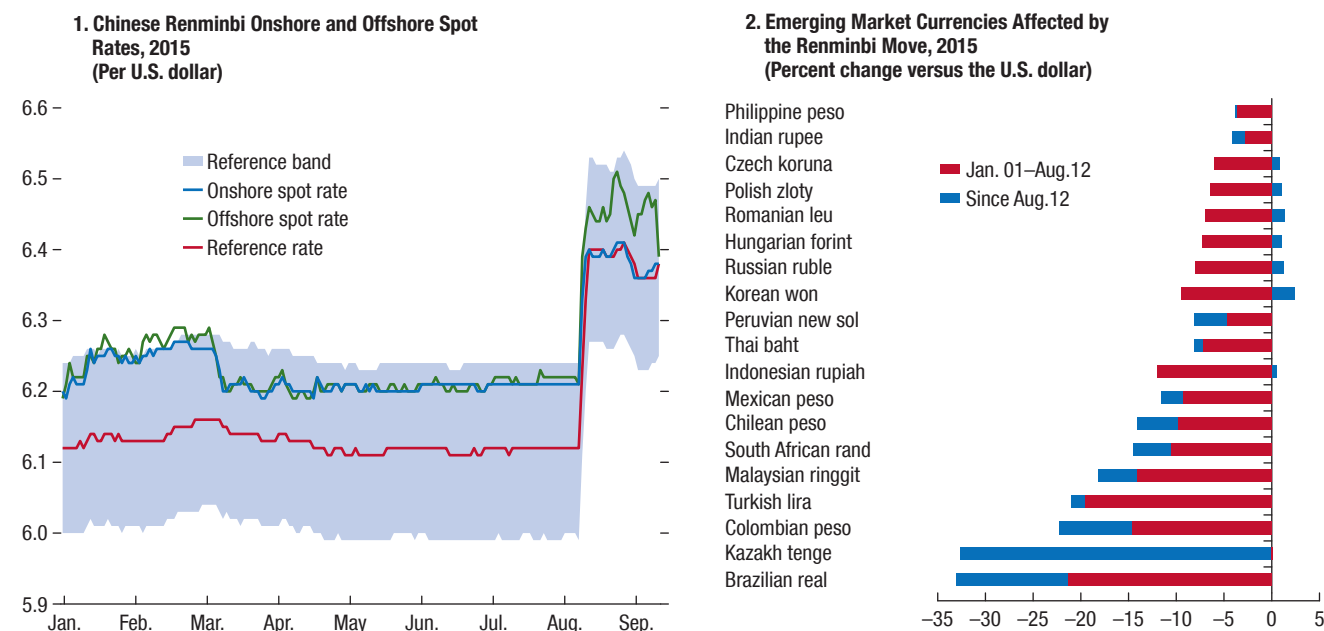
China's major financial sector challenge is to gradually give a greater role to market forces and reduce debt-related vulnerabilities. Both processes will help facilitate economic rebalancing and will involve an appropriately paced withdrawal of explicit and implicit public support across broad areas of the financial system, with increased tolerance for defaults and volatility. China still has policy buffers to absorb financial shocks, including a relatively strong public sector balance sheet, but overreliance on these buffers could exacerbate existing vulnerabilities. For example, measures designed to boost credit growth could further weaken highly leveraged corporate balance sheets in some vulnerable sectors.

Even with these buffers, the potential remains for bouts of financial volatility during China's transition that reach beyond the equity market to undermine market confidence and trigger a tightening of domestic financial conditions. Notwithstanding the central role of large state-owned banks, fragility in the corporate and financial sectors, notably in the opaque and still-large nonbank financial system, suggests that the sensitivity to a change

in financial conditions could be high. Higher exchange rate uncertainty could further increase risk aversion.

Such a tightening of financial conditions would weaken the debt-servicing capacity of vulnerable firms, elevating counterparty risks, further undermining fixed asset investment, and weakening the growth outlook.

The main spillover channels from China to the rest of the world remain economic growth and trade, but confidence channels and direct financial linkages have also become stronger since 2010. Concerns about weaker Chinese import demand have already contributed to lower global commodity prices. In turn, currencies have weakened in emerging market economies with strong trade ties to China and high commodity dependence. Intensified capital flight to perceived safer assets would further weaken exchange rates and increase financial market volatility in emerging markets, with adverse effects for sovereigns and companies with large foreign indebtedness. Direct financial spillovers include a possibly adverse impact on the asset quality of at least \$800 billion of cross-border bank exposures; repricing in Asia's external dollar bond markets, which are increasingly dominated by Chinese issuers; and capital flows from China, including through the Shanghai–Hong Kong SAR stock connect program.

Figure 1.14. Chinese Exchange Rate Movements and Effect on Emerging Market Currencies

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

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

Gaps in the euro area architecture need to be addressed to consolidate stability gains

Significant policy measures in recent years at the European and national levels have strengthened the collective commitment to monetary union. This has removed the extreme tail risks evident in mid-2012, helping to put the Economic and Monetary Union (EMU) on a sounder footing and limit recent market volatility associated with Greece. In addition, direct financial exposures of foreign banks and nonbanks to Greece have been sharply reduced since 2010 (Figure 1.15). The exposure has shifted to the European official sector, which now holds nearly €260 billion of Greek assets, of which the European Stability Mechanism (ESM) holds about half. Importantly, the recent agreement on a new program with the ESM underscores the strong collective efforts at the European level.

Nevertheless, in the absence of greater integration, lingering questions remain about the medium-term viability of the EMU, particularly as the specter of “euro exit” was raised anew before the new ESM program with Greece was put in place. Although financial market contagion from recent difficulties in Greece has been quite limited, there could be indirect spillovers through broad, negative confidence effects if the situation deteriorates or risks flare up once again. Further policy actions

to address the remaining gaps in euro area architecture are thus needed to reduce the euro area’s vulnerability to shocks and to the risk of prolonged stagnation.

The most immediate impact of higher redenomination risk would be a widening of sovereign spreads of other euro area countries, although quantitative easing combined with the Outright Monetary Transactions framework would be likely to contain excessive pressures.¹ An additional channel through which redenomination risk could act would be reduced confidence in the medium-term viability of the EMU, which could undermine investment plans and capital flows both within and to the region, raise sovereign spreads and fragmentation, and possibly restart the destabilizing sovereign-bank nexus (Figure 1.15, panel 4). Finally, political contagion could emerge in some countries, in the form of increased opposition to further integration of the monetary union.

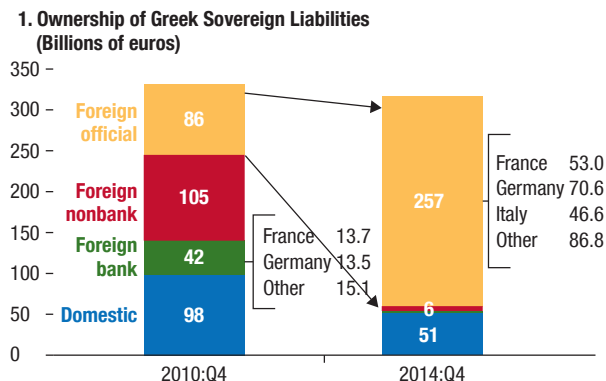
Advanced economy banks face profitability challenges

Reduced profitability in advanced economy banks limits their ability to generate capital and better support the

¹“Core euro area” consists of Austria, Belgium, Finland, France, Germany, and the Netherlands. “Other euro area” consists of Greece, Ireland, Italy, Portugal, and Spain. (This division does not include all euro area countries.)

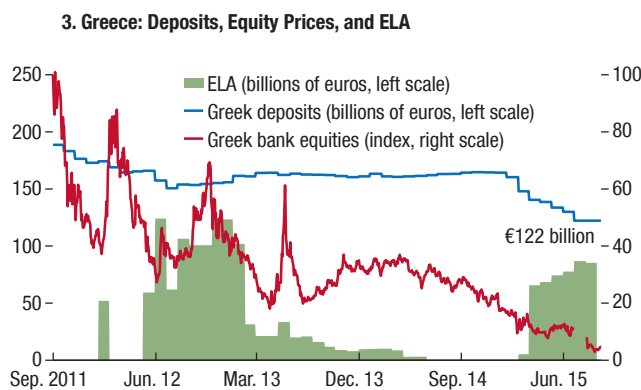
Figure 1.15. Greece: Developments

Private exposures to Greece have been absorbed by the official sector, mitigating recent market volatility.



Sources: Arslanalp and Tsuda (2014a); and Bank for International Settlements. Note: Individual country holdings represent those on an ultimate risk basis, including indirect holdings through the European Stability Mechanism and the European Financial Stability Facility.

...reinforcing deposit flight from Greek banks and their reliance on European Central Bank emergency funding.

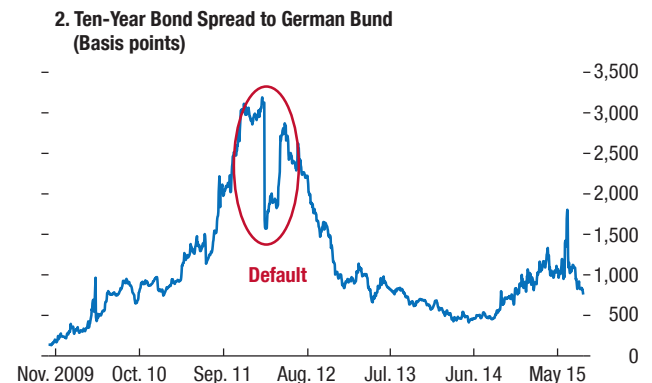


Sources: Bank of Greece; Bloomberg, L.P.; European Central Bank; Haver Analytics; and IMF staff calculations. Note: ELA = Emergency Liquidity Assistance.

recovery. Their 2014 aggregate return on equity was about 8 percent, down from an average of about 13 percent during the 2000–06 period (Figure 1.16, panel 1). More than 3 percentage points of the decline is attributable to the structurally higher capital in bank balance sheets. This reflects tighter regulation of capital levels and quality, intended to make banking systems safer. The remaining 2 percentage points of the difference is due to a decline in underlying profitability, particularly through the loss of profits stemming from the cutback on trading profit.

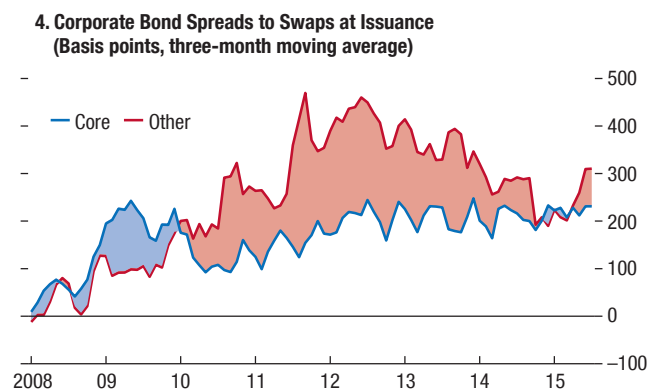
Regarding regional variations (Figure 1.16, panel 2), euro area banks are struggling the most to generate

Political difficulties surrounding negotiations have been reflected in higher uncertainty...



Sources: Bank of Greece; Bloomberg, L.P. Haver Analytics; and IMF staff calculations.

There have been signs of financial fragmentation, with borrowing costs of firms in non-core countries rising modestly over those in the core.



Sources: Dealogic; and IMF staff calculations.

Note: "Core" countries comprise Austria, Belgium, Finland, France, Germany, Luxembourg, and the Netherlands. "Other" countries comprise Cyprus, Estonia, Greece, Ireland, Italy, Latvia, Portugal, Slovak Republic, Slovenia, and Spain.

sustainable profits, partly because of their high rates of nonperforming loans (see the April 2015 GFSR). Expectations of continued weak profitability in a number of banks are reflected in current market pricing, with price-to-book ratios lower for institutions whose profitability is forecast to be weaker (Figure 1.16, panel 3).²

Advanced economy banks will be cautious about lending until their medium-term regulatory environment is clearer, as the Basel III framework is being implemented

²For a formal explanation of this relationship, see the price-to-book model in Wilcox and Philips (2004).

Box 1.1. China's Equity Market

The rise and fall of China's equity market has been dramatic. Although the systemic implications for the broader financial system appear limited, broad-ranging interventions by the authorities to stem the decline appear to have increased investor uncertainty about financial sector policies.

The dramatic upswing in Chinese equity prices that began in mid-2014 was driven by a combination of factors. Perceptions of official support for equities, a reallocation of household saving from a weaker property market, and optimism about reforms in state-owned enterprises all contributed. The defining feature, however, was the surge in individual investor leverage in the form of margin financing.¹¹ By early 2015, equity valuations reached very high premiums of about 50 percent over international peers, and even higher in some segments of the market. Daily market turnover rose to 1.7 trillion renminbi (RMB) in June 2015 from less than RMB 0.2 trillion the previous year, compared with a free-float market capitalization of RMB 24 trillion at end-June.

The risk of defaults on margin loans rose as investors rapidly increased borrowing and prudential margin rules were eased. The self-reinforcing dynamic of steep equity price falls, margin calls, and forced selling was clearly evident over the summer in the initial disorderly unwinding of margin balances, which fell by more than a third to RMB 1.4 trillion (\$225 billion) in just three weeks (Figure 1.1.1, panel 3). Official measures intended to limit selling pressure also meant that investors could have been unable to liquidate their positions sufficiently quickly or could post a wider range of possibly less liquid collateral to meet margin calls. These measures may have increased risks for the margin financing exposures of some securities firms.

The authors of this box are Shaun Roache and Daniel Law.

¹¹First permitted in late 2011, access to margin financing was initially available to only the wealthiest investors, but a progressive easing in rules expanded this access. Important easing measures included broadening the range of eligible securities (early 2012), lower capital charges for securities firms' margin financing (early 2012), and relaxed margin borrowing qualifications for individual investors (mid-2013).

The systemic importance of equities remains limited but the market's interconnectedness with the rest of the Chinese financial system has grown. Increased short-term borrowing by securities firms has strengthened linkages between equity markets, banks, and short-term funding markets. As a result, securities firms could quickly transmit a liquidity shock to funding markets if they were unable to meet their rising debt service as a result of customer defaults on margin loans. One prominent securities firm's inability to meet its obligations could trigger uncertainty about the liquidity or solvency of all securities firms and threaten a cut-off in financing, widespread account liquidations by clients, and, potentially, a vicious circle. However, in aggregate, securities firms appear to have adequate liquidity and capital (Figure 1.1.1, panels 4 and 5).

Banks' indirect exposures, other than lending to securities firms, are also likely to have increased since 2013.²² The most important of these is the issuance of wealth-management products to customers who then provided loans to high net worth investors in "umbrella trusts."³³ These products were typically structured with a senior fixed-income tranche funded by the wealth-management product and a junior equity tranche that provided up to five times leverage to the high net worth investors. The main risk of this product is that in a disorderly market decline, the junior tranche is unable to liquidate equity positions fast enough to protect the senior tranche from a loss on the principal. The de facto (if not de jure) obligation for the bank that sponsored the wealth management product is to make the investor whole by absorbing the loss.

²²Market estimates of firms using listed equity as collateral vary widely but at the peak hovered around RMB 1 trillion (\$160 billion) or about 1.1 percent of total bank loans. For the other risks, including firms and individuals using bank loans to invest in equities, there are almost no reliable data on which to provide an assessment, though most bank analysts suggest that such exposures are not large.

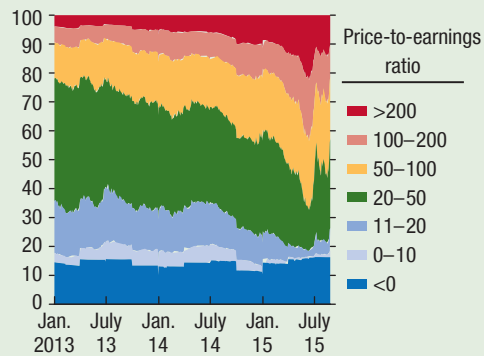
³³Assessing how large umbrella trusts became is difficult because of lack of data, though analysts' estimates suggest that this form of leverage peaked between RMB 0.8 trillion and RMB 2 trillion (\$130 billion and \$322 billion) with exposures concentrated in medium-sized joint-stock banks.

Box 1.1. (continued)

Figure 1.1.1. Chinese Equity Market

At the June 2015 peak, valuations touched very high levels for a wide range of stocks...

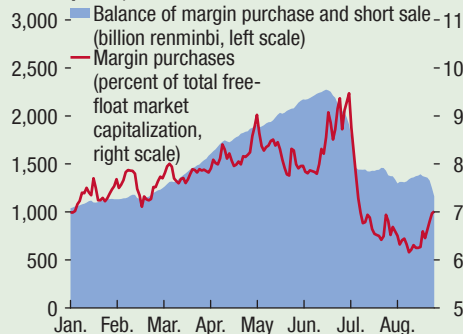
1. A-Share Price-to-Earnings Ratios (Distribution, percent)



Sources: Wind Info Co.; and IMF staff calculations.
Note: Price over reported earnings for the previous four quarters.

A surge in margin borrowing by individual investors fueled the rally...

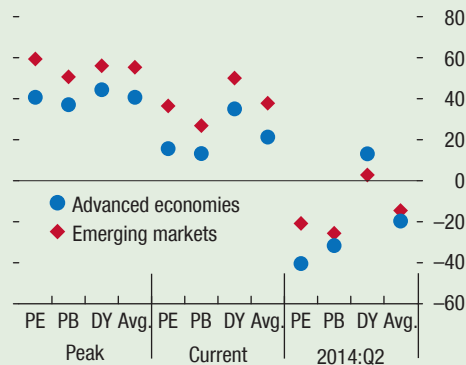
3. Outstanding Amount of Margin Lending for Equities, 2015



Source: CEIC.

...pushing China's market valuation to rich premiums over international peers.

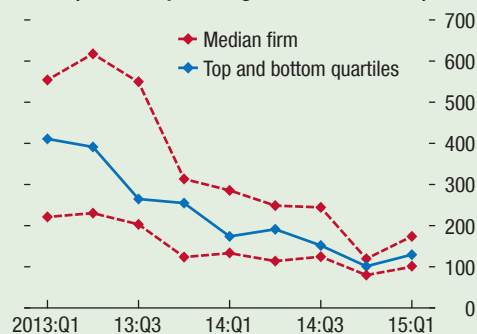
2. Equity Market Valuations Relative to Peers (Percent premium over peers)



Sources: Bloomberg, L.P.; Morgan Stanley Capital International; and IMF staff calculations.
Note: "Advanced economies" is the market-capitalization-weighted average of Group of Seven economies. "Emerging markets" is the market-capitalization-weighted average of Group of 20 emerging market economies. Avg. = average; DY = dividend yield; PB = price to book; PE = price to earnings.

...but for now, the securities firms that provided margin finance have adequate liquidity...

4. Liquidity of Securities Firms (Cash as a percentage of short-term debt)

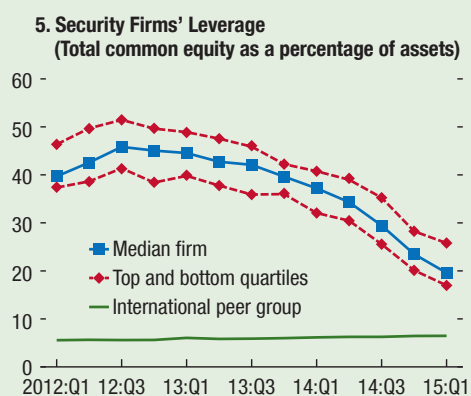


Sources: Bloomberg, L.P.; Wind Info Co.; and IMF staff calculations.
Note: Unbalanced panel of 22 securities firms.

(Figure 1.1.1 continues)

Box 1.1. (continued)**Figure 1.1.1. (continued)**

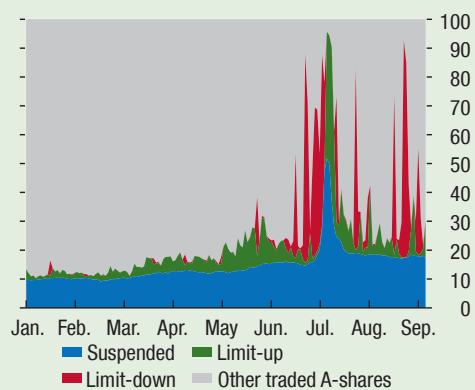
...and capital buffers to absorb shocks.



Sources: Bloomberg, L.P.; Wind Info Co.; and IMF staff calculations.

Note: Unbalanced panel of 22 securities firms. The international peer group is a sample of 10 firms from Europe, Japan, and United States.

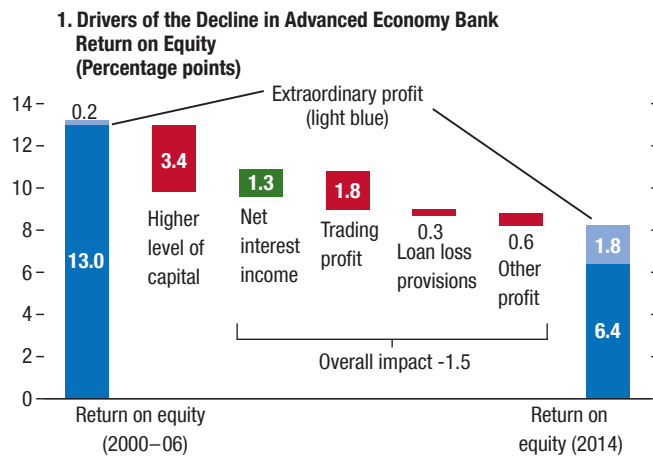
Shortcomings in the regulatory regime, including widespread trading halts, damaged confidence.

6. Trading Status of All A-Shares, 2015

Sources: Bloomberg, L.P.; Wind Info Co.; and IMF staff calculations.

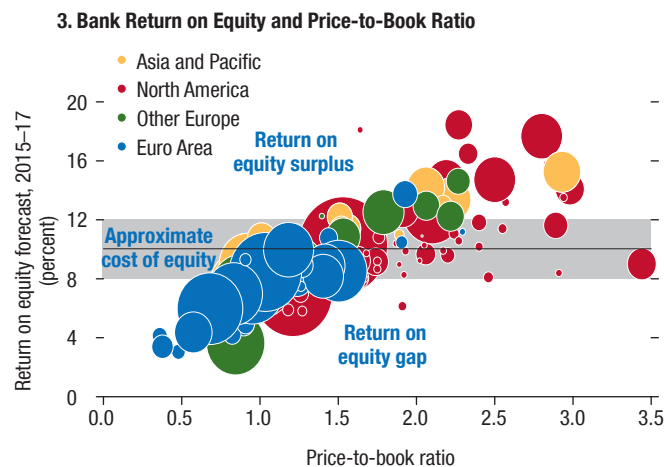
Figure 1.16. Bank Profitability and Balance Sheet Strength

Bank profitability has fallen...



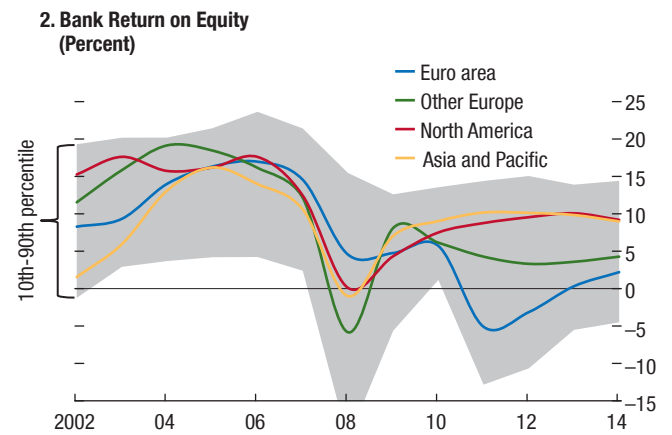
Sources: Bloomberg, L.P.; and IMF staff calculations.
Note: Based on a sample of more than 300 banks.

...and is reflected in market prices.



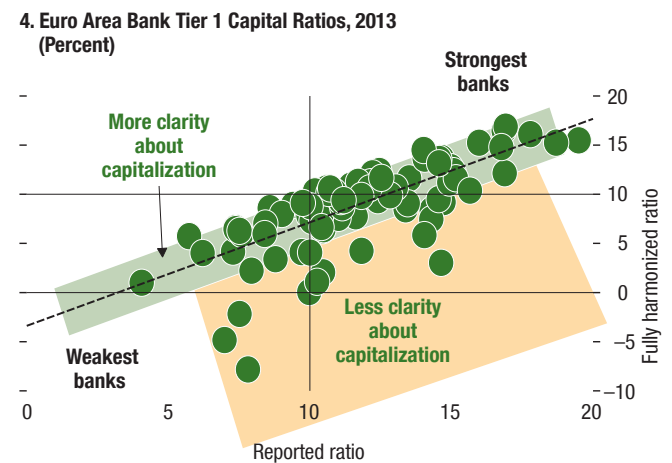
Sources: Bloomberg, L.P.; and IMF staff calculations.
Note: The size of the circles is proportional to bank assets in 2014.

...across all advanced economies...



Sources: Bloomberg, L.P.; and IMF staff estimates.
Note: Based on a sample of more than 300 banks.

Questions about bank capital quality remain.



Sources: European Banking Authority; European Central Bank; and IMF staff calculations.
Note: The fully harmonized ratio uses the “fully loaded” definition of capital under the Capital Requirements Directive (CRD-IV) and the harmonization of asset quality definitions from the European Central Bank’s Comprehensive Assessment.

on a national basis.³ In the euro area, in particular, this process is taking place alongside initiatives to harmonize options and national discretion set out in the European capital regulation, and as supervision of the largest banks is being centralized within the Single Supervisory Mechanism. A key challenge is to make rapid progress toward a fully harmonized definition of regulatory capital ratios in

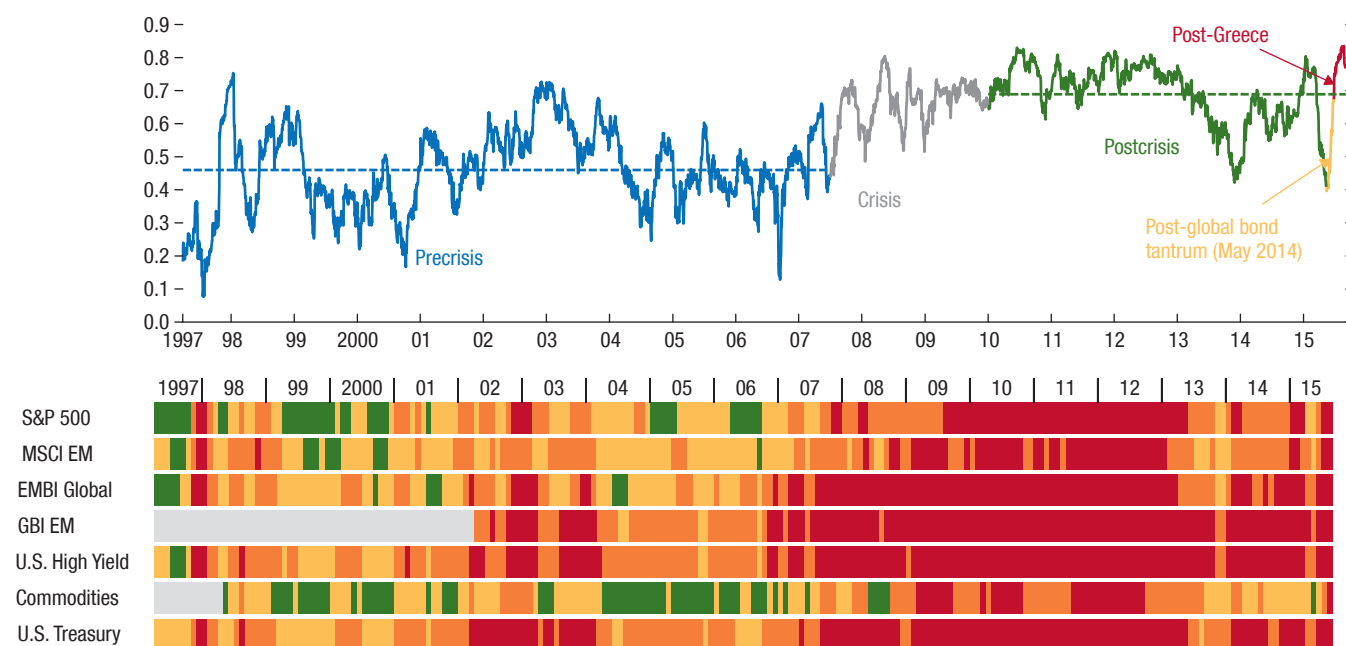
³See Annex 1.1 for a discussion on the progress toward completion of the global regulatory reform agenda.

the euro area. The recent Single Supervisory Mechanism Comprehensive Assessment showed that full implementation of Basel III and a more harmonized approach to asset quality resulted in 2013 capital ratios that were significantly lower than reported ratios (those shown in yellow in Figure 1.16, panel 4) in banks accounting for about 20 percent of the risk-weighted assets of participating institutions. Box 1.3 examines the effect of Europe’s banking challenges on the availability of credit to finance economic growth.

Figure 1.17. Potential Amplifiers of Market Stress

Asset correlations have increased in the postcrisis era, reflecting a rise across most major asset classes.

1. Cross-Asset Correlations (median daily) and Correlation Heat Map



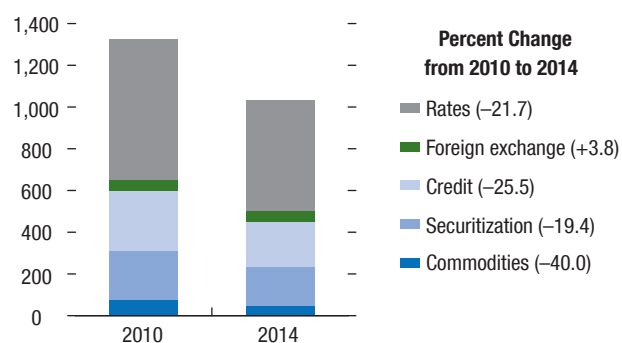
Sources: Bank of America Merrill Lynch; Bloomberg, L.P.; and IMF staff estimates.

Note: The correlation index summarizes the median daily cross-asset correlations of Sharpe ratios across all of the following asset classes: U.S. Standard & Poor's 500, MSCI Emerging Markets, U.S. Treasuries, EMBI Global Bond Index, GBI Emerging Markets Bond Index (local currency), U.S. High Yield, and Commodities. The heat map displays the underlying median correlation for each of the seven asset classes against the remaining six asset classes. The correlation of U.S. Treasuries, being a "risk-free" asset, is expressed in absolute terms, as it is typically negative vis-à-vis risk. Correlation key: green 0.00–0.30; yellow 0.31–0.50; orange 0.51–0.65; and red 0.66–1.00.

Liquidity has declined as broker-dealers have retreated from market-making activities...

...while volatility appears to rise as market depth declines.

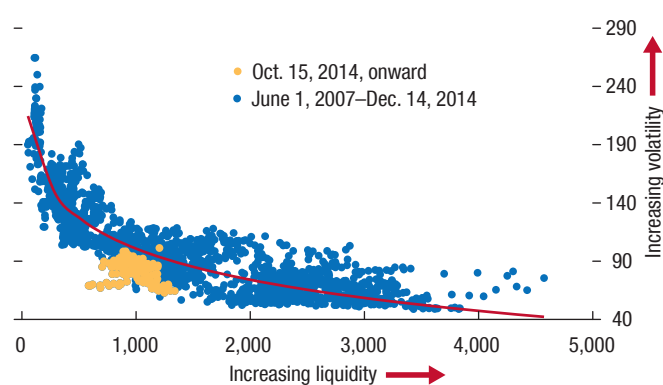
2. Fixed-Income Trading Assets for Top U.S. Banks (Billions of U.S. dollars)



Source: Goldman Sachs.

Note: Data for 2014 are average of first three quarters.

3. U.S. Treasury Market Depth and Volatility



Sources: Bloomberg, L.P.; BrokerTec; JPMorgan Chase & Co; and IMF staff calculations.

Note: Volatility is proxied by the Merrill Lynch Option Volatility Estimate (MOVE) index, which is a yield-curve-weighted index of normalized implied volatility on three-month Treasury options. Market depth, defined as the sum of the three bids and offers in on-the-run two-year Treasuries (average between 8:30 a.m. and 10:30 a.m. each day), is measured in millions of U.S. dollars.

Vulnerable market structures could amplify the impact of shocks and the scope for financial contagion

At the global level, several financial market fragilities could amplify the impact of a decompression in market risk premiums and thus heighten the challenge to financial stability (Box 1.2):

- Prices across asset classes are moving increasingly in unison. The tendency of global asset prices to move together across markets is now at its highest level since the beginning of the Great Recession. As examined in the April 2015 GFSR, not only have asset correlations been much higher on average since 2010 across advanced and emerging economies (Figure 1.17 panel 1), but they have remained elevated even during periods of low volatility. More recently, they rose in the wake of European sovereign bond market volatility in May and the subsequent difficulties in Greece. Data on cross-asset correlations suggest that the assets most vulnerable to price contagion include emerging market bonds and U.S. high-yield bonds.
- Mutual funds are vulnerable to potential large-scale redemptions. Mutual funds have become increasingly important in supplying credit to the U.S. corporate bond market. The search for yield has contributed to the increase in the retail share of corporate bond ownership, which is held largely in mutual funds, to one-third, the highest level on record. As noted in previous GFSRs and in Chapter 2, those mutual funds that invest in relatively illiquid assets are subject to liquidity mismatches. Their promise of liquidity may be challenged under elevated outflows, and could generate a vicious circle of further price declines and redemptions.
- Excess leverage⁴ in the derivatives positions of a number of regulated investment funds could further amplify the impact of redemptions. The

⁴While U.S. regulated investment funds are subject to explicit leverage limits, derivatives exposures may mask implicit leverage since there is less explicit regulation on leverage through derivatives as there is in Europe. For certain specifically approved derivatives that require cash settlement, mutual funds in the United States are required to hold only enough cash to cover the current mark-to-market value of their positions, which in practice allows them to have large notional exposures. In the EU, the Undertaking for Collective Investment in Transferable Securities Directive expressly limits derivatives leverage to 100 percent of the fund's net asset value. However, the directive's implementing measures allow mutual funds to use an advanced value-at-risk methodology to measure their market exposure, thus permitting mutual funds to exceed the 100 percent limit as long as the value at risk is within certain bounds.

search for yield may also be the impetus for the growth of large bond mutual funds that actively use derivatives; their assets under management now amount to more than \$900 billion, or about 13 percent of the world's bond fund sector (Figure 1.18, panel 1).⁵ Derivatives can be used to hedge risks, but they can also be used to boost returns through excessive leveraging.⁶ In the low-volatility conditions of recent years, leveraged bond funds exhibited a risk profile similar to that of U.S. fixed-income benchmarks (Figure 1.18, panel 3). However, this relative performance may mask the risks of leverage,⁷ given that the market value of a number of speculative derivatives positions could possibly have been unaffected by the limited price action. A significant portion of leveraged bond funds exhibit both relatively high leverage and sensitivity to fixed-income assets (measured by the Barclays U.S. aggregate index in Figure 1.18, panel 4). This combination suggests a risk that losses from highly leveraged derivatives positions could accelerate with an abrupt increase in volatility and risk premiums and reinforce a vicious circle of fire sales, redemptions, and volatility.

What happens when liquidity suppliers retreat?

Markets for some assets, including U.S. Treasury securities, are exhibiting episodes of volatility, marked by a disappearance of liquidity and depth. As discussed in Chapter 2, the loss of market depth reflects a combination of factors—including smaller trade sizes, less frequent trading, and greater volatility—that have

⁵Funds with reported leverage in derivatives positions in the sample account for some \$600 billion of these assets, including the assets of the U.S.-domiciled version of the same EU-domiciled funds that report leverage. Although these funds are separate investment vehicles, they share the same mandate and portfolio manager and therefore have closely matched portfolios, exhibiting a high correlation of returns. The remaining \$300 billion of assets correspond to a group of selected funds that do not report leverage in derivatives positions but are known to be active in derivatives (the funds' latest annual reports list at least 15 derivatives positions).

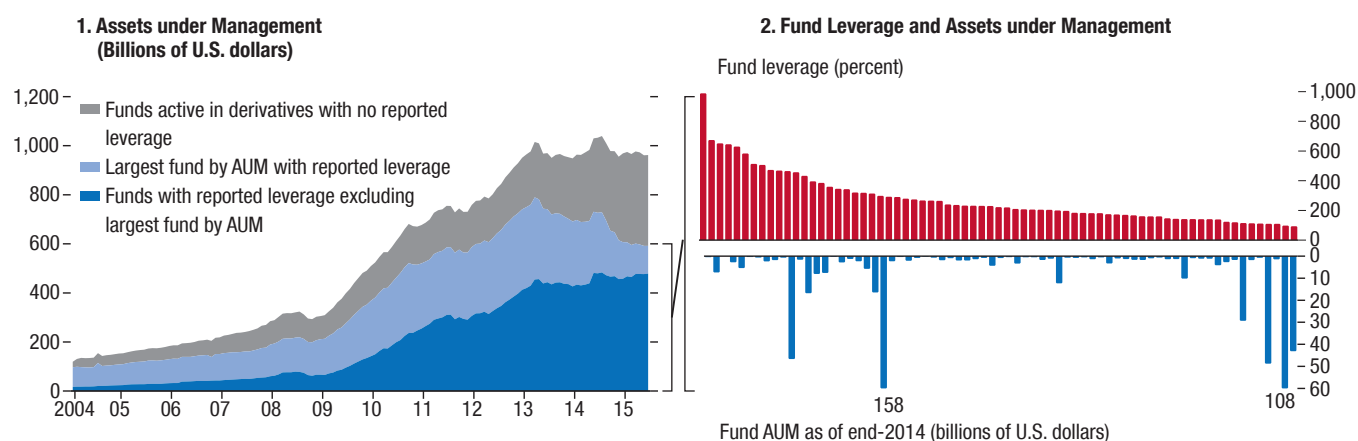
⁶The notional exposure of derivatives of the funds in the sample range from 100 percent to 1,000 percent of net asset value according to their latest annual reports. This range may be conservative (see AIMA 2015) because the exposures are adjusted for hedging and netting at the asset manager's discretion. See CESR (2010) for a discussion on the guidelines and the methodology.

⁷In addition to the risk of amplifying losses, some derivatives, particularly complex over-the-counter instruments, may be illiquid and some previously liquid derivatives (as well as cash securities) may become illiquid during periods of market stress (SEC 2011; IDC 2008).

Figure 1.18. Large United States and European Regulated Bond Investment Funds with Derivatives-Embedded Leverage

Growth is strong in the assets under management of selected large regulated bond funds that use derivatives...

...with embedded leverage exceeding 100 percent of net asset value...

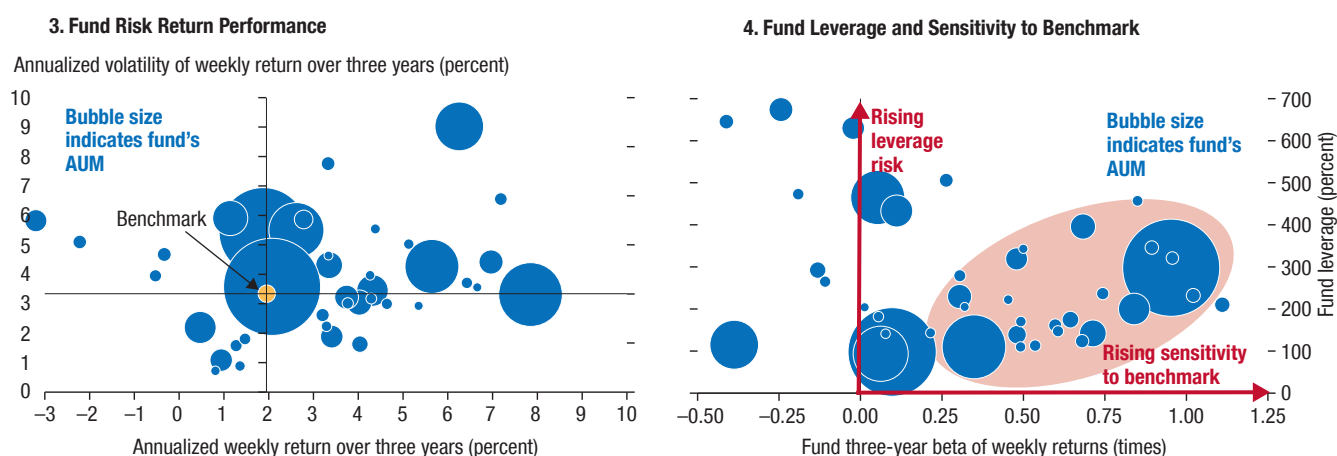


Sources: Bloomberg, L.P.; funds annual reports; and IMF staff calculations.

Note: Includes funds with assets under management (AUM) > \$0.5 billion for funds with reported leverage, and AUM > \$1 billion for other funds active in derivatives without reported leverage. Reported leverage during the previous year is obtained from the funds' latest annual reports under the Committee of European Securities Regulators' commitment approach. Leverage is defined as notional exposure of derivatives positions adjusted by hedging and netting. The AUM calculation of funds with reported leverage includes the assets of the U.S.-domiciled version of the same European Union-domiciled funds that report leverage. Funds active in derivatives without reported leverage have a minimum 15 separate derivatives lines in their latest annual reports. The sample includes two multistrategy funds that have significant exposure to fixed income.

...and similar risk return performance to U.S. fixed income amid low volatility conditions...

...but those sensitive to U.S. fixed income could be at risk from higher volatility and risk premiums.



Sources: Bloomberg, L.P.; funds annual reports; and IMF staff estimates.

Note: Includes funds with reported leverage and assets under management (AUM) > \$1 billion, amounting to total AUM of \$550 billion. The beta is a measure of a fund's sensitivity to the benchmark, calculated as the covariance between the fund's return and the benchmark return divided by the variance of the benchmark return. The benchmark is the Barclays U.S. aggregate total return bond index.

increased the cost to dealers of trading and holding inventory (April 2015 GFSR).⁸ Analysis suggests that

⁸As banks retreat from risk warehousing, market depth can be reduced. In an environment of low market depth, large intermittent ("chunky") trades have a higher price impact than they would under normal trading conditions, taking market prices deep into the order

the likelihood of rapid and significant spikes in volatility rises considerably as two-year U.S. Treasury market depth falls below a critical level of approximately \$1

book where new market makers (that is, high-frequency traders and asset managers) tend not to operate.

Box 1.2. Compression of Global Risk Premiums and Market Abnormalities

Exceptionally¹ easy monetary policies, required by the severity of the global financial crisis, have encouraged financial risk taking, resulting in asset price inflation, but have also eroded normal relations between key asset prices and fundamentals. By removing low-risk, long-duration assets from the market through quantitative easing, and by lowering short-term rates to near zero (or even negative levels), officials have herded market participants into riskier and longer-duration assets. As a result, global sovereign bond valuations appear overvalued even though, in a number of countries, deflation risks have been mitigated, confidence in policy has risen, and economic prospects have improved (Figure 1.2.1, panel 3).

By suppressing the real cost of capital, easy monetary policies may have also impaired the market's ability to efficiently distribute capital. As credit and term premiums narrowed, asset prices increased, but with less differentiation in pricing, leading to increased correlation in the prices of major asset classes. Instead of being driven largely by fundamentals, price action in global assets has become more binary—investors are either “risk on” or “risk off.” In the United States, monetary policy has helped contain corporate credit risk despite a steady rebound in leverage (Figure 1.2.1, panel 4).

The search for yield has forced capital to flow into illiquid assets or to entities that might otherwise not be viable if rates returned to more normal levels. Markets have already priced in some expectation of future

liquidity problems, with many bond funds running high allocations to cash (despite near-zero rates) and increasing premiums observed on the most liquid bond issues. Pockets of excessive leverage have emerged because the low-yield environment has compelled investors to employ leverage (often through derivatives) to meet their return targets.

Until the market correction in late August, global equity markets had traded at new highs. However, in the United States, much of the gain has been driven by defensive stocks—such as utilities, which typically offer a high dividend component—rather than cyclical stocks, which normally lead the business cycle and recoveries (Figure 1.2.1, panels 5 and 6). Taken together, the overvaluation of sovereign bonds and outperformance of defensive stocks may reflect an ongoing search for yield and concern for the medium-term outlook.

Shocks like these could be expected to cause a significant, though likely manageable, increase in global risk premiums. However, given the current tight levels of risk premiums in some markets (such as sovereign bonds), the imminent reduction of monetary accommodation in the United States, and the reduced capacity of markets to efficiently transfer risk, a major shock could cause risk premiums to rise dramatically and abruptly. A sharp decompression in risk premiums would lead to a marked tightening of financial conditions, raise financial stability challenges, and act as a drag on economic growth. As a result, monetary policy exit could be delayed or stalled if already under way.

The authors of this box are David Jones and Francis Vitek.

billion (Figure 1.17, panel 3). Underlying market liquidity is also being affected by changes in regulation and bank business models and by the rise of algorithmic and high-frequency traders. These newer market participants have dramatically reshaped the structure of many markets and reduced the attractiveness of the traditional risk-warehousing role played by dealers.⁹ As

highlighted in Chapter 2, market liquidity is correlated across markets.

The loss of market liquidity carries systemic implications

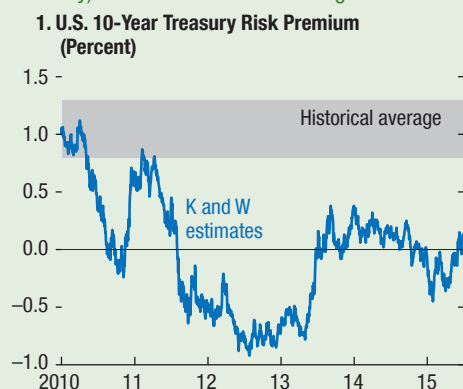
A loss in market liquidity carries wider systemic implications that can be illustrated in the corporate bond market. For example, a permanent 200 basis point rise in the spread for high-yield U.S. corporate debt¹⁰ from a liquidity shock could result in a

⁹Kite (2010) reports that high-frequency traders accounted for 45 percent of overall trading in U.S. Treasuries in 2010, while Jiang and others (2014) find that high-frequency traders accounted for 40 percent of trades in 2011, and Light (2014) estimates that high-frequency traders account for more than 50 percent of the volume in the Treasury market.

¹⁰Consisting of a 100 basis point rise in both term premiums and credit risk premiums for the outstanding stock of high-yield debt.

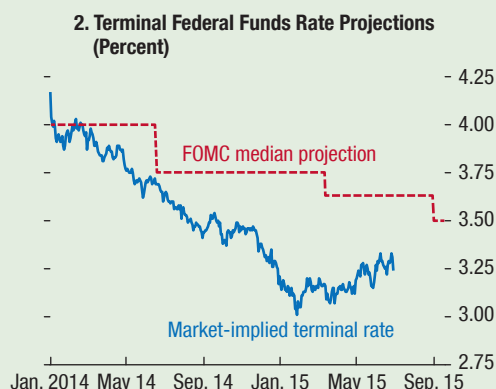
Box 1.2. (continued)**Figure 1.2.1. Policies Have Led to Compressed Term Premiums and Market Abnormalities**

Quantitative easing programs in the United States have compressed term premiums (10-year Treasury) well below historical averages...



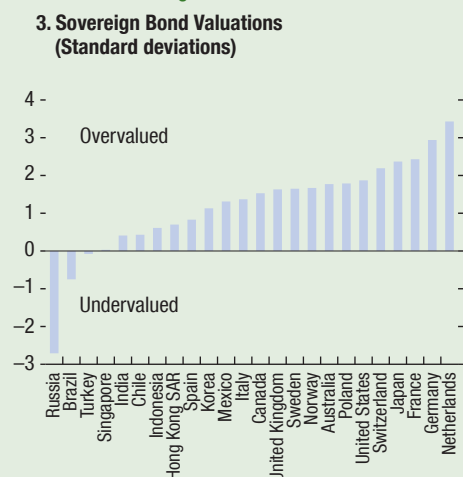
Sources: Kim and Wright (K and W) (2005, updated); and IMF staff estimates.
Note: K and W estimates as of end-June 2015. The upper bound of the blue bar indicates the average K and W term premium from 1990 to 2007, while the lower bound indicates the average term premium from 2000 to 2007.

...dampening market expectations of the terminal federal funds target.



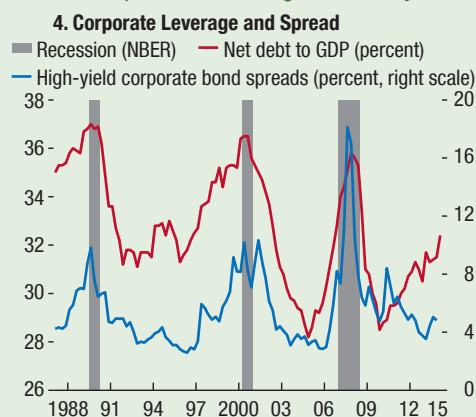
Sources: Bloomberg, L.P.; Kim and Wright (K and W) (2005, updated); and IMF staff estimates.
Note: The market-implied terminal rate is derived from the 10-year Treasury rate, the 10-year term premium (Kim and Wright 2005), and the expected months to liftoff in the federal funds rate. The pace of rate hikes is assumed to be 100 basis points per year until the terminal rate is reached. Market-implied terminal rate as of June 2015; FOMC projection as of September 2015. FOMC = Federal Open Market Committee.

Accommodative policies have led to signs of overvalued sovereign bonds.



Sources: Bloomberg, L.P.; and IMF staff calculations.
Note: Five-year-five-year sovereign bond yield in local currency terms minus five-year-five-year survey-based expectation of real GDP growth and inflation. Z-score computed as mean-adjusted return, scaled by the standard deviation: $(y - \bar{y})/\sigma$. Inverted, up = overvalued.

Corporate leverage in the United States has risen but credit spreads have diverged in recent years.

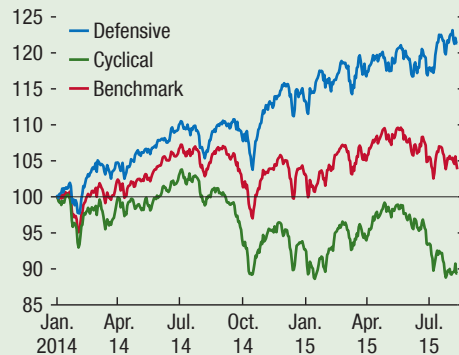


Sources: Bank of America Merrill Lynch; Federal Reserve, Flow of Funds; National Bureau of Economic Research (NBER); and IMF staff calculations.

(Figure 1.2.1 continues)

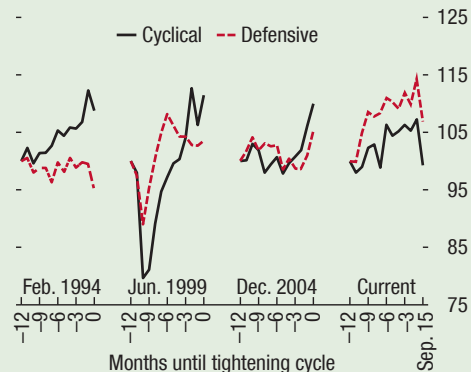
Box 1.2. (continued)**Figure 1.2.1. (continued)**

Dividend yield and defensive stocks have outperformed cyclical and growth stocks...

5. Cyclical versus Defensive Sectors
(Index, Jan. 1, 2014 = 100)

Sources: Bloomberg, L.P.; Financial Times Stock Exchange; and IMF staff calculations.

...unlike in previous recovery cycles.

6. Standard & Poor's 500 Price Index
(Index, 12 months before the first rate hike = 100)

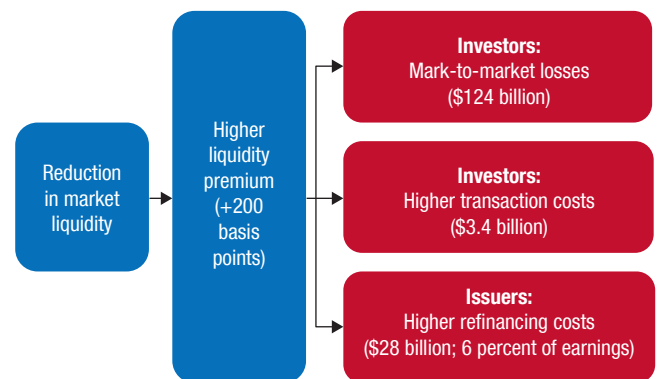
Sources: Bloomberg, L.P.; and IMF staff calculations.
Note: Cyclical sectors include basic materials, consumer discretionary, and financial services. Defensive sectors include consumer staples, health care, and utilities.

number of costs for investors (Figure 1.19). First, retail and institutional investors would be hit by significant mark-to-market losses on their holdings. Second, corporate issuers would suffer from higher borrowing costs, particularly hurting those with large rollover needs. Third, investors and dealers would face higher transaction costs, further limiting turnover in this market.¹¹ High-yield companies would face additional issuance costs of \$3.4 billion, or roughly 6 percent of current one-year earnings. A shock of this nature could reinforce a cycle of redemption risks in retail mutual bond funds and pressures on other illiquid assets. Moreover, risks of further shocks (or decompression in risk premiums) would only reinforce this negative cycle.

¹¹The impact on investors is measured by computing the mark-to-market losses resulting from increased yields (and the corresponding decline in prices) and by increasing a measure of actual transaction costs (costs of a roundtrip buy-and-sell transaction for the same quantity). The costs for issuers are computed by estimating the additional issuance costs required to roll over the entire stock of debt.

Figure 1.19. Systemic Implications of a Liquidity Shock

A risk premium shock results in costs to high-yield issuers and investors.



Sources: Federal Reserve; Oliver Wyman; Securities Industry and Financial Markets Association; Trade Reporting and Compliance Engine (TRACE); and IMF staff estimates.

Note: Issuance costs account for 6 percent of high-yield companies' one-year earnings as of 2015:Q1.

Policy mistakes can turn risk decompression into a global asset market disruption

If policymakers mishandle the triad of challenges that they face, the expected further decompression in risk premiums could turn into an abrupt one, pushing the global financial system from the baseline to a

downside scenario: a global asset market disruption. The likely implications of this downside are quantified with the help of the IMF's Global Macrofinancial Model (Annex 1.2), which allows us to elaborate on the discussion of disruptive asset price shifts and financial market turmoil in the October 2015 WEO. The shock sizes are informed by the historical behavior of key variables, making the scenario plausible and adverse, but not extreme. The exercise is useful in bringing together knowledge about business cycle dynamics in the world economy, macrofinancial linkages under bank and market-based intermediation, and diverse channels for the transmission of spillovers. A particularly relevant feature of the model is that it captures financial contagion and balance sheet effects. As with any model, the interpretation of results must take into account the underlying assumptions and model limitations.

On the downside, monetary normalization in systemic advanced economies would be delayed or stalled by realization of financial stability risks. The scenario consists of three main layers:

- *First, an abrupt further decompression of asset risk premiums.* The decompression is amplified by low secondary market liquidity in systemic advanced economies. The risk premium decompression elevates long-term government bond yields relative to the baseline, but yields in Japan, the United Kingdom, Germany, and the United States are relatively lower as the result of "safe haven" capital flows. Higher long-term government yields interact with a reemergence of financial strains in some euro area economies. Lower risk appetite also leads to a stock market selloff and declining equity prices. Elevated global capital market volatility widens the spread of the money market interest rate over the policy interest rate.
- *Second, credit cycle downturns in emerging markets.* These downturns result in higher default rates on bank loans to nonfinancial firms in emerging markets, given the rising share of corporate debt at risk, in addition to defaults induced by spillovers from advanced economies. In China, the emergence of counterparty credit risk widens the spread of the money market interest rate over the policy interest rate.
- *Third, a worldwide decline in economic risk taking,* and an additional decline in private investment and consumption. The contraction of private domestic demand is driven by a loss of business

and household confidence, which increases saving rates and delays investment. Monetary authorities in the systemic advanced economies continue quantitative easing to keep policy rates at or near the zero lower bound. In emerging market economies, monetary policy loosens in response to the adverse shock.

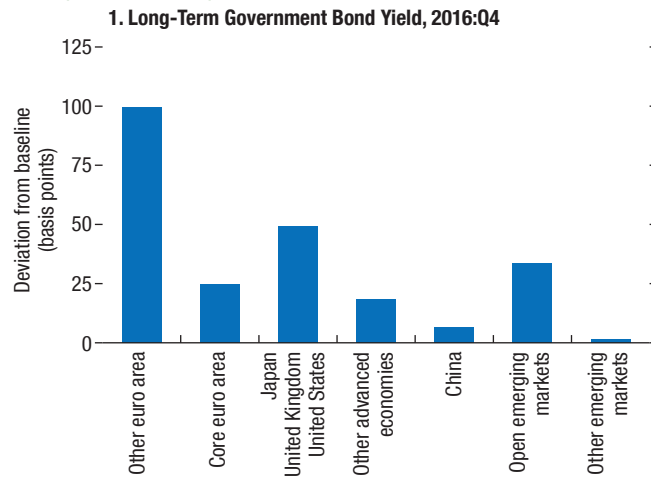
The scenario reduces bank capitalization and worsens government debt sustainability (Figure 1.20, panels 5 and 6). Output is lower relative to the baseline, inflation falls, and unemployment rises. These developments induce cuts in policy interest rates where possible. Automatic fiscal stabilizers operate fully in all economies, but discretionary fiscal stimulus measures are not considered. The deployment of policy buffers is not considered, which would mitigate the negative growth impact, particularly in China where substantial buffers exist. The banking sector responds and contributes to reductions in private investment by decreasing bank credit and nonfinancial corporate debt. Bank capital ratios fall, especially in emerging market economies, where loan default and credit loss rates increase relatively more. Reflecting lower nominal output, government debt ratios rise, especially in advanced economies, where initial government debt ratios and debt-service cost increases are higher.

In aggregate, world output is lower by 2.4 percent by 2017 relative to the baseline, which implies still positive but low global growth. Energy and non-energy commodity prices fall by 22.7 percent and 11.8 percent, respectively.

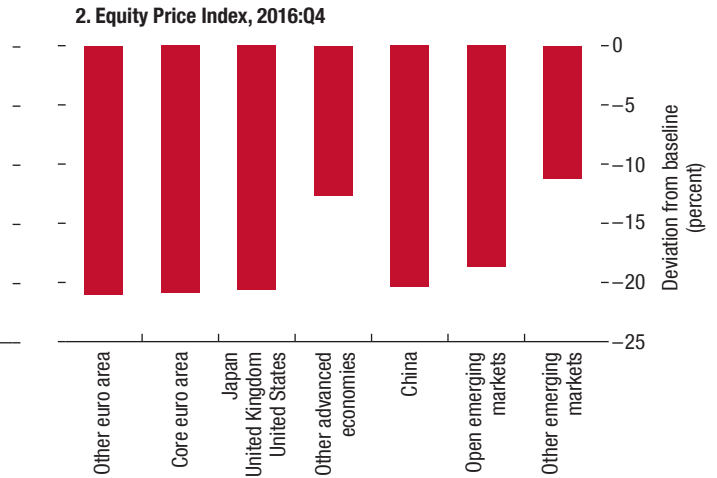
For comparison, the October 2015 WEO includes a scenario illustrating the impact of a longer-term structural slowdown in potential output growth of emerging market economies. The WEO scenario includes lower capital inflows and tighter financial conditions. Country risk premiums on interest rates rise as investors worry about default risks on loans made before expected growth fell. The scenario suggests that worldwide economic growth in 2016 would be about 0.4 percentage points below the WEO baseline. Economic growth in the major emerging markets (Brazil, Russia, India, China, and South Africa) worsens by about 1¾ percentage points relative to the baseline after five years. A second version of the scenario adds in the impact of depreciation in emerging market currencies, and a larger increase in country risk premiums, which would amplify the extent of the slowdown.

Figure 1.20. Effect of a Global Asset Market Disruption

The global asset market disruption scenario entails rapid decompression of risk premiums in bonds...

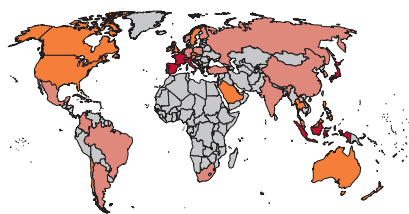


...and equities.

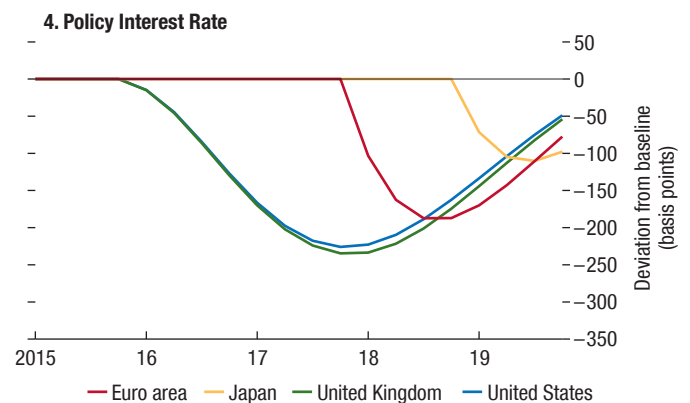


The scenario generates moderate to large output losses worldwide...

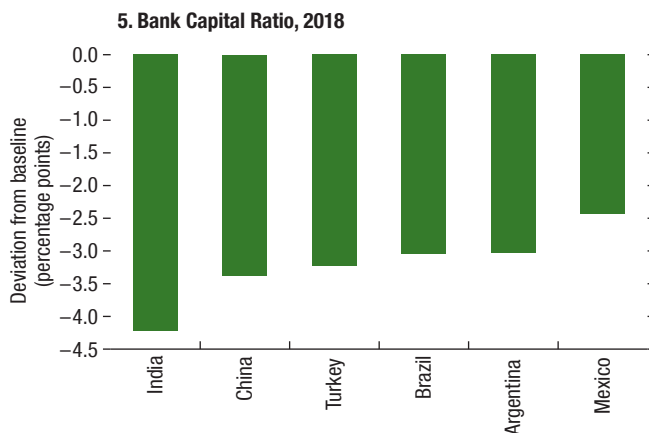
3. Output, 2017



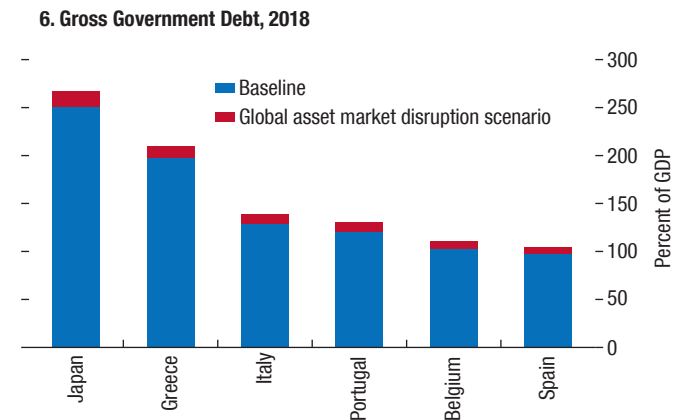
...and delays or stalls monetary policy normalization in advanced economies.



Banking sector capitalization suffers...



...as does government debt sustainability.



Source: IMF staff calculations.

Note: For the methodology, see Annex 1.2. Open emerging markets = Argentina, Brazil, Colombia, India, Indonesia, Mexico, Philippines, Poland, Russia, South Africa, Thailand, and Turkey.

Figure 1.21. Emerging Market Local Currency Bond Yields

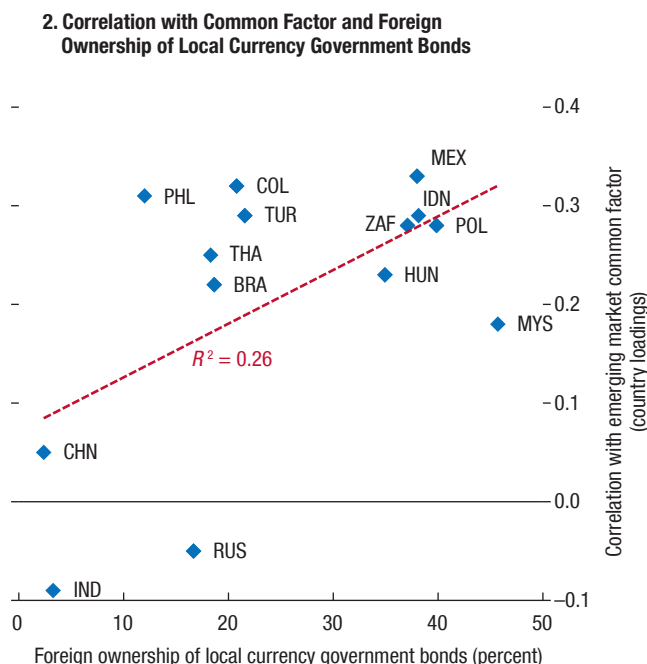
Comovements in emerging market local currency bond yields are largely explained by a common factor, which is highly correlated with the U.S. Treasury rate.



Source: IMF staff calculations.

Note: The emerging market common factor is the first component of 10-year government bond yields from 14 emerging market economies using principal component analysis. The common factor was transformed to have the same mean and variance as the U.S. 10-year Treasury yield.

Countries with higher foreign ownership of local currency government bonds tend to have higher sensitivity to the common factor.



Sources: Arslanalp and Tsuda (2014b); national authorities; and IMF staff calculations.

Note: Data labels in the figure use International Organization for Standardization (ISO) country codes.

Emerging markets would be hit with multiple shocks

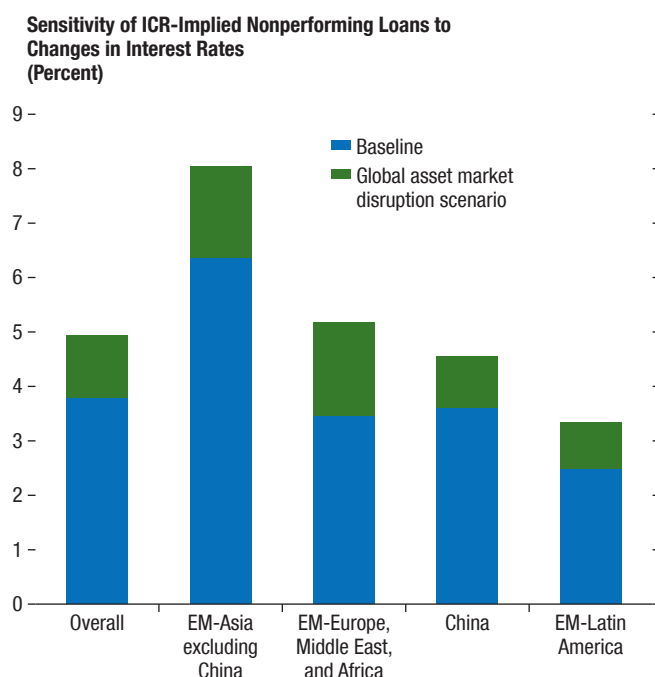
The likely adverse effects of the global asset market disruption scenario vary considerably across countries, but most are hit by one or more of three transmission channels: financial contagion shocks (via equity, bond, and money markets), corporate debt shocks (affecting bank soundness), and commodity shocks (affecting net commodity exporters). Financial contagion—via portfolio outflows from emerging markets—is a particularly important transmission channel in the global asset market disruption scenario. Emerging market sovereign bonds face a particularly rocky adjustment in the scenario. Emerging market bond yields tend to comove, especially during stress episodes. About half of this variation can be explained by a single common factor. The common factor is highly correlated to the 10-year U.S. Treasury rate and this relationship has become stronger since the 2013 taper tantrum (Figure 1.21,

panel 1), implying that the U.S. rate plays a key role in the transmission channel.¹² The adjustment would be particularly painful for emerging markets with high foreign participation in bond markets. The sensitivity of each country's bond yield to the common factor can be partly explained by the share of foreign ownership in local government bond markets (Figure 1.21, panel 2), even though other factors, such as the quality of domestic fundamentals, also have an influence.

The scenario's combination of risk premium reversal (higher rates) and deteriorating economic outlook (lower corporate cash flows) would particularly compromise emerging market firms' debt-service capacity. Asset quality would deteriorate in all regions under the simulation, significantly so in emerging Asia

¹²Statistical analysis shows that the causation runs from the U.S. rate to the common factor rather than the reverse.

Figure 1.22. Corporate Debt Burden in Market Disruption Scenario



Sources: Standard & Poor's Capital IQ; and IMF staff calculations.

Note: The global asset market disruption scenario consists of a 25 percent increase in borrowing costs and growth shocks. Vulnerable debt is defined as the debt of firms whose EBITDA does not cover interest expenses for six consecutive quarters. EBITDA = earnings before interest, taxes, depreciation, and amortization; EM = emerging markets; ICR = interest coverage ratio.

(Figure 1.22). These calculations assume relatively small changes in exchange rates; if larger depreciation risks were to materialize, solvency risks for unhedged dollar borrowers, especially property developers, would increase, translating into even larger nonperforming loans (this is also discussed in Chapter 3).

Corporate weaknesses highlight the corporate-sovereign risk nexus in emerging markets

Several emerging market sovereigns—Brazil, South Africa, and Turkey, for example—are at the lower end of the investment-grade ratings scale (Figure 1.23). The global asset market disruption scenario, with weaker growth and higher risk premiums, would put pressure on the ratings of several economies in the medium term. A loss of investment-grade ratings would cement higher borrowing costs for sovereigns and firms. This underscores the need to take the necessary fiscal policy adjustments

and reform efforts to maintain investment grade ratings.

The sovereign–state-owned enterprise nexus can also amplify headwinds to the sovereign when contingent liabilities of the state-owned enterprises are assumed by the sovereign. Since 2010, an increasing portion of externally issued emerging market corporate debt has been issued by state-owned entities (Figure 1.23). Firms in the oil, gas, and utility sectors can feed commodity price and credit turmoil back to the sovereign as, for example, Petrobras in Brazil, PDVSA in Venezuela, Rosneft in Russia, KazMunayGas in Kazakhstan, and Eskom in South Africa (Figure 1.24).

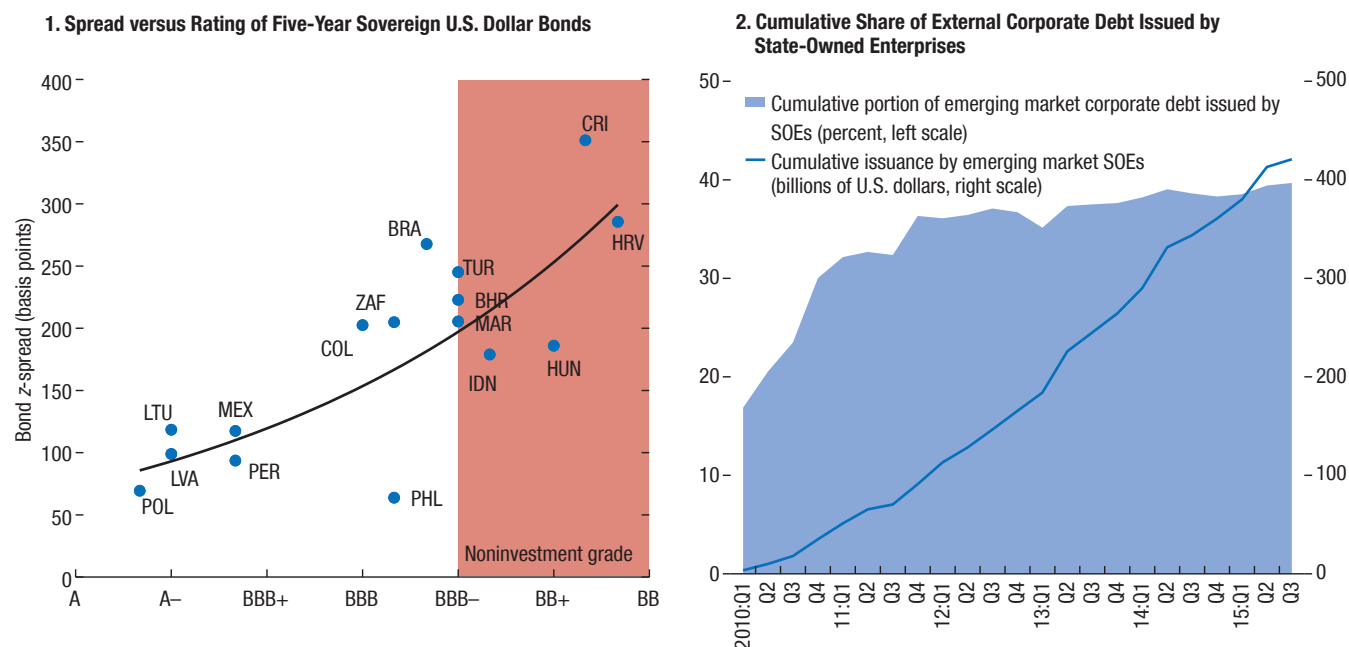
Policies for Successful Normalization

Successful normalization of financial and monetary conditions would yield significant financial stability benefits. Accomplishing this objective will require concerted policy efforts across several fronts in advanced and emerging market economies.

Confidence in policymaking remains essential in a challenging environment

The smooth absorption of a rise in the U.S. policy rate will be important to global financial health. The commencement of policy normalization—even if accompanied by a strong underlying economy—may lead to financial market volatility, a repricing of the U.S. yield curve, or a selloff of riskier assets. The Federal Open Market Committee should remain data dependent, with the first increase in the federal funds rate waiting until there are firmer signs of inflation rising steadily toward the Federal Reserve's 2 percent medium-term inflation objective, with continued strength in the labor market. The pace of subsequent policy rate increases should be gradual and clearly communicated. Such an approach would reduce the possibility that episodes of financial market volatility could disrupt the current economic expansion. Stronger growth in the United States would help cushion the impact of rising rates in emerging markets.

In Japan, the central bank should be prepared to ease further to achieve its inflation target, and should provide stronger guidance to markets, as outlined in the IMF's 2015 Article IV report for Japan. Since supply and demand dynamics suggest the Bank of Japan may need to taper its government bond purchases in 2017 or 2018 (Arslanalp and Botman 2015), contin-

Figure 1.23. Lower Ratings Would Lock in Higher Borrowing Costs

Sources: Bloomberg, L.P.; Fitch; Moody's; Standard & Poor's; and IMF staff calculations.
 Note: Data labels in the figure use International Organization for Standardization (ISO) country codes.

Sources: Dealogic; and IMF staff calculations.
 Note: SOE = state-owned enterprise.

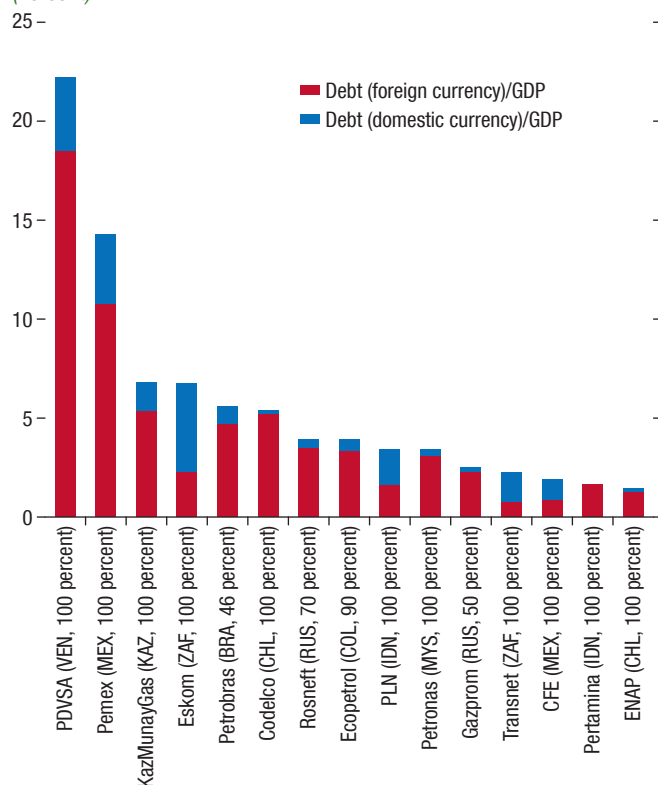
ued monetary stimulus will likely require extending the maturity of its government bond purchases or scaling up private asset purchases. Even with further easing, reaching the inflation target in a stable manner is likely to take longer than envisaged in the absence of deeper structural reforms and adequate fiscal policy. To further stimulate bank lending to the private sector, the authorities should jumpstart the securitization market for loans to small and medium-sized enterprises and mortgages, and enhance the provision of risk capital, in part by encouraging more asset-based lending and removing barriers to entry and exit for small and medium-sized enterprises.

In the euro area, more progress is needed to bolster market confidence. So far, at the most difficult times during the negotiations with Greece, ECB policy has staved off potential contagion emanating from concerns about a Greek default or exit from the euro. But euro area policymaking cannot rely on the ECB alone to move financial stability onto firmer ground. The agenda to strengthen the currency union must include finishing the essential pillars of a banking union, including establishing a pan-European deposit insurance scheme;

lowering the obstacles to direct recapitalization of banks by the ESM, thereby severing the bank-sovereign link; laying the groundwork for a capital markets union; and advancing fiscal and economic integration (EC Presidents' report June 22, 2015).

Further strengthening euro area banks by comprehensively tackling nonperforming loans will improve the outlook and further bolster market confidence, as discussed in the IMF's 2015 Article IV Staff Report for the euro area and in previous GFSRs. At the European Union (EU) level, the Single Supervisory Mechanism could accelerate loan resolution in a number of ways: (1) by strengthening incentives for write-offs or debt restructuring, (2) by ensuring that banks provision prudently and value collateral conservatively, (3) by imposing higher capital surcharges or time limits on long-held nonperforming loans, and (4) by developing standardized criteria for identifying nonviable firms for quick liquidation. Improvements in national insolvency and foreclosure rules would also help, including by reducing foreclosure times to help close the gap between the market value and book value of distressed debt, and passing reforms to accelerate out-of-court

Figure 1.24. Selected Quasi-Sovereign Company Ownership and Debt
(Percent)



Sources: Bloomberg, L.P.; company annual reports; Standard & Poor's Capital IQ; and IMF staff calculations.
Note: Country and sovereign ownership (percent) are identified within parentheses. Country abbreviations in the figure use International Organization for Standardization (ISO) country codes.

procedures and facilitate out-of-court workouts to reduce costs and encourage more market-led corporate restructuring. National asset management companies, acting in compliance with EU rules, could help achieve economies of scale in handling distressed debt by purchasing nonperforming loans and quickly disposing of them (Box 1.3).

Rebalancing and deleveraging in China will require great care

The Chinese authorities face an unprecedented policy challenge in carrying out their objectives to make the transition to a new growth model and a more market-based financial system, and to reduce vulnerabilities inherited from the old system. Achieving this outcome will require careful pacing of reforms and policy consistency.

Appropriately deleveraging the corporate sector would avoid directing credit and labor resources toward inefficient activities, which diminishes growth prospects and leads to a further deterioration in balance sheets. A more proactive restructuring—which could include increased write-offs of nonperforming loans, bankruptcies, and exits (including of unviable state-owned enterprises)—would more quickly break this trend. It would help unclog credit intermediation, allowing the dynamic firms that will drive future growth to get better access to credit, and free up labor that could flow to more productive activities. Although it would initially hurt bank balance sheets and increase unemployment, these problems could be addressed by a comprehensive plan that would include a strong social safety net for laid-off workers, and a financial sector restructuring program to deal with bad assets and recapitalize banks as needed. Moving faster may ultimately prove less costly than trying to “grow out of the problem” through a protracted period of fairly tight credit conditions.

The removal of unconventional measures, including those to stem recent equity price declines, combined with steps to strengthen the resilience of the financial system would ensure continued progress toward a well-regulated, more market-based financial system in China. Shortcomings in the supervisory framework should be addressed, including by filling data gaps regarding equity-related leverage and linkages between financial institutions. The market role of the China Securities Finance Corporation, including the extent of its interventions and equity holdings, should be clarified, and an eventual exit strategy from its current balance sheet should be established. Incentives for leverage in equity markets should be removed, and leverage, including margin borrowing by equity investors, should be regulated more tightly. Authorities should also review trading-halt criteria and other stock exchange regulations.

Looking forward, the commitment to reform will be key to policy credibility and effectiveness. Policy priorities include completing interest rate liberalization and containing the risk of excessive competition through supervision, regulation, and better liquidity management by the central bank. Authorities should rely less on moral suasion to guide banks' lending activities and allow loan policies and interest rates to be determined by commercial considerations. Loss-absorbing buffers for banks should also be enhanced. The web of implicit guarantees to the corporate, bank, and nonbank sectors should be broken to better price risk and allocate

Box 1.3. Banking in Europe: The Impact of Nonperforming Loans

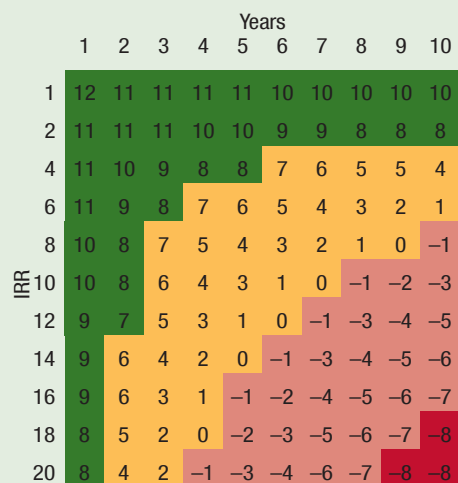
A pickup in credit growth will be needed to secure broader economic growth in Europe. Although banks' capital bases have improved—making banks safer—lending capacity remains constrained and profitability expectations are subdued.¹ At the end of 2014, nonperforming loans (NPLs) locked up some €52 billion, or 3 percent of regulatory capital, at euro area banks. Reducing NPLs would free up bank capital and encourage credit growth.

A heat map (Figure 1.3.1) illustrates the capital relief that euro area banks might achieve as a function of foreclosure time and investors' return expectations at the end of 2014, assuming a 5 percent additional loss. It shows that despite the loss, banks could free up regulatory capital at the current foreclosure time of about three years.

Progress has been made in resolving NPLs, provisioning ratios have improved, and distressed asset markets have been successfully developed in certain countries.² However, one impediment to a reduction in NPLs is the pricing gap—the difference between book values on bank balance sheets and the prices investors are willing to pay. Reducing the time required to foreclose allows the present value of the collateral to be maximized, which works to the benefit of both debtor and creditor. Quick foreclosures facilitate the workout for any asset holder, whether the bank itself or an investor, and they are one mark of an efficient judicial system that helps develop investor confidence and reduce return expectations. If NPLs were sold to investors expecting a 10 percent return, €602 billion in new lending capacity

Figure 1.3.1. Euro Area Capital Relief from Nonperforming Loans

(Percentage of total regulatory capital as a function of foreclosure time and investors' return expectations)



Sources: European Banking Authority, European Central Bank; Haver Analytics; IMF, Financial Soundness Indicators; national central banks; SNL Financial; and IMF staff calculations.

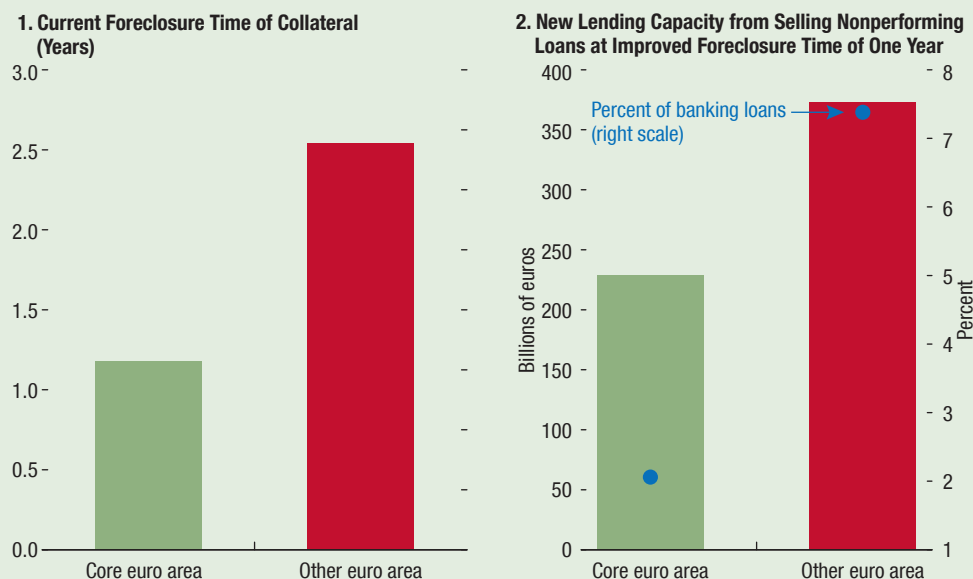
Note: Investor price derived from foreclosure time and internal rate of return; assumes 80 percent collateralization, usual servicing fees, 5 percent additional loss, actual risk-weighted assets and coverage ratios at end-2014, and 16 percent capital asset ratio. IRR = internal rate of return. Green shading indicates that the percentage of regulatory capital (when rounded to whole numbers) is 8% or larger, orange is between 0% and 7%, pink is between -7% and 0%, and red indicates below -8%.

(3.7 percent of bank loans to EA residents) could be obtained in the overall euro area, of which €373 billion would be made available in other (non-core) euro area countries (7.4 percent of bank loans to other (non-core) euro area residents), if foreclosure times were reduced to the euro area best-practice level of one year (Figure 1.3.2).

The authors of this box are Jean Portier and Luca Sanfilippo.

¹October 2014 GFSR. More than 70 percent of the largest euro area banks by assets would be unable to increase credit by more than 5 percent to finance growth.

²For example, Spain has set up asset management companies and kick-started active management of nonperforming assets.

Box 1.3. (continued)**Figure 1.3.2. Euro Area Foreclosure Time and Lending Capacity from Foreclosure Time Reduction**

Source: European Banking Authority; European Central Bank; Haver Analytics; IMF, Financial Soundness Indicators; national central banks; SNL Financial; World Bank, Doing Business Report; and IMF staff calculations.

Note: Assumes a best practice foreclosure time of one year. Dots in second panel refer to new lending capacity as a percentage of banking loans in the respective region. Core euro area comprises Austria, Belgium, France, Germany, and Netherlands. Other euro area comprises Cyprus, Greece, Ireland, Italy, Portugal, Slovenia, and Spain.

capital more efficiently. The transition will require an upgraded monetary policy framework that uses market interest rates as the main policy tool.

Building and maintaining policy confidence in emerging markets will be crucial

Many emerging markets have increased their resilience to external shocks with increased exchange rate flexibility, higher foreign exchange reserves, increased reliance on FDI flows and domestic-currency external financing, and generally stronger policy frameworks. However, the turning of the credit cycle to its late stage and recent market turbulence put the spotlight on prevention of deterioration in financial sector conditions. Authorities in emerging markets should develop a more in-depth understanding of continued credit growth in their banks and assess its financial risk against economic benefits, bringing to bear micro- and macroprudential tools to discourage the buildup of excessive leverage and foreign indebtedness. This includes considering

higher risk weights (capital requirements) for corporate foreign currency exposures as well as caps on the share of such exposures on banks' balance sheets. At the microprudential level, regulators need to conduct bank stress tests related to foreign currency risks and regularly monitor corporate foreign currency exposures, including derivatives positions. Furthermore, policymakers should encourage banks to strengthen provisioning to deal with rising nonperforming loans, improve regulations on credit quality classification, and address important data gaps in the corporate and nonbank sectors.

As set out in Chapter 3, corporate leverage in emerging markets is a potential source of vulnerability if financial conditions tighten. Special attention should be paid to foreign currency exposures and risks, reducing or cushioning exposures as needed and reforming corporate insolvency regimes. Maintaining sovereign investment-grade status is a priority. Accelerating measures to foster money market and corporate bond issuance may also help corporate borrowers reduce their dependence on balance sheet-constrained banks. Sovereign borrowers should buttress

their investment-grade ratings. They should also manage and contain contingent liabilities from state-related entities by ensuring effective management and oversight.

Safeguarding against market illiquidity and strengthening market structures are priorities

The weakening of liquidity in fixed-income markets has potential effects on both market efficiency and financial stability (Table 1.2), and it requires a multi-faceted solution. Diminished liquidity carries a high risk of contagion—it impairs the ability of markets to adjust and absorb events and may prompt episodes of excessive volatility, cause fire sales that disrupt asset values, and spread shocks across markets as the result of increased asset correlations.

Although the full effect of changed market conditions may not be known until a stress event occurs, as set out in Chapter 2 some markets show clear signs that liquidity conditions have worsened and that accommodative monetary policy is masking underlying risks. To assess these risks properly, authorities must develop greater monitoring capacity, particularly across markets, and put in place preemptive strategies. The cumulative impact of new banking regulations should also be evaluated. The changes in the investor base should be recognized by removing first-mover advantage from investment fund products (see Chapter 2). Moreover, addressing the lack of harmonization in over-the-counter derivatives markets would reduce costs and improve liquidity conditions.

Market structure solutions to liquidity shortages should be explored, for example, by working with market participants to introduce market making or raise minimum requirements for market makers. For markets without primary dealers, possibilities include minimum limits on bid-ask spreads, minimum amounts of quoted volumes, and a minimum presence during the usual trading periods. Trading venues could encourage liquidity provision by imposing small fees on liquidity consumers and using the revenue to pay liquidity providers (so-called maker/taker fees).

More study of the effect on liquidity of technological innovations such as high-frequency trading is also warranted (U.S. Department of the Treasury and others 2015; Bouveret and others, forthcoming). Banks should upgrade their technology infrastructure to allow for a unified trading book that can distribute capital dynamically across trading desks. Most banks currently run separate books for each desk; as a result, one desk may hit its risk limits faster than others and thus be unable to take on additional risk. Consequently, individual trading desks may lack the capacity to take significant positions during stress periods even though the bank as a whole may be adequately capitalized.

Conditions constraining market liquidity are likely to continue for some time and supervisors should ensure that institutional investors are adequately prepared. The supervision of liquidity risk at nonbanks

Table 1.2. Why Is Resilient Liquidity Important?

Effect of Diminished Liquidity	Implication
Less market making	More difficult to execute trades without affecting asset prices Greater asset price volatility Further breaches of value-at-risk limits leading to forced sales of assets
Reduced activity in repo (repurchase agreement) markets	Less funding available for hedge funds to arbitrage away discrepancies in asset prices More difficult to trade short positions, affecting market efficiency More difficult to hedge market risk Likely sporadic “snapbacks” in some asset prices as dislocations are corrected
Lower trading in single-name CDS	No single instrument to trade credit risk in an individual company Hedges move to CDS indices, with fragmentation between indices and single-name CDS Less efficient hedging of credit exposure
Cutback in interest rate swaps	More difficult to hedge floating or fixed interest rate exposure
Liquidity herding	Greater fragmentation of liquidity and breakdown of relationships between assets More difficult to hedge risks in financial markets Greater use of foreign exchange markets as proxy hedges More difficult for banks to manage good-quality liquid asset portfolios

Source: IMF staff.

Note: CDS = credit default swap.

should be enhanced, especially for investment funds, as discussed in the October 2014 and April 2015 GFSRs.

Leverage in investment funds has the potential to amplify market shocks

The use of embedded leverage through derivatives appears to be on the rise as fund managers seek to enhance low yields, and the lack of sufficient data collection and oversight by regulators compounds the risks.¹³ Implementing comprehensive and globally consistent reporting standards across the asset management industry would give regulators the data necessary to locate leverage risks. Reporting standards should include enough leverage information (level of cash, assets, and derivatives) to show funds' sensitivity to large market moves (for example, bond funds should report their sensitivity to rate and credit market moves) and to facilitate meaningful analysis of risks across the financial sector.¹⁴

Adopting a clear and common definition of leverage would be useful. Definitions vary across jurisdictions and are often insufficiently precise. Reporting based on a single well-understood definition would permit authorities to stress test for potential losses from market spillovers, unexpected moves in the yield curve, and changes in market volatility. Authorities should also make sure they have the right infrastructure in place to collect and interpret this information, both at the firm level and from a financial stability perspective.

These policies can support successful normalization

The baseline outlook is for sluggish growth and ongoing financial stability risks. There is also a nonnegligible risk that the baseline becomes a more pernicious scenario in which financial stability is compromised. Successful normalization of financial and monetary conditions in the context of sustainable medium-term growth and inflation requires policymakers to act on the various fronts outlined in this

chapter. The upside scenario of successful normalization shows what would happen if the authorities took such action:

- First, successful normalization would entail a smooth transition from financial risk taking to economic risk taking in systemic advanced economies, boosting economic activity relative to the baseline. Monetary normalization would be accompanied by gradual upward shifts of yield curves as investors move away from long-term bonds.¹⁵ Higher risk appetite would drive a gradual and moderate rise in stock prices.
- Second, the scenario also assumes smooth financial liberalization and orderly deleveraging in China, accompanied by an orderly rebalancing of private domestic demand from investment to consumption.

Successful normalization would reinvigorate financial and corporate risk taking, helping to anchor optimism for medium-term financial stability and economic growth. On the banking side, stronger balance sheets would mean new lending capacity, which is especially important in the euro area. Moreover, the firms in the long-term savings-investment complex—insurance companies, pension funds, and other nonbank financial institutions—would be able to generate stronger earnings and returns, improving their balance sheet health.

Under this favorable upside scenario, world output would expand by an additional 0.4 percent by 2018 relative to the baseline, while energy and non-energy commodity prices would rise by 3.1 percent and 1.5 percent, respectively.¹⁶ Because the primary focus of these scenarios is on financial policies, this upside scenario does not include any growth-enhancing structural reforms (to increase growth potential) or possible further expansionary demand policies (such as infrastructure spending) to close output gaps. In other words, the main benefit of these financial sector policies in the successful normalization scenario is that they insure against the loss of financial stability, which would entail high losses of output. Specifically,

¹³No disclosure requirements for detailed leverage information for regulated investment funds are in place in the United States, and requirements are in place only on a selected basis in some European countries.

¹⁴A welcome reporting initiative is the proposal by the U.S. Securities and Exchange Commission for U.S. mutual funds to disclose metrics such as sensitivity to rate and credit market moves (SEC 2015).

¹⁵The shift away from long-term bonds is induced by decompression of term premiums, which in turn is driven by internationally correlated shocks to duration risk premiums.

¹⁶Wide variation in output across economies reflects differences in the extent to which positive trade spillovers from the systemic advanced economies outweigh net negative financial spillovers from those economies (via higher interest rates) and negative trade spillovers from China.

successful normalization avoids the financial risks that could return the global financial system back to crisis. For medium- and long-term growth, macroeconomic policies and structural reforms are needed—a topic addressed more fully in the October 2015 WEO.

Annex 1.1. Progress on the Financial Regulatory Reform Agenda

Many of the key elements of the financial regulatory reform agenda, particularly in the banking sector, have been agreed upon. Additional effort is now focused on three areas: consistent implementation, finalization of outstanding reforms, and addressing emerging risks.

Implementation monitoring is well established through the Basel Committee on Banking Supervision's (BCBS's) regular update reports and its Supervisory Capital Assessment Program. The Financial Stability Board will support and broaden this initiative, incorporating the outcomes from its own peer reviews and those of the standards-setting bodies—the International Association of Insurance Supervisors and the International Organization of Securities Commissions—with the first annual consolidated report on implementation of the regulatory reforms and their effects, which will be delivered at the next summit of the Group of 20.

In the area of banking regulatory policy development, priorities include assessing the interaction, coherence, and overall calibration of the reform policies. The BCBS's work to reduce excessive variability in measuring risk-weighted assets has led to a review of the nonmodeled approaches to risks in the regulatory capital framework, including most recently through the consultation on the standardized approach to credit risk. The BCBS has also launched a consultation on the treatment of interest rates in the banking book, which is not at present subject to mandatory internationally agreed-upon minimum capital requirements. The supervisory community has been concerned with ensuring that banks are well placed to manage their balance sheet risks given that the low interest rate environment is likely to change. The review of the regulatory treatment of sovereign risk has begun, while the criteria for identifying simple, transparent, and comparable securitizations have been agreed upon.

Ending too-big-to-fail remains a cornerstone of the postcrisis reform agenda. Two key outstanding design

elements include international agreement on the quantity and composition of total loss-absorbing capital instruments that global systemically important banks should hold to support orderly resolution. Nonetheless, further action is needed in many jurisdictions to ease resolution of large, complex firms. Steps to achieve this include fully aligning resolution regimes with international best practice; reducing impediments to effective cross-border resolution, which includes finalizing policy measures to support cross-border recognition of resolution; and developing policies for recovery and resolution of systemically important nonbank intermediaries, such as central counterparties.

The reform agenda has moved forward in the nonbank financial sector. The International Association of Insurance Supervisors has issued consultation papers on risk-based global insurance capital standards and higher loss-absorbency requirements for globally systemically important institutions. The Financial Stability Board launched work on identifying financial stability risks associated with market liquidity in fixed-income markets and asset management activities and a peer review of the implementation of its policy framework for financial stability risks posed by nonbank financial entities other than money market funds.

Although jurisdictions have continued to make some headway in building the necessary legal and regulatory frameworks, efforts to achieve reform of over-the-counter derivatives have been restrained by implementation challenges. Five jurisdictions have central clearing requirements in effect for at least one product type. Most jurisdictions are in the early stages of implementing the new framework on margin requirements for non-centrally cleared derivatives. The availability and use of trade repositories and central counterparties continue to expand. However, limited progress has been made on the cross-border application of the new rules. While the European Commission and the U.S. Commodity Futures Trading Commission continue their negotiations on the cross-border application of their respective requirements, regulatory uncertainty for market participants persists.

Emerging risks are attracting increasing regulatory focus. These include financial stability risks stemming from market-based finance, including those associated with asset management activities (see Chapter 3 of the April 2015 GFSR). Addressing misconduct risks and the impact on emerging market and developing economies of banks' derisking their activities is also gaining prominence.

Annex prepared by Kate Seal with contributions from Nobuyasu Sugimoto, Constant Verkoren, and Eija Holttinen.

Annex 1.2. Simulating the Global Macrofinancial Scenarios

This annex provides additional details on the report's analysis of the global macrofinancial effects of global asset market disruption and successful normalization scenarios. These scenarios are simulated using the Global Macrofinancial Model documented in Vitek (2015), which is a structural macroeconomic model of the world economy. As with any scenario analysis, the simulation results need to be interpreted carefully, taking into account the underlying assumptions and limitations of the model. Nonetheless, this estimated panel dynamic stochastic general equilibrium model consolidates much existing theoretical and empirical knowledge concerning business cycle dynamics in the world economy. It features a range of nominal and real rigidities, extensive macro-financial linkages with both bank- and capital-market-based financial intermediation, and diverse spillover transmission channels.

The global macrofinancial model

Estimated dynamic stochastic general equilibrium models are widely used by monetary and fiscal authorities for policy analysis and forecasting purposes. This class of structural macroeconomic models has many variants, incorporating a range of nominal and real rigidities, and increasingly often macrofinancial linkages. Its unifying feature is the derivation of approximate linear equilibrium conditions from constrained optimization problems facing households and firms, which interact with governments in an uncertain environment to determine equilibrium prices and quantities under rational expectations.

The Global Macrofinancial Model is a structural macroeconomic model of the world economy, disaggregated into 40 national economies. This panel dynamic stochastic general equilibrium model features a range of nominal and real rigidities and diverse spillover transmission channels. Following Smets and Wouters (2003), the model features short-term nominal price and wage rigidities generated by monopolistic competition, staggered reoptimization, and partial indexation in the output and labor markets. Following Christiano, Eichenbaum, and Evans (2005), the resultant inertia in inflation and persistence in output is enhanced with other features such as habit persistence in consumption, adjustment costs in investment, and variable capital utilization. Following Galí (2011), the model incorporates involuntary unemployment through a reinterpretation of the labor market. Households are differentiated

according to whether they are bank intermediated, capital market intermediated, or credit constrained. Bank-intermediated households have access to domestic banks where they accumulate deposits, whereas capital-market-intermediated households have access to domestic and foreign capital markets where they trade financial assets. Following Vitek (2013), these capital-market-intermediated households solve a portfolio balance problem, allocating their financial wealth across domestic and foreign money, and bond and stock market securities, which are imperfect substitutes. To address dimensionality issues, targeted parameter restrictions are imposed on the optimality conditions determining the solution to this portfolio balance problem, avoiding the need to track the evolution of bilateral asset allocations. Firms are grouped into differentiated industries. Following Vitek (2013), the commodity industries produce internationally homogeneous goods under decreasing returns to scale, while all other industries produce internationally heterogeneous goods under constant returns to scale. Banks perform international financial intermediation subject to financial frictions and a regulatory constraint. Building on Hülsewig, Mayer, and Wollmershäuser (2009), they issue risky domestic-currency-denominated loans to domestic and foreign firms at infrequently adjusted predetermined lending rates. Also building on Gerali and others (2010), they obtain funding from domestic-bank-intermediated households via deposits and from the domestic money market via loans, and accumulate bank capital out of retained earnings given credit losses to satisfy a regulatory capital requirement. Motivated by Kiyotaki and Moore (1997), the model incorporates a financial accelerator mechanism linked to collateralized borrowing. Finally, following Monacelli (2005) the model accounts for short-term incomplete exchange rate pass through with short-term nominal price rigidities generated by monopolistic competition, staggered reoptimization, and partial indexation in the import markets.

An approximate linear state space representation of the model is estimated by Bayesian maximum likelihood, conditional on prior information concerning the generally common values of structural parameters across economies. In addition to mitigating potential model misspecification and identification problems, exploiting this additional information may be expected to yield efficiency gains in estimation. These cross-economy equality restrictions, which are necessary for this estimation procedure to be computationally feasible, are justified by assuming that these structural parameters do not vary too much across economies.

Annex prepared by Francis Vitek and Martin Čihák.

This estimated panel dynamic stochastic general equilibrium model of the world economy has been used to quantify the monetary, fiscal, and macroprudential transmission mechanisms; account for business cycle fluctuations; and generate forecasts of inflation and output growth. The monetary, fiscal, and macroprudential transmission mechanisms, as quantified with estimated impulse response functions, are broadly in line with the empirical literature, as are the drivers of business cycle fluctuations, as accounted for with estimated historical decompositions. Sequential unconditional forecasts of inflation and output growth dominate a random walk in terms of predictive accuracy by wide margins, on average across economies and horizons.

Scenario assumptions

The global asset market disruption scenario assumes that the realization of financial stability risks delays or stalls monetary normalization in the systemic advanced economies. In particular, it assumes an abrupt decompression of asset risk premiums relative to the baseline amplified by low secondary market liquidity in all of the systemic advanced economies as financial risk taking unwinds, interacted with the reemergence of financial stress in some euro area countries. The collapse of financial risk taking is represented by a 50 basis point increase in the long-term government bond yield in Japan, the United Kingdom, and the United States during 2016, induced by term premium decompression driven by internationally correlated duration risk premium shocks. The reemergence of financial stress in some euro area countries is driven by contagion from Greece, reigniting redenomination risk. This is represented by the divergence of long-term government bond yields between other (non core) euro

area countries, where they rise by 100 basis points during 2016, and core euro area countries, where they rise by only 25 basis points. There is also a selloff in stock markets due to lower risk appetite, with the real price of equity falling by 20 percent in the euro area, Japan, the United Kingdom, and the United States during 2016, driven by internationally correlated equity risk premium shocks. The elevated global capital market volatility generated by these bond and stock market adjustments widens the spread of the money market interest rate over the policy interest rate by 25 basis points in the euro area, Japan, the United Kingdom, and the United States during 2016, driven by internationally correlated credit risk premium shocks. The calibration of these global capital market adjustments, summarized in Annex Table 1.2.1, is informed by relevant historical episodes. This makes the global asset market disruption scenario plausible and adverse, but not extreme. In particular, it is broadly consistent with the approximately 20 percent likelihood of failed normalization shown for the United States in Figure 1.3.

The global asset market disruption scenario also assumes credit cycle downturns in all emerging market economies to varying degrees, reflecting their respective stages in the credit cycle (with China undergoing sizable deleveraging). These credit cycle downturns are represented by an increase in the default rate on bank loans to nonfinancial firms in all emerging economies, above and beyond those induced by spillovers from the systemic advanced economies. These exogenous default rate increases average 2 percentage points across emerging market economies, are proportional to their estimated share of corporate debt at risk, and are phased in gradually during 2016 and 2017. In China, the emergence of counterparty credit risk widens the spread of the money market

Annex Table 1.2.1. Global Asset Market Disruption Scenario: Assumptions

Scenario component	Deviation from baseline
<i>Layer 1: Tightening of financial conditions in systemic economies (2016)</i>	
Long-term government bond yield, term premium shocks	
euro area (other)	+100 basis points
euro area (core)	+25 basis points
Japan, United Kingdom, United States	+50 basis points
Real equity price, equity risk premium shocks	
China, euro area, Japan, United Kingdom, United States	–20 percent
Money market interest rate spread, credit risk premium shocks	
China	+100 basis points
euro area, Japan, United Kingdom, United States	+25 basis points
<i>Layer 2: Credit cycle downturns in emerging economies (2016–2017)</i>	
Loan default rate, loan default shocks	+0.1 to 4.5 percentage points
<i>Layer 3: Suppressed economic risk taking worldwide (2016–2017)</i>	
Private investment, investment demand shocks	–0.500 percent
Private consumption, consumption demand shocks	–0.125 percent

Source: IMF staff.

Annex Table 1.2.2. Successful Normalization Scenario: Assumptions

Scenario Component	Deviation from Baseline
<i>Layer 1: Handover from financial to economic risk taking in United Kingdom and United States (2016–17) and euro area and Japan (2017–18)</i>	
Private investment, investment demand shocks	+4.0 percent
Private consumption, consumption demand shocks	+1.0 percent
Long-term government bond yield, duration risk premium shocks	+50 basis points
Real equity price, equity risk premium shocks	+10 percent
<i>Layer 2: Credit cycle upturns in non-core euro area countries (2017–18)</i>	
Loan default rate, loan default shocks	–2.0 percentage points
<i>Layer 3: Smooth financial liberalization and orderly deleveraging in China (2016–17)</i>	
Money market interest rate spread, credit risk premium shocks	+50 basis points
Real equity price, equity risk premium shocks	–20 percent

Source: IMF staff.

interest rate over the policy interest rate by 100 basis points during 2016, driven by internationally correlated credit risk premium shocks. There is also a selloff in the stock market due to lower risk appetite, with the real price of equity falling by 20 percent in China during 2016. Finally, the scenario assumes suppressed economic risk taking worldwide, with private investment falling by an additional 0.5 percent and private consumption declining by an additional 0.125 percent in all economies during 2016 and 2017. These private domestic demand contractions are driven by negative investment and consumption demand shocks representing confidence losses by non-financial firms and households, which raise their saving rates and delay their expenditures. Under this scenario, monetary policy remains at or near the zero lower bound in the systemic advanced economies, where quantitative easing programs remain at their baseline scales. Automatic fiscal stabilizers operate fully in all economies, but discretionary fiscal stimulus measures are not considered. The deployment of policy buffers is not considered, which would mitigate the negative growth impact, particularly in China where substantial buffers exist.

In contrast, the successful normalization scenario assumes that macroeconomic expansions accelerate asynchronous monetary normalization in the systemic advanced economies. In particular, it assumes macroeconomic expansions relative to the baseline in all of the systemic advanced economies as economic risk taking takes hold, with private investment increasing by 4 percent and private consumption rising by 1 percent in the United Kingdom and the United States during 2016 and 2017, and in the euro area and Japan during 2017 and 2018. These private domestic demand expansions are driven by positive investment and consumption demand shocks representing confidence gains by nonfinancial firms and households, which reduce their saving rates and bring forward their expenditures. The reflation they generate accelerates smooth exits of monetary policy from the zero

lower bound, with gradual policy interest rate increases in the wake of successful quantitative easing programs in the United Kingdom and the United States beginning in the first quarter of 2016, and in the euro area and Japan beginning in the first quarter of 2017.

This asynchronous monetary normalization is accompanied by gradual upward shifts of yield curves, with the long-term government bond yield rising by 50 basis points in the United Kingdom and the United States during 2016 and 2017, and in the euro area and Japan during 2017 and 2018. These long-term government bond yield increases are residually induced by term premium decomposition driven by internationally correlated duration risk premium shocks, which shift investor preferences away from long-term bonds. There are also gradual and moderate stock price increases, with the real price of equity rising by 10 percent in the United Kingdom and the United States during 2016 and 2017, and in the euro area and Japan during 2017 and 2018. These stock price increases are residually driven by higher risk appetite represented by internationally correlated equity risk premium shocks, which shift investor preferences toward equities. Finally, the successful normalization scenario assumes credit cycle upturns in some (non-core) euro area countries following successful nonfinancial corporate debt restructuring initiatives, above and beyond those induced by their macroeconomic expansions. This is represented by a decrease in the default rate on bank loans to nonfinancial firms by an additional 2 percentage points during 2017 and 2018. This calibration of the successful normalization scenario, summarized in Annex Table 1.2.2, is designed to clearly differentiate it from the baseline while making it achievable with suitable policies. It is broadly consistent with the approximately 15 percent likelihood of successful normalization shown for the United States in Figure 1.3.

The successful normalization scenario also assumes smooth financial liberalization and orderly deleveraging in China. In particular, it assumes that financial liber-

alization gradually widens the spreads of the deposit and money market interest rates over the policy interest rate by 50 basis points during 2016 and 2017, driven by credit risk premium shocks. It also assumes that a moderation in risk appetite gradually lowers the real price of equity by 20 percent during 2016 and 2017, driven by equity risk premium shocks. This smooth financial liberalization and equity risk premium decompression induces a gradual increase in the default rate on bank loans to non-financial firms, as well as an orderly reduction in the ratio of bank credit to nominal output, reducing the likelihood and severity of a financial crisis. This gradual deleveraging is accompanied by an orderly rebalancing of private domestic demand from investment to consumption.

Shock transmission mechanisms

The Global Macrofinancial Model features a wide range of shock transmission mechanisms. Under both the global asset market disruption and successful normalization scenarios, spillovers are transmitted across economies via trade, financial, and commodity price linkages. These financial linkages encompass cross-bor-

der bank lending, portfolio debt and portfolio equity exposures, as well as contagion effects.

Under the global asset market disruption scenario, output losses are generated by the contractionary effects on private domestic demand of the tightening of financial conditions in systemic economies, credit cycle downturns in emerging market economies, and suppressed economic risk taking worldwide. The operation of these shock transmission mechanisms is explained in Annex Table 1.2.3.

Under the successful normalization scenario, output gains are generated by the expansionary effects on private domestic demand of the handover from financial to economic risk taking in the systemic advanced economies, together with credit cycle upturns in other (non-core) euro area countries. These output gains are offset by losses associated with the smooth financial liberalization and orderly deleveraging in China. The operation of these shock transmission mechanisms is explained in Annex Table 1.2.4.

Simulation results

The global asset market disruption scenario is mildly to severely negative for banking sector capitalization and

Annex Table 1.2.3. Global Asset Market Disruption Scenario: Shock Transmission Mechanisms

Tightening of Financial Conditions in Systemic Economies:

Increases in long-term government bond yields driven by higher term premiums induce:

- Households to raise saving rates in response to higher expected portfolio returns and correspondingly to reduce consumption.
- Firms to reduce investment financed by retained earnings as shareholders discount dividend payments generated from future production at higher rates.
- Governments to gradually face higher debt service costs as outstanding long-term bonds mature and are rolled over in primary markets.

Decreases in real equity prices driven by higher equity risk premiums induce:

- Households to raise saving rates in response to higher expected portfolio returns and correspondingly to reduce consumption.
- Firms to reduce investment financed by retained earnings as shareholders discount dividend payments generated from future production at higher rates.

Increases in money market interest rate spreads driven by higher credit risk premiums induce:

- Households to raise saving rates in response to higher deposit interest rates and expected portfolio returns and correspondingly to reduce consumption.
- Banks to gradually and partially pass through higher funding costs to firms through higher lending interest rates while eroding their profitability and capital buffers.
- Firms to reduce investment financed by retained earnings as shareholders discount dividend payments generated from future production at higher rates, and to reduce investment financed with bank loans in response to higher corporate loan interest rates.
- Governments to immediately face higher debt service costs as outstanding short-term bonds mature and are rolled over in primary markets.

Credit Cycle Downturns in Emerging Economies:

Loan default rate increases reflect endogenous and exogenous components.

- Endogenous loan default rate increases reflect materialization of systemic risk given financial spillovers from systemic advanced economies.
- Exogenous loan default rate increases are proportional to estimated share of corporate debt at risk and capture position in credit cycle.

Loan default rate increases raise credit loss rates of exposed banking sectors, which in turn raise lending interest rates to compensate for higher risk and gradually rebuild capital buffers.

- Higher bank lending interest rates translate into higher corporate loan interest rates, reducing investment by firms.

Suppressed Economic Risk Taking Worldwide:

Confidence losses by households and firms raise their saving rates and delay their expenditures.

- Households intertemporally substitute future for current consumption.
- Firms intertemporally substitute future for current investment.
- Firms to reduce investment financed by retained earnings as shareholders discount dividend payments generated from future production at higher rates.

Source: IMF staff.

government debt sustainability. Reflecting lower financial and economic risk taking, output contracts by 1.2 to 4.0 percent relative to the baseline across economies by 2017, while consumption price inflation falls by 0.9 to 2.2 percentage points, and the unemployment rate rises by 0.4 to 1.3 percentage points. These disinflationary macroeconomic contractions induce policy interest rate cuts of 1.6 to 2.7 percentage points across economies not constrained by the zero lower bound by 2017. The banking sector accommodates and contributes to reductions in private investment with 2.8 to 7.9 percent decreases in bank credit by 2019, implying similar decreases in non-financial corporate debt. Bank capital ratios fall by 0.5 to 4.2 percentage points across emerging market economies by 2018, where loan default and credit loss rates increase more, versus 0.1 to 0.9 percentage points across advanced economies. Reflecting lower nominal output, government debt ratios rise by 1.1 to 17.4 percentage points across advanced economies by 2018, where initial government debt ratios and debt-service cost increases are higher, versus 1.2 to 5.4 percentage points across emerging market economies. Energy and non-energy commodity prices fall by 22.7 and 11.8 percent, respectively, by 2017. In

aggregate, world output is lower by 2.4 percent by 2017 (Annex Figures 1.2.1 and 1.2.2).

The successful normalization scenario has mixed effects on banking sector capitalization and government debt sustainability. Reflecting a successful handover from financial to economic risk taking, output expands by 0.8 to 1.0 percent relative to the baseline across the systemic advanced economies by 2018, while consumption price inflation rises by 0.2 percentage points, and the unemployment rate falls by 0.2 to 0.3 percentage points. These inflationary macroeconomic expansions induce policy interest rate hikes of 0.5 to 0.6 percentage points across the systemic advanced economies by 2018. The banking sector accommodates and contributes to increases in private investment with 1.7 to 2.1 percent increases in bank credit by 2020, implying similar increases in nonfinancial corporate debt. In other (non-core) euro area countries, materially lower loan-default and credit-loss rates translate into 1.2 to 1.5 percentage point increases in bank capital ratios by 2019. As a result of higher nominal output, government debt ratios fall by 0.9 to 2.7 percentage points across the

Annex Table 1.2.4. Successful Normalization Scenario: Shock Transmission Mechanisms

Handover from Financial to Economic Risk Taking in Systemic Advanced Economies:

Confidence gains by households and firms reduce their saving rates and bring forward their expenditures.

- Households intertemporally substitute current for future consumption.
- Firms intertemporally substitute current for future investment.

Increases in long-term government bond yields driven by higher term premiums induce:

- Households to raise saving rates in response to higher expected portfolio returns and correspondingly to reduce consumption.
- Firms to reduce investment financed by retained earnings as shareholders discount dividend payments generated from future production at higher rates.
- Governments to gradually face higher debt service costs as outstanding long-term bonds mature and are rolled over in primary markets.

Increases in real equity prices driven by lower equity risk premiums induce:

- Households to reduce saving rates in response to lower expected portfolio returns and correspondingly to raise consumption.
- Firms to raise investment financed by retained earnings as shareholders discount dividend payments generated from future production at lower rates.

Credit Cycle Upturns in Other (Non-Core) Euro Area Countries:

- Successful nonfinancial corporate debt restructuring initiatives reduce loan default rates.
- Loan default rate decreases reduce credit loss rates of exposed banking sectors, which in turn reduce lending interest rates given lower risk and higher capital buffers.
- Lower bank lending interest rates translate into lower corporate loan interest rates, raising investment by firms.

Smooth Financial Liberalization and Orderly Deleveraging in China:

Increases in deposit and money market interest rate spreads driven by rises in credit risk premiums induce:

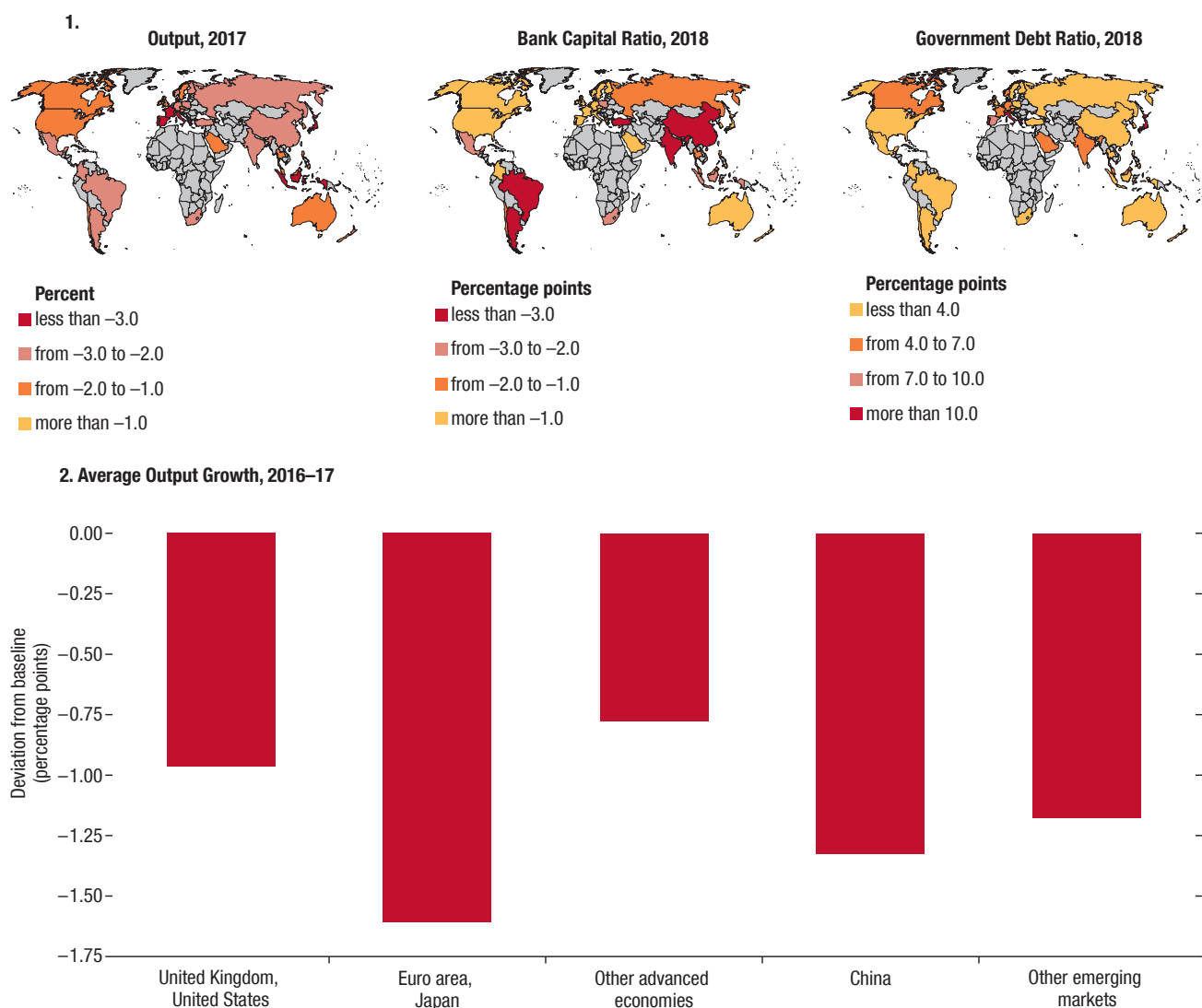
- Households to raise saving rates in response to higher deposit interest rates and expected portfolio returns and correspondingly to reduce consumption.
- Banks to gradually and partially pass through higher funding costs to firms through higher lending interest rates while eroding their profitability and capital buffers.
- Firms to reduce investment financed by retained earnings as shareholders discount dividend payments generated from future production at higher rates, and to reduce investment financed with bank loans in response to higher corporate loan interest rates.
- The government to immediately face higher debt service costs as outstanding short-term bonds mature and are rolled over in the primary market.

Decreases in real equity prices driven by rises in equity risk premiums induce:

- Households to raise saving rates in response to higher expected portfolio returns and correspondingly to reduce consumption.
- Firms to reduce investment financed by retained earnings as shareholders discount dividend payments generated from future production at higher rates.

Source: IMF staff.

Annex Figure 1.2.1. Global Asset Market Disruption Scenario: Simulated Peak Effects



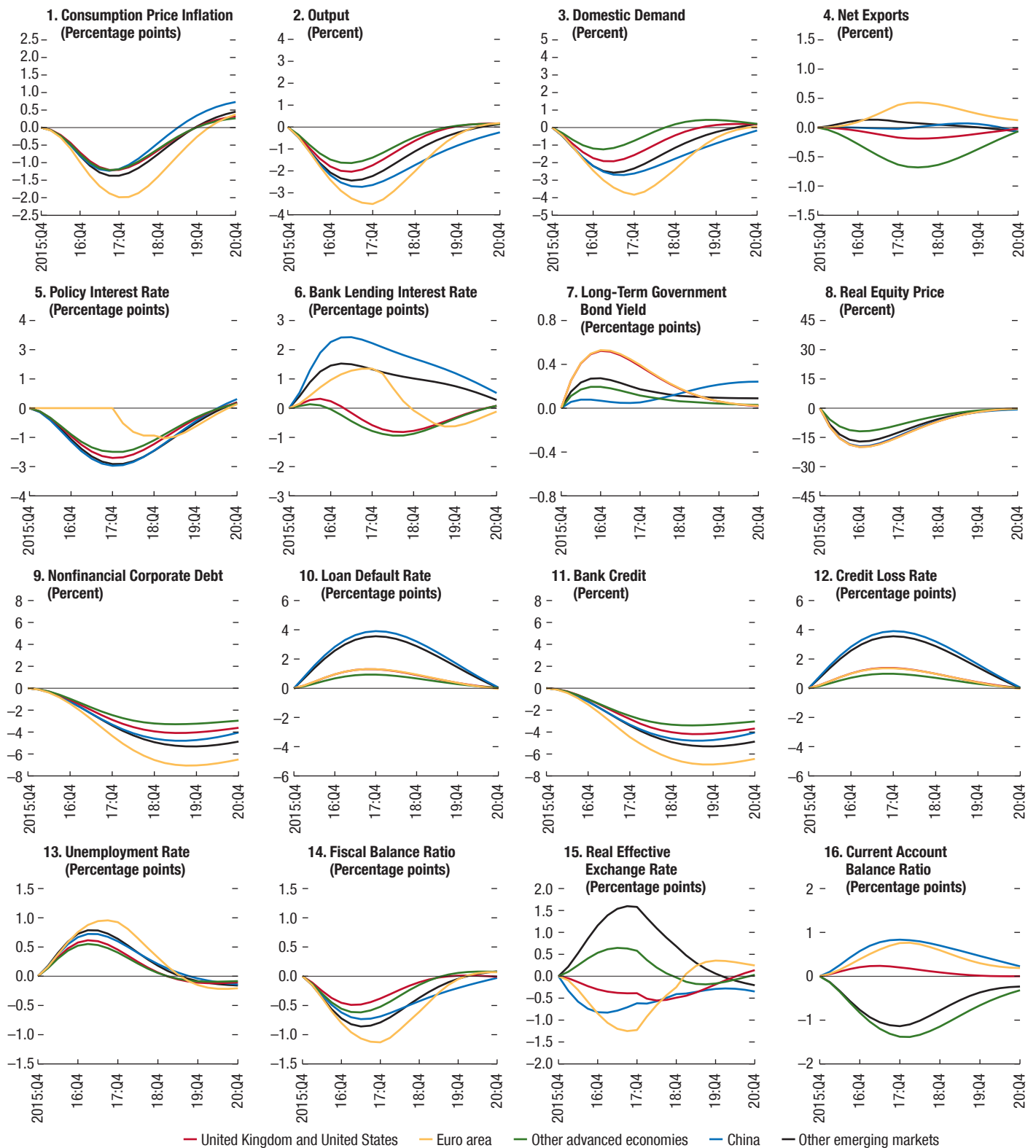
Source: IMF staff calculations, based on Vitek (2015).

Note: Other advanced economies: Australia, Canada, Czech Republic, Denmark, Israel, Korea, New Zealand, Norway, Sweden, and Switzerland. Other emerging markets: Argentina, Brazil, Chile, Colombia, India, Indonesia, Malaysia, Mexico, Philippines, Poland, Russia, Saudi Arabia, South Africa, Thailand, and Turkey.

systemic advanced economies by 2019, in spite of higher debt-service costs. In China, output is lower by 1.4 percent by 2018, reflecting a 7.2 percent fall in private investment, versus a 2.1 percent decline in private consumption. The banking sector accommodates and contributes to this reduction in private investment with a 2.1 percent decrease in bank credit by 2020, implying a similar decrease in nonfinancial corporate debt. In the rest of the world, output expands by up to 0.5 percent or contracts by up to 0.3 percent by 2018. This wide variation across economies reflects differences in the extent to which

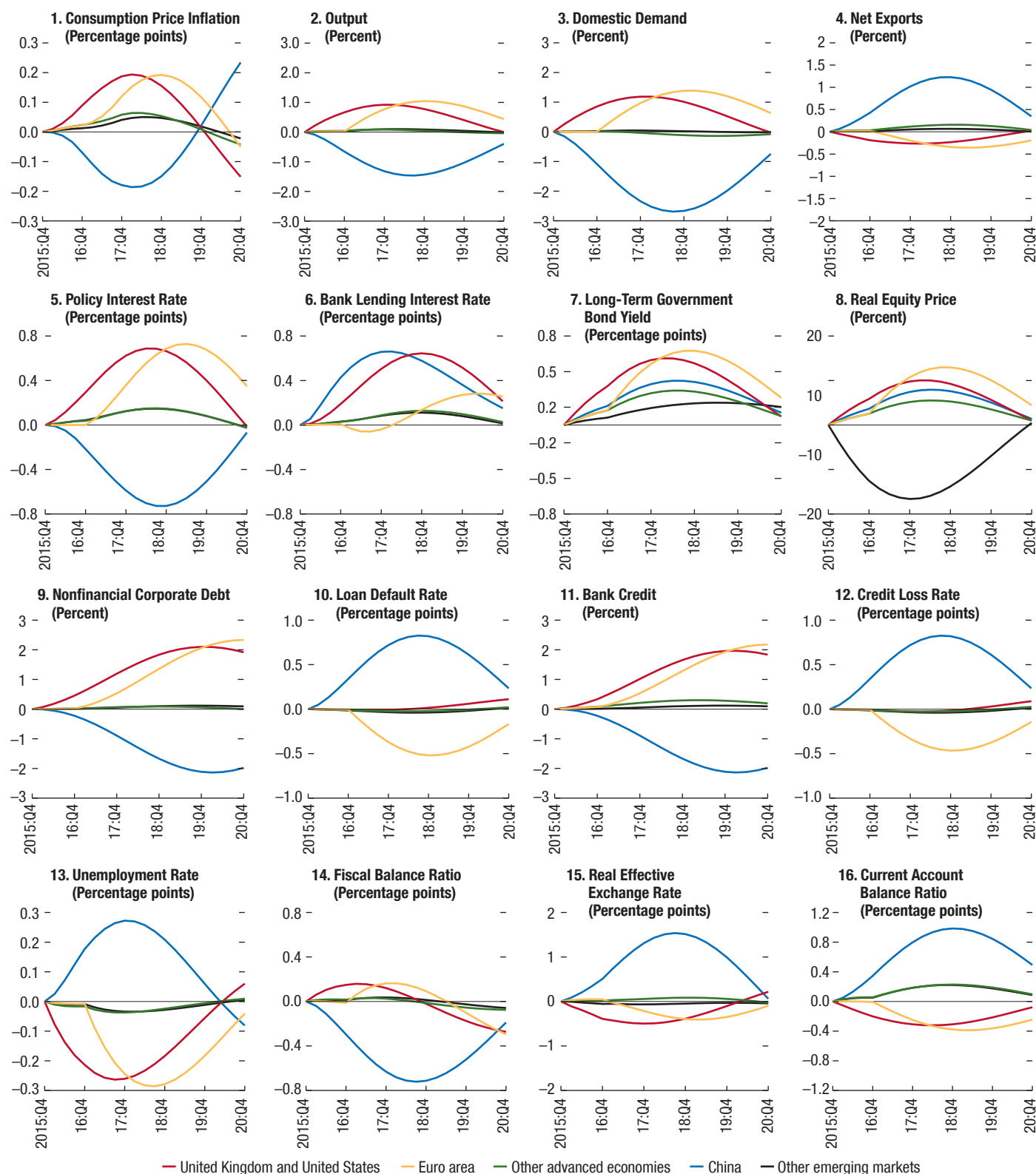
positive trade spillovers from the systemic advanced economies outweigh the sum of net negative financial spillovers from the systemic advanced economies and negative trade spillovers from China. These trade and financial spillovers are interacted with opposing commodity price spillovers from the systemic advanced economies versus China, which differ in sign across net commodity exporters versus importers. Energy and non-energy commodity prices rise by 3.1 and 1.5 percent, respectively, by 2018. In aggregate, world output expands by 0.4 percent by 2018 (Annex Figures 1.2.3 and 1.2.4).

Annex Figure 1.2.2. Global Asset Market Disruption Scenario: Aggregated Simulated Paths



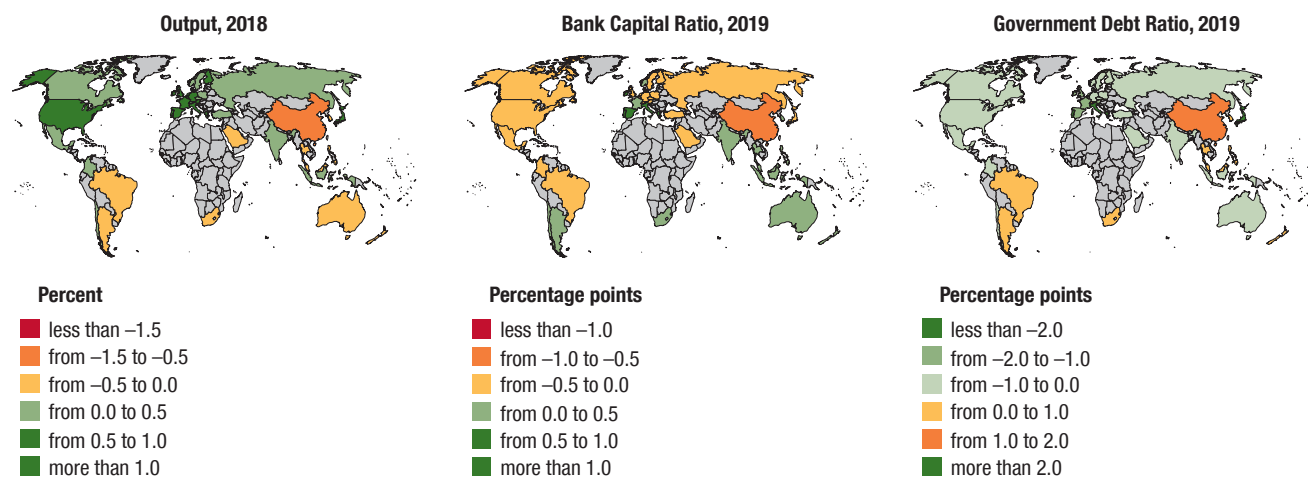
Source: IMF staff estimates.

Note: Other advanced economies: Australia, Canada, Czech Republic, Denmark, Israel, Japan, Korea, New Zealand, Norway, Sweden, and Switzerland. Other emerging markets: Argentina, Brazil, Chile, Colombia, India, Indonesia, Malaysia, Mexico, Philippines, Poland, Russia, Saudi Arabia, South Africa, Thailand, and Turkey.

Annex Figure 1.2.3. Successful Normalization Scenario: Aggregated Simulated Paths

Source: IMF staff estimates.

Note: Other advanced economies: Australia, Canada, Czech Republic, Denmark, Israel, Japan, Korea, New Zealand, Norway, Sweden, and Switzerland. Other emerging markets: Argentina, Brazil, Chile, Colombia, India, Indonesia, Malaysia, Mexico, Philippines, Poland, Russia, Saudi Arabia, South Africa, Thailand, and Turkey.

Figure 1.2.4. Successful Normalization Scenario: Simulated Peak Effects

Source: IMF staff calculations, based on Vitek (2015).

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SUMMARY

Market participants in advanced and emerging market economies have become worried that both the level of market liquidity and its resilience may be declining, especially for bonds, and that as a result the risks associated with a liquidity shock may be rising. A high *level* of market liquidity—the ability to rapidly buy or sell a sizable volume of securities at a low cost and with a limited price impact—is important to the efficient transfer of funds from savers to borrowers and hence to economic growth. Highly *resilient* market liquidity is critical to financial stability because it is less prone to sharp declines in response to shocks. Market liquidity that is low is also likely to be fragile, but seemingly ample market liquidity can also suddenly drop.

This chapter separately examines the factors that influence the level of market liquidity and those that affect its resilience, and finds that cyclical factors, including monetary policy, play an important role. In particular, the chapter finds that only some markets show obvious signs of worsening market liquidity, although dynamics diverge across bond classes. However, the current levels of market liquidity are being sustained by benign cyclical conditions—and some structural developments may be eroding its resilience. In addition, spillovers of market liquidity across asset classes, including emerging market assets, have increased.

Not enough time has passed for a full evaluation of the impact of recent regulatory changes to be made. Reduced market making seems to have had a detrimental impact on the level of market liquidity, but this decline is likely driven by a variety of factors. In other areas, the impact of regulation is clearer. For example, restrictions on derivatives trading (such as those imposed by the European Union in 2012) have weakened the liquidity of the underlying assets. In contrast, regulations to increase transparency have improved the level of market liquidity.

Changes in market structures appear to have increased the fragility of liquidity. Larger holdings of corporate bonds by mutual funds, and a higher concentration of holdings among mutual funds, pension funds, and insurance companies, are associated with less resilient liquidity. At the same time, the proliferation of small bond issuances has almost certainly lowered liquidity in the bond market and helped build up liquidity mismatches in investment funds.

The chapter recommends measures to bolster both the level of market liquidity and its resilience. Since market liquidity is prone to suddenly drying up, policymakers should adopt preemptive strategies to cope with such shifts in market liquidity. Furthermore, because current market liquidity conditions can provide clues about the risk of liquidity evaporations, policymakers should also carefully monitor market liquidity conditions over a wide range of asset classes. The chapter does not, however, aim to provide “optimal” benchmarks for the level or resilience of market liquidity. Market infrastructure reforms (including equal-access electronic trading platforms and standardization) can help by creating more transparent and open capital markets. Trading restrictions on derivatives should be reevaluated. Regulators should consider using tools to help adequately price in the cost of liquidity at mutual funds. A smooth normalization of monetary policy in the United States is important to avoid disruptions in market liquidity in both advanced and emerging market economies.

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Introduction

Market liquidity—the ability to rapidly execute sizable securities transactions at a low cost and with a limited price impact—and its resilience are important for financial stability and real economic activity.¹ A lower level of market liquidity reduces the efficiency with which funds are intermediated from savers to borrowers, and can potentially inhibit economic growth. Market liquidity that is low is also likely to be fragile, that is, prone to evaporation in response to shocks. When liquidity drops sharply, prices become less informative and less aligned with fundamentals, and tend to overreact, leading to increased volatility. In extreme conditions, markets can freeze altogether, with systemic repercussions. Market liquidity is likely to be high if market infrastructures are efficient and transparent, leading to low search and transactions costs; if market participants have easy access to funding; if risk appetite is abundant; and when a diverse investor base ensures that factors affecting certain types of investors do not translate into broader price volatility.

The private provision of market liquidity may not be socially optimal, especially during stress periods. Market participants benefit from abundant and stable market liquidity because it makes transactions less costly and less risky. However, individual traders do not fully internalize the positive externalities for the whole financial system that their participation in the market entails—the more traders trade in a market, the more liquid it becomes. Moreover, because of the network nature of markets, effects tend to be self-reinforcing—high market liquidity tends to attract more traders and so forth. This creates scope for multiple equilibria with different degrees of liquidity (Buiter 2008). To alleviate these problems, in some markets, designated market makers have the obligation to provide liquidity in return for certain advantages.² However, in stress situations, other important market failures play a role. For example, market liquidity can be severely impaired as a result of asset price drops, margin calls, and induced fire sales and liquidity feedback loops.³ Similarly, liquidity contagion across markets can occur.⁴ The

potentially dramatic effects of sharp declines in liquidity were evident in 2008, during the financial crisis, when market illiquidity amplified shocks originating elsewhere.⁵

Concerns about both a decline in current market liquidity, especially for fixed-income assets, and its resilience have risen lately. Events such as the October 2014 Treasury bond flash rally in the United States, or the April 2015 Bund tantrum in Europe, have reminded us that market liquidity is fickle and that market dislocations can occur even for some of the most liquid assets. Market participants in both advanced and emerging market economies have been expressing worries about a perceived decline in liquidity in a variety of markets. Associated with these worries are concerns about the resilience of market liquidity to larger shocks, such as a “bumpy” normalization of monetary policy in advanced economies. In this context, Chapter 1 of the April 2015 *Global Financial Stability Report* (GFSR) warned of the risk that liquidity could potentially vanish.

In recent years, important transformations in financial markets have had potentially conflicting effects on market liquidity. As banks have been changing their business models and shrinking their inventories, market-making services seem to have become concentrated in fewer clients.⁶ In addition, regulations requiring banks to increase capital buffers and restrictions on proprietary trading may have led them to retrench from trading and market-making activities. The introduction of electronic trading platforms and the growing use of automated calculations for computerized trades may have made market liquidity less predictable.

Another key development has been the rise of larger but more homogeneous buy-side institutions, particularly investment funds.⁷ Mutual funds have become

⁵During the crisis, the effects of the uncertainty surrounding the valuation of asset-backed securities was most likely amplified by a dry-up in liquidity in some markets (Acharya and others 2009).

⁶An intermediary makes a market in a security when it stands ready to sell the instrument at the announced “ask” price and buy it at the announced “bid” price. Market making requires sufficient inventories of the security and large risk-bearing capacity. Under liquid market conditions, market makers (or dealers) execute financial transactions at low bid-ask spreads. See CGFS (2014) for additional explanations and the results of a survey of market participants.

⁷Buy-side institutions are asset managers and other firms that demand “liquidity services,” that is, the immediate execution of trades. Sell-side institutions, including many banks, can trade at announced prices, thus providing immediate execution (Hasbrouck 2007).

¹Two alternative and widely used concepts of liquidity are funding liquidity—the ease with which financial intermediaries can borrow—and monetary liquidity, typically associated with monetary aggregates. See Box 2.1.

²See Bessembinder, Hao, and Lemmon (2011) for a theoretical discussion.

³See Brunnermeier and Pedersen (2009).

⁴Externalities caused by market illiquidity during stress periods are well documented in the literature. Specifically, readers can refer to Duarte and Eisenbach (2015) and the references therein.

Box 2.1. How Can Market Liquidity Be Low Despite Abundant Central Bank Liquidity?

As a response to the global financial crisis, several central banks adopted a variety of unconventional monetary policy measures that included asset purchases, or so-called quantitative easing (QE) measures, and the expansion in the availability of central bank liquidity to the financial sector through specific facilities. Various facilities included changes to eligible collateral against which the central bank would extend credit. As a consequence, bank reserves with central banks have soared. Despite this, fears about bouts of market illiquidity have increased. This box tries to explain this apparent contradiction.

Impact on market liquidity

It has long been argued that monetary policy affects market liquidity (Fleming and Remolona 1999). Traditional monetary policy expansions affect market liquidity by reducing the costs of market making and trading. The reduction in market-making costs may be greater if overall uncertainty is reduced. However, the unconventional measures taken by central banks after the global financial crisis have had additional effects on market liquidity. Overall, the above measures affect market liquidity of their targeted markets through the following channels:

The bank funding channel—Like other open-market operations, central banks' purchases of long-term securities increase bank reserves, and therefore funding liquidity. The improved funding liquidity of banks relaxes their funding constraints, making it easier to finance their inventories and thereby supporting market liquidity (Brunnermeier and Pedersen 2009).¹ Indirectly, banks' greater funding liquidity also allows them to continue or increase margin funding to traders or lending to other market makers, with positive effects on the liquidity of securities markets.

However, the link between monetary liquidity and market liquidity is not straightforward, and in recent years, banks have actually retrenched from repo markets. Market participants often attributed this to regulatory changes that have raised the cost of this activity for banks (ICMA 2014). More generally, however, banks may be reluctant to engage in repo or margin lending because of high aggregate uncertainty

(Freixas, Martin, and Skeie 2011) or the need to self-insure against funding shocks (Ashcraft, McAndrews, and Skeie 2011).

The market functioning channel—Outright purchases by central banks directly affect the liquidity of the securities being bought by central banks by reducing search frictions that prevent investors from finding counterparties for trades (Lagos, Rocheteau, and Weill 2011).² In addition, the presence of a committed and solvent buyer in the market reduces the illiquidity risk for the target securities, and may therefore support market making in these securities and enhance market functioning. As a consequence, the liquidity premium—the compensation investors require to hold a security that cannot easily be sold at a fair market value—is reduced. This market-functioning channel only works for the duration of the QE program or if investors believe the central bank would intervene again in the market should the price of the securities drop too much (Christensen and Gillan 2015).

On the other hand, when certain assets become scarce as a result of central banks' purchases, search costs are raised and those assets' market liquidity is reduced. In particular, outright purchases of high-quality government debt securities may be reducing the total amount of collateralizable securities and contributing to reduced liquidity in repo markets (Singh 2013). Evidence presented in the chapter suggests that this effect may have recently become more important in the United States.

The risk appetite channel—Evidence indicates that accommodative monetary policy increases risk appetite (Bekaert, Hoerova, and Lo Duca 2013; Jiménez and others 2014). When market makers' appetite grows, they are more likely to hold inventories and facilitate trades. Similarly, increased risk appetite implies a higher propensity to engage in trades by other market participants.

Longer-term impact on the investor base and market structure

The prolonged period of easy monetary policies and low interest rates in advanced economies has likely induced a “search for yield” by investors seeking

This box was prepared by Luis Brandão-Marques, Frederic Lambert, and Kai Yan.

¹For example, the report discusses the role of the European Central Bank's collateral eligibility framework.

²These frictions may include dealer failures, communications breakdowns, uncertainty about counterparties' abilities to fulfill trades, and informational asymmetries between dealers and traders. In extreme situations, such frictions may lead to considerable market illiquidity even when funding liquidity is high.

Box 2.1. (continued)

higher returns by investing in less-liquid and more risky bonds. Furthermore, it has also boosted the growth of open-end mutual funds and exchange-traded funds investing in longer-term assets while offering daily liquidity, potentially raising liquidity risk (GFSR October 2014, Chapter 2; GFSR April 2015, Chapter 3). Moreover, these developments have resulted in a more homogeneous, and partly more concentrated, ownership structure.

Other forces and overall effects

Overall, this chapter argues that monetary policy has had a positive impact on market liquidity in recent years. On the other hand, as discussed in the text, various structural changes have been working in the opposite direction, reducing market liquidity. The combination of these forces has yielded the mixed picture of market liquidity that we currently observe.

more important for financial intermediation while becoming more sensitive to redemption pressures, more prone to herd behavior (as documented in the April 2015 GFSR), and less likely to absorb order flow imbalances or to make markets. The behavior of hedge funds has become more comparable to that of mutual funds, the role of index-driven and benchmark-driven investment has grown, and the inclination of pension funds and insurance companies to act countercyclically may have declined (Chapter 1 of the October 2014 GFSR).

In addition, unconventional monetary policies involving protracted, large-scale asset purchases are likely to have affected market liquidity in contradictory ways. On the one hand, in some markets the policies have probably enhanced market liquidity by positioning the central bank as a predictably large buyer. On the other hand, the asset purchases have drastically reduced the net supply of certain securities available to investors. Moreover, easy monetary policies have induced a search for yield, prompting funds to invest in bonds with low market liquidity.

These developments call for a better understanding of the factors influencing market liquidity and its resilience, especially in bond markets. Bond prices strongly affect consumption and investment—and hence macroeconomic stability—through interest rate and wealth effects. Bond prices also affect financial stability through their pivotal role in the repo market and their connection to funding liquidity.⁸ Moreover, evidence suggests that the bond market is the medium through which monetary policy affects the market liquidity of other asset classes (Goyenko and Ukhov 2009).

⁸Repo markets, for the purposes of this chapter, are considered pertinent mostly to funding liquidity and are not covered by the empirical analyses.

With a special focus on fixed-income assets, this chapter investigates the following questions:

- How has market liquidity evolved in key markets in recent years?
- How has the resilience of market liquidity evolved across markets?
- What factors have driven these developments?

The chapter tackles these issues in three stages, using novel approaches to analyze rich and highly granular data sets. First, the chapter discusses developments in key markets. Next, relying largely on event studies, it sheds light on the different effects of various factors on the level of market liquidity. Finally, the chapter (1) demonstrates that high liquidity can be fragile, and (2) shows how liquidity shocks propagate across markets.

The main findings are as follows:

- *Only some markets show obvious signs of worsening market liquidity.* The evidence, however, points to diverging dynamics across bond classes. Market liquidity indicators for high-yield and emerging market bonds have started to weaken relative to those for investment-grade bonds.
- *Benign cyclical conditions are masking liquidity risks.* Cyclical factors are among the most important drivers of liquidity, and changes in them can help predict shifts in liquidity regimes. Currently, many of these cyclical determinants—investor risk appetite, and macroeconomic and monetary policy conditions—are creating very benign market liquidity conditions, but they can turn quickly, and spillovers of weak liquidity across asset classes (including emerging market assets) have increased.
- *Regulatory changes are likely to have had mixed effects on market liquidity.* Reductions in market making appear to have harmed market liquidity, and banks

now seem to face tighter balance sheet constraints for market making compared with the precrisis period. Nevertheless, conclusive evidence regarding the role of regulation as the driver of this development is still lacking. Restrictions on derivatives trading imposed by the European Union (EU) also have weakened the liquidity of the underlying assets. In contrast, regulations to increase transparency have improved market liquidity by facilitating the matching of buyers and sellers and reducing uncertainty about asset values.

- *Changes in the investor base have likely increased liquidity risk.* Larger holdings by mutual funds, and a higher concentration of holdings among mutual funds, pension funds, and insurance companies, are associated with less resilient liquidity.
- *On balance, monetary policy has had a positive impact on market liquidity in recent years but may have increased liquidity risk.* Monetary policy helped relax funding constraints for financial intermediaries and heighten risk appetite, with important effects on market liquidity. However, outright purchases of some securities have reduced their supply; in the United States, this effect now seems to have started to dominate for those securities, to the detriment of their liquidity. Moreover, accommodative monetary policy has triggered a search for yield, with a rise in holdings of less liquid assets by funds and institutional investors.

The findings suggest the following policy recommendations:

- Policymakers should adopt preemptive strategies to deal with sudden shifts in market liquidity. Since current market liquidity conditions provide information about the risk of liquidity suddenly drying up, policymakers should monitor market liquidity conditions in real time and for a wide range of asset classes using transactions-based metrics.
- Since electronic trading platforms can facilitate the emergence of new market makers, asset managers and other traders should, in principle, have access to these platforms on equal terms.
- Trade transparency in capital markets and instrument standardization should be promoted to improve market liquidity.
- Given their negative effect on market liquidity, restrictions on derivatives trading, such as those implemented by the EU in 2012, should be reevaluated.

- Central banks should be mindful of the side effects on market liquidity arising from their policies on collateral and outright purchases of securities.
- Ways to reduce both liquidity mismatches and the first-mover advantage at mutual funds should be considered (April 2015 GFSR, Chapter 3).
- As the Federal Reserve begins to normalize its monetary policy, a smooth implementation will be critical to avoid disruptions of market liquidity, in both advanced and emerging market economies.

Market Liquidity—Concepts and Drivers

Concept and Measurement

Market liquidity is the ability to rapidly execute sizable securities transactions at a low cost and with a limited price impact. Market liquidity is different from the notions of funding liquidity (the ability by market participants to obtain funding at acceptable conditions) and monetary liquidity (typically used in relation to monetary aggregates). Despite their differences, these three concepts are related. Funding liquidity, for example, is typically a prerequisite for market liquidity, since market makers also use credit to maintain inventories. Market liquidity, for its part, tends to enhance funding liquidity because margin requirements depend on the ease with which securities can be sold (Foucault, Pagano, and Roell 2013). Monetary expansions ease funding conditions for banks, which in turn can facilitate market-making activities (see Box 2.1 for more details). However, the relationship between these three concepts is not one-to-one, and other factors play a role.

Two aspects of market liquidity must be considered: its level and its resilience. Low levels of liquidity may foretell low resistance to shocks. But measures of the level in normal times may be insufficient to assess the risk that a shock will produce if liquidity “freezes.” A well-known characteristic of market liquidity is that it can suddenly disappear during periods of market stress, causing asset prices to strongly overreact to unexpected events.

Can market liquidity be too high? It is difficult to envisage adverse effects of market liquidity in the absence of other major distortions. Higher market liquidity in general reduces volatility and speeds up information aggregation. Conceivably, high market liquidity levels that are largely driven by cyclical factors

can foster the “illusion” of resilient market liquidity, inducing excessive risk taking (Clementi 2001). However, in this case it is the lack of resilience in market liquidity, rather than high market liquidity itself, that is harmful for financial stability. When investors are irrationally overconfident, in theory, high market liquidity could favor trading frenzies and amplify asset price bubbles (Scheinkman and Xiong 2003).⁹ Yet, in general, it is easier to think of situations in which funding liquidity rather than market liquidity can be excessive. For example, high funding liquidity can lead financial institutions to take on excessive leverage, which can be detrimental to financial stability (Geanakoplos 2010).

A challenge for financial stability policy is to understand and attenuate the forces that, in the presence of a shock, can suddenly transform a state of high liquidity into one of low liquidity. Abundant and stable market liquidity has aspects of a public good—it benefits all the participants in the market and it is difficult to exclude participants from it; moreover, a sharp decline in market liquidity can adversely affect financial stability. These considerations suggest the potential for liquidity underprovisioning and imply a role for public policy in fostering sound market infrastructures and regulations to enhance liquidity. Moreover, the externalities associated with collapses in market liquidity and associated adverse feedback loops provide an argument for monitoring and managing the conditions that affect the resilience of market liquidity to financial shocks. In situations of stress, direct intervention may be needed. The chapter analyzes factors influencing the level of liquidity in the section on “Changes in Drivers of Market Liquidity—Empirical Evidence on Their Impact.” The problem of predicting its resilience is examined in the section on “Liquidity Resilience, Liquidity Freezes, and Spillovers.”

The level of market liquidity has many dimensions and cannot be captured by any single measure. However, depending on what dimension of market liquidity one is trying to assess—time, cost, or quantity—some measures are more informative than others. Some measures, such as imputed “round-trip costs,” effective spreads (actual or estimated), and Amihud’s (2002) price impact measure capture the cost dimension. Others, such as quote depth or dealer depth, capture the quantity dimension (see Table 2.1). This chapter emphasizes the following cost measures, which closely correspond to the definition of the level of market

liquidity used in this chapter: the round-trip costs of trades (the cost of buying a security and immediately selling it), effective bid-ask spreads (actual or estimated), and price impact measures.¹⁰

General Drivers of Market Liquidity Levels and Resilience

The drivers of market liquidity levels and resilience comprise three broad categories (Figure 2.1). These include (1) the risk appetite, funding constraints, and market risks faced by financial intermediaries, all of which affect their inclination to provide liquidity services and correct the mispricing of assets by taking advantage of arbitrage opportunities; (2) search costs, which influence the speed with which buyers and sellers can find each other; and (3) investor characteristics and behavior reflecting different mandates, constraints, and access to information (Vayanos and Wang 2012; Duffie 2012).

- In recent years, structural developments, as well as monetary policy, have probably affected these fundamental drivers.
- Tighter funding constraints for trading—induced by changes in regulations and in business models—have arguably lowered dealers’ risk-taking capacity or willingness to make markets and reduced banks’ proprietary trading activities (CGFS 2014; Elliott 2015). Less market making impedes the matching of buyers and sellers, thereby increasing search costs.
- New regulations in major jurisdictions have also affected search costs both positively and negatively in various asset markets.¹¹ For instance, new trade transparency requirements probably reduced search costs, whereas the EU’s ban on uncovered sovereign credit default swap (CDS) positions had the opposite effect.

¹⁰Some commonly used metrics can be misleading. Market turnover is a widely available quantity measure whose high readings during turbulent times are often taken to indicate high liquidity even though market liquidity at such times may, in fact, be very low (that is, transactions have a large price impact). For cost, quoted bid-ask spreads that are not based on actual transactions may not reflect the actual costs of trades.

¹¹For instance, since 2002 the United States has gradually increased posttrade transparency for corporate bonds by requiring the dissemination of trade information. Also in the United States, the Dodd-Frank Act of 2010 brought greater transparency to over-the-counter derivatives by mandating the disclosure of trades in swap data repositories. In 2017, the Directive on Markets in Financial Instruments (MiFID 2) regulation is scheduled to extend to fixed-income markets many of the pre-and posttrade transparency requirements that currently apply to equities.

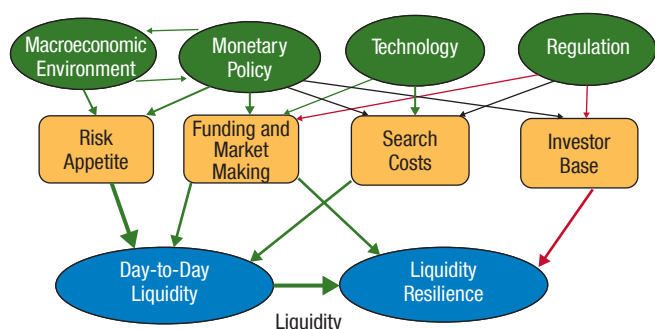
⁹Asset price bubbles also occur in highly illiquid markets such as the real estate market (Shiller 2000).

Table 2.1. Liquidity Measures

Measures	Data Requirements	Calculation Method	Aspect of Market Liquidity
Bid-ask spread	Quotes	The quoted ask price minus the quoted bid price.	A measure of transaction costs. It shows how much a trader pays by buying and then immediately selling a given security.
Turnover	Volume data	Trade volume divided by market value of outstanding securities.	A measure of trading activity not necessarily related to market liquidity.
Roll's (1984) price reversal	Price data	Covariance between price change in time t and time $t-1$.	A measure of bid-ask spreads. It exploits the fact that buy and sell orders arrive randomly and force prices to bounce between ask and bid quotes. This generates a negative autocovariance of returns, under restrictive assumptions.
Corwin and Schultz's (2012) high-low spread	Price data	Nonlinear function of two-day high and low prices.	Similar to Roll's (1984) metric. It measures transaction costs by estimating a bid-ask spread when quote data are not available or unreliable. It uses information on intraday high and low prices.
Effective spread	Price and quotes data	The transaction price minus the quoted mid price (simple average of the best bid and ask quotes).	The actual, round-trip-equivalent, cost of trading to the liquidity demander. It captures how far away from the mid price trades are actually taking place.
Imputed round-trip cost	Price and volume data	The highest price of a security minus the lowest price of the same security with the same trade size within one day.	An indirect measure of the round-trip cost. Captures transaction costs in fixed-income markets by calculating how much it costs if a trader buys and sells the same security at the same day in the same amount. It is useful when there are no quoted prices available.
Price impact	Price and trading volume	Slope coefficient of a regression of price change on signed order flow (buyer-initiated trades minus seller-initiated trades).	A measure of market depth. It estimates the change in price for a given trading volume. In other words, it represents the marginal cost of trading an additional unit of quantity (Holden, Jacobsen, and Subrahmanyam, forthcoming).
Amihud's (2002) measure	Daily price and volume	Absolute daily return divided by daily volume.	A measure of market depth. It shows the daily price change associated with one dollar of trading. Market depth captures the quantity dimension of market liquidity, that is, the ease with which one can trade securities in large amounts.
Quote depth	Quotes	Total number of quotes or sum of quote sizes (total quantities dealers are willing to buy or sell at announced ask and bid prices).	A direct measure of market depth. It documents the depth of the order book and captures the quantity of securities for which dealers are willing to supply liquidity services.
Dealer count	Unique providers of quotes	Number of dealers quoting the security or showing some availability to trade.	An indirect measure of market depth that documents the number of dealer quotes we have on a given security. It also roughly captures the availability of market making.
Markit's liquidity score	Price and quotes data	An instrument-specific index of liquidity calculated by Markit that captures the following aspects: number of dealers; number of quotes; number of price sources; and bid-ask spreads. For bonds, it also takes into account the maturity and whether a benchmark yield curve with liquid bonds exists. For CDS contracts, it also includes volumes, number of price points, and index membership (for single-name CDS).	A composite measure of market liquidity. It provides an ordinal approximation of the many dimensions of liquidity based on observable bond and trade characteristics, with special emphasis on trade costs and data quality. According to Markit, it estimates market breadth—the number of participants in a market—and implied liquidity (useful when data are incomplete or securities do not trade often). A smaller value implies higher liquidity.

Source: IMF staff.

Note: CDS = credit default swap.

Figure 2.1. Drivers of Liquidity and Liquidity Resilience

Source: IMF staff.

Note: Green (red) arrows signify a positive (negative) effect. Black arrows signify an ambiguous or unknown effect. A thicker arrow suggests a stronger effect.

- The growth of electronic trading platforms should have, in principle, reduced search costs. But the implications of the associated advance of automated trades (algorithmic trading) are unclear. They are potentially adverse if such trading is mainly used to demand immediate liquidity or the algorithms are poorly designed. Conceivably, they may have increased the probability and severity of large market dislocations (Box 2.2; Laganá and others 2006).¹²
- Central banks' large-scale purchases of securities under unconventional monetary policy are likely to have affected market liquidity both positively and negatively—positively by relaxing funding constraints, reducing term and default premiums, and raising risk appetite; and negatively by reducing the supply of certain bonds and thereby raising search costs for market participants (Box 2.1). However, the search for yield in a low-interest-rate environment has likely spurred the demand for corporate bonds and stimulated an increase in the number of smaller issues, thus increasing search costs.

These issues are examined empirically in the “Changes in Drivers of Market Liquidity—Empirical Evidence on Their Impact” section.

Changes in other factors have potentially reduced the resilience of liquidity (Box 2.3), while the smaller

role of highly leveraged financial intermediaries may have dampened the risk that liquidity might suddenly disappear.

- The growing role in bond markets of mutual funds that offer daily redemptions to retail investors, coupled with signs of increasing herding and concentration among market participants, has made market liquidity more vulnerable to rapid changes in sentiment (CGFS 2014; April 2015 GFSR, Chapter 3).
- This buildup of liquidity risk in the asset management industry was likely encouraged by accommodative monetary policy and the ensuing search for yield (Gungor and Sierra 2014).
- Similarly, the growth of index investors and the more widespread use of benchmarks are likely to have increased commonality in liquidity and thereby systemic liquidity risk.
- At the same time, hedge funds are said to have become more similar to mutual funds in their behavior (October 2014 GFSR, Chapter 1).
- Developments at hedge funds and traditional broker-dealers since the global financial crisis have likely moderated liquidity risk. Although these institutions may have reduced market making by paring back their leverage or their trading activities, they have also reduced the self-reinforcing link between leverage and market liquidity risk.¹³

The issue of predicting the risk of liquidity freezes is examined in the “Liquidity Resilience, Liquidity Freezes, and Spillovers” section.

Market Liquidity—Trends

This section examines the evolution of market liquidity for corporate and sovereign bonds with an emphasis on cost measures of liquidity. The precise choice of market liquidity measure varies according to data availability and market micro-structure; however, all measures try to approximate trade costs.¹⁴

Among major bond markets, only the U.S. Treasury market appears at first glance to have recently suffered a

¹²Compared with other asset classes, electronic platforms are not prevalent in the trading of corporate bonds (with a share between 10 percent and 20 percent) (McKinsey & Company and Greenwich Associates 2013). Hence, in this chapter, electronic trading does not receive as much attention as other drivers of market liquidity.

¹³See Acharya and Viswanathan (2011) for a theoretical explanation of the link between bank leverage, asset fire sales, and market liquidity spirals.

¹⁴For instance, for markets in which securities trade infrequently, such as the corporate bond markets, a measure such as Corwin and Schultz's (2012) estimated bid-ask spreads cannot be calculated.

Box 2.2. Electronic Trading and Market Liquidity

In the past few decades, electronic trading platforms have been introduced in a wide variety of markets. This box examines the potential benefits and costs of electronic trading platforms. Using the example from the over-the-counter (OTC) derivatives market, it argues that the introduction of electronic platforms is generally beneficial to market liquidity. However, some recent liquidity episodes also point to the potential vulnerabilities brought about by electronic trading, especially high-frequency trading.

Electronic trading platforms can potentially affect market liquidity in several ways. On the one hand, electronic trading can greatly facilitate matching between buyers and sellers. On the other hand, new trading strategies enabled by electronic trading platforms can potentially cause disruptions to market liquidity in the face of shocks.

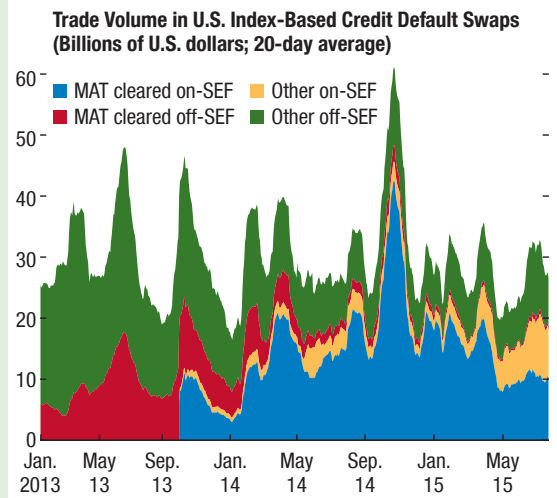
Although studies of the impact of electronic trading on the market liquidity of corporate bonds are still scarce, in general they find it to be beneficial. The electrification of fixed-income markets makes it easier to match buyers and sellers by accessing a central limit order book on electronic trading venues. Hendershott and Madhavan (2015) find that electronic auction markets improve the liquidity of thinly traded corporate bonds (although the effects are larger for the most liquid ones). Furthermore, Chaboud and others (2014) find that, in the foreign exchange market, algorithmic trading enhanced price efficiency and average liquidity.

For securities that are originally traded in the OTC markets, the migration to electronic trading platforms can lead to a boost in trading volume and market liquidity, or improve price discovery (Zhu 2012). In the United States, the migration of several OTC derivatives contracts to electronic trading platforms started in October 2013, with the Commodity Futures Trading Commission (CFTC) authorizing the first Swap Execution Facility (SEF). Furthermore, effective in February 2014, the U.S. authorities mandated that all contracts that the CFTC has designated as “made available to trade” with U.S. counterparties be executed on a SEF or exchange market. The first wave of made-available-to-trade designations has focused on highly standardized and centrally cleared contracts, such as certain interest rate swaps and index-based credit default swaps (Figure 2.2.1). Once the implications of these developments

This box was prepared by Antoine Bouveret, Yingyuan Chen, David Jones, John Kiff, Tsuyoshi Sasaki, and Kai Yan.

Figure 2.2.1. Trade Volume in U.S. Credit Default Swaps

The volume of on-SEF trading in credit default swaps in the United States has greatly increased.



Sources: ISDA-SwapsInfo; and IMF staff calculations.

Note: MAT = made available to trade; SEF = Swap Execution Facility.

for market liquidity in OTC derivatives become clear, important lessons may be drawn for the greater electrification and standardization of the corporate bond markets.

However, electronic trading platforms can also facilitate the growth of high-frequency trading (HFT) firms, with a potential negative impact on the resilience of liquidity. These firms are thought to have been one of the causes of the October 2014 flash rally episode in the U.S. Treasury market. Events such as this, and the May 6, 2010, flash crash in U.S. equity and equity futures markets, show how liquidity can evaporate very quickly even on the most liquid markets in the world and how the lack of liquidity can amplify shocks, resulting in heightened levels of volatility (see Easley, Lopez De Prado, and O'Hara 2011).

The structure of U.S. Treasury markets has experienced significant changes during the past decade, with a declining role for banks and a rise of HFT. The provision of liquidity changed because banks arguably now have less balance sheet space dedicated to market-making strategies, and HFT firms typically operate with very low capital. In normal times, liquidity is ample but when confronted with a shock, the market is more vulnerable because traditional and new market makers are unable or unwilling to provide liquidity.

Box 2.2. (continued)

On October 15, 2014, the U.S. Treasury futures market experienced one of the most volatile episodes of the past 25 years. A disappointing retail sales data release prompted hedge funds to reposition for a delayed Fed rate increase. As prices gradually rose, traditional market makers reduced their provision of liquidity, as shown by the steady decline in order book depth between 8:50 a.m. and 9:33 a.m. of that day (Figure 2.2.2¹). At the same time, large volumes of algorithmic and other HFT activity were taking place. In the next 12 minutes, liquidity evaporated and a few large trades had a large enough impact on the market

¹Figure 2.2.2 is available online as a PDF download at IMF.org and elibrary.IMF.org.

to set into motion the dynamics of the flash event. High trading volumes amid very low liquidity resulted in a feedback loop: HFT firms traded aggressively to reduce their risk but given that liquidity was low, the price impact of each trade increased volatility, leading to further trades (Bouveret and others, forthcoming).

A joint report by U.S. authorities (U.S. Department of the Treasury and others 2015) also emphasizes the predominance of HFT and the declining role of broker-dealers. During the flash dynamics, the share of trading done by HFT firms increased markedly to account for 80 percent of trading activity (compared with 50 percent on control days), as HFT firms aggressively bought during the price rise and sold during the decline.

deterioration of liquidity (Figure 2.2, panel 2). Nevertheless, that market remains highly liquid compared with most other large markets, and estimated bid-ask spreads are close to their 2004 levels. In the bond markets of the United States, Europe, and emerging market economies, imputed round-trip costs (or similar metrics of liquidity) are generally below their 2007 levels.

The level and resilience of market liquidity for higher-grade corporate bonds appears to be becoming increasingly stronger than that for lower grades. During the past year, quoted spreads of corporate bonds issued in emerging market economies have been rising faster than the spreads for those issued in advanced economies. For investment-grade corporate bonds, the short-term resilience of market liquidity—expressed as the pace at which the level of market liquidity recovers from bad news or unexpected events—seems to be improving faster than that for high-yield issues (Figure 2.3).¹⁵

Finally, the price impact of trades has risen in some markets. The price impact has increased for various European sovereign bonds and, to a lesser extent, for high-yield corporate bonds. An indication that large trades may now be harder to execute than 10 years ago is that the share of large transactions in trades involving U.S. corporate bonds has fallen (Figure 2.3).¹⁶

¹⁵The speed at which liquidity recovers from small perturbations is calculated by regressing the daily changes in aggregate market liquidity on the lagged changes and the lagged level of liquidity. When the coefficient of lagged liquidity is closer to zero, the resilience of liquidity is estimated to be lower.

¹⁶Likewise, in the futures and equity markets, large trades are more expensive than smaller trades (Kraus and Stoll 1972), and the share of

Changes in Drivers of Market Liquidity— Empirical Evidence on Their Impact

This section examines some of the drivers of the level of market liquidity. Because causality between drivers and market liquidity often goes both ways, most of the analyses rely on event studies. Although most (but not all) of the data pertain to securities issued or traded in advanced economies, many implications carry over to emerging market economies.¹⁷

When considering the extent to which changes in the various drivers have affected liquidity, it is typically difficult to sort out the direction of causality. Thus, the testing of the link between a change in a driver such as market making and a change in the level of market liquidity must take reverse causality into account—that is, the possibility that a change in liquidity can cause a change in the supposed driver. For example, market makers are more willing to provide liquidity services for securities that are more liquid. The approach taken here to overcome problems of reverse causality is to

large trades has declined (see the statistics of the World Federation of Exchanges). But as in the corporate bond market, traders now avoid the higher cost of executing a large trade by exploiting technological improvements in risk management and trading platforms to break large trades into many small ones. Hence, the total cost of making what used to be a large trade has probably declined. In addition, the recent increase in corporate bond issuance also reflects a higher share of small issues.

¹⁷In addition, for the asset class featured prominently in the section—corporate bonds traded in the United States—some of the securities were issued by entities domiciled in emerging market economies.

Box 2.3. Structural Drivers of the Resilience of Market Liquidity

Several structural drivers have potentially affected the ability of market liquidity to withstand shocks. This box uses two event studies to analyze the contributions of market making, pretrade transparency, issue size, and the investor base to the behavior of corporate bond market liquidity in the face of a significant financial shock.

Impact of reduced market marking on liquidity resilience

During the “taper tantrum” episode of 2013, bonds for which there were fewer market makers saw the greatest deterioration of liquidity (Figure 2.3.1). The analysis is based on an examination of a large sample of corporate bonds from across the world, after controlling for various bond characteristics (see Annex 2.2 for details on the methodology). Accordingly, the presence of an additional dealer quoting a bond before the taper tantrum (April 2013) is associated with an improvement in that bond’s performance relative to the sample average of roughly 15 percent. The same analysis also shows that higher-credit-quality bonds—thus with lower market-making costs—also experienced smaller declines in liquidity.

Issue size

The combination of the proliferation of a variety of smaller issuances and the growth in riskier bonds is likely to have reduced the resilience of liquidity. Bond size or total amount issued by a borrower should be positively related to bond liquidity because larger issues are more likely to have a credit default swap or to belong to an index, or because of economies of scale in gathering information about credit risk. In fact, during the taper tantrum, everything else constant, the liquidity of larger issues exhibited greater resilience.

Trade transparency and liquidity resilience

Pretrade transparency—measured by the number of quotes—is positively related to the resilience of market liquidity.¹ Again for the taper tantrum, the market liquidity of bonds with better pretrade (or quote) transparency performed better than that for bonds with fewer advertised quotes (Figure 2.3.1). Although the result does not unequivocally establish causality,² it suggests that better dissemination of trading interest

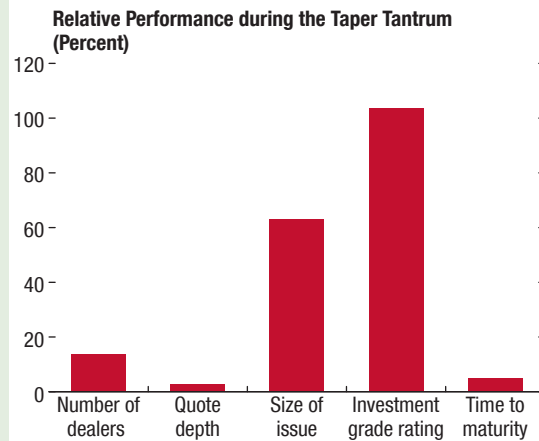
This box was prepared by Luis Brandão Marques and Kai Yan.

¹Pretrade transparency refers to the dissemination of quotations or other indications of trading interest (Bessembinder and Maxwell 2008).

²It is possible that dealers refrain from posting quotes for bonds that they know to have low resilience.

Figure 2.3.1. Liquidity during the Taper Tantrum

Relative liquidity performance during the taper tantrum episode was better for bonds with more dealers, larger size, or better credit rating.



Sources: Markit; and IMF staff estimations.

Note: The figure shows the contribution of each factor to a non-financial corporate bond's liquidity performance during the taper tantrum episode. Liquidity is measured using Markit's liquidity score, which is a composite index of market liquidity. Solid columns mean statistical significance at least at the 10 percent level. See Annex 2.2.

is associated with smaller declines in liquidity during periods of financial stress, in line with similar findings for the equity market (Boehmer, Saar, and Yu 2005).

Investor landscape and liquidity resilience

Empirically, larger holdings by mutual funds, in particular, open-end mutual funds, are associated with more severe liquidity declines during stress periods (Figure 2.3.2). When bonds were more heavily held by mutual funds before the financial crisis or the 2013 taper tantrum, liquidity (imputed round-trip costs) tended to decline more during the event.³ The result is stronger if the measure of ownership concentration focuses on open-end mutual funds, which is consistent with the view that these funds have a more fickle investor base (Chapter 3 of the April 2015 GFSR). There is no evidence to support the notion that insurance companies or pension funds had a stabilizing impact on liquidity by acting as contrarian investors.

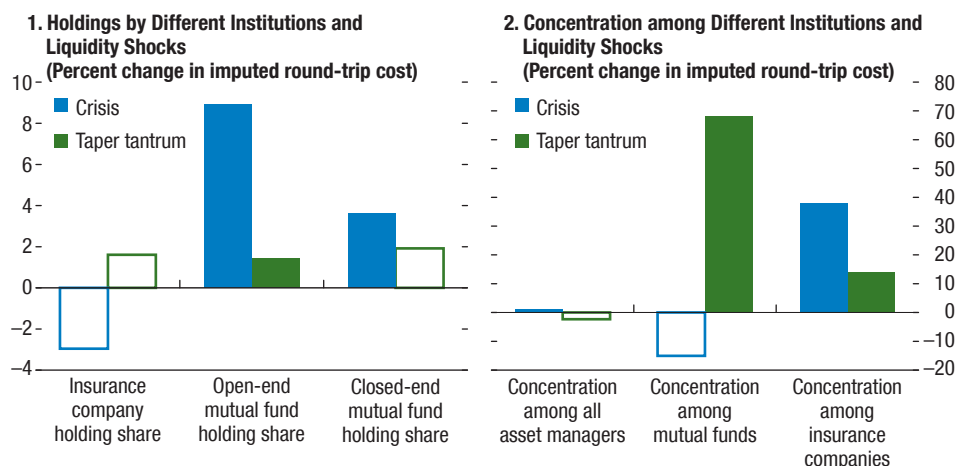
Finally, bond liquidity declines when ownership is more concentrated. During the global financial crisis of 2008, corporate bonds traded in the United States

³The hypotheses were tested using alternative measures of liquidity such as Amihud's (2002) price impact and Roll's (1984) price reversal, with qualitatively similar results.

Box 2.3. (continued)**Figure 2.3.2. Ownership and Market Liquidity**

Corporate bond liquidity is more fragile when mutual funds own a larger share.

Concentration of ownership—in particular among mutual funds—makes liquidity more sensitive to financial shocks.



Sources: FINRA Trade Reporting and Compliance Engine; and IMF staff estimations.

Note: The charts show the estimated impact of ownership and ownership concentration on imputed round-trip costs for corporate bonds traded in the United States. A positive value signifies a decline in liquidity. Solid columns mean statistical significance at least at the 10 percent level. See Annex 2.2.

with more concentrated ownership by institutional investors (mutual funds, pension funds, and insurance companies) at the onset of the crisis (first quarter of 2008) experienced a significantly greater decline of

liquidity during that year. Similarly, for the 2013 taper tantrum, bonds with more concentrated ownership among mutual funds also saw greater deterioration of liquidity.

use event studies, that is, to identify and examine events in which changes in potential drivers arise from sources independent of the state of liquidity.¹⁸ The event studies are complemented by an econometric analysis of the role of cyclical drivers. The analyses do not, however, aim to quantify the net impact of all the discussed changes on market liquidity.

¹⁸The empirical work draws information on corporate and sovereign bonds from security-level data and from intraday transactions-level data in three data sets: (1) Financial Industry Regulatory Authority Trade Reporting and Compliance Engine, which covers about 140 million transactions on 100,000 corporate bonds traded in the United States since 2002; (2) MTS, which covers 120 million interdealer transactions in European sovereign bonds since 2005; and (3) Markit's GSAC and CDS databases, which provide liquidity metrics for a large number of bonds and CDS contracts. See Annex 2.1.

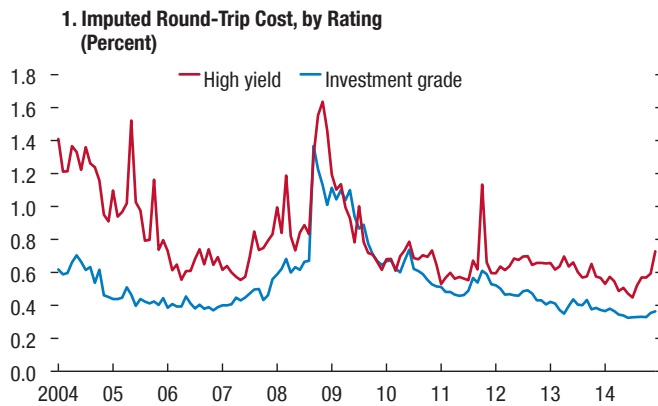
Event Studies of Market-Making and Funding Constraints

Evidence of reduced market making

Dealer banks in advanced economies show signs of being less active market makers in fixed-income securities (Figure 2.4, panels 3 and 4). In several advanced economies, bank holdings of corporate debt have declined (amid a large increase in total outstanding debt). The evidence on sovereign bonds is more mixed, however, with smaller holdings at U.S. banks and larger holdings at German banks. In addition, surveys by the Federal Reserve and the European Central Bank (ECB) suggest that market making has declined, mostly because of bank balance sheet constraints, internal charges to market making and trading, and regulatory reforms.

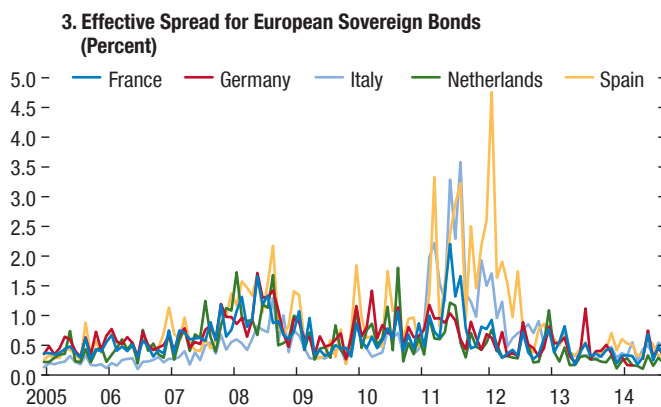
Figure 2.2. Trends in Bond Markets—Market Liquidity Level

Imputed round-trip costs for U.S. corporate bonds have declined...



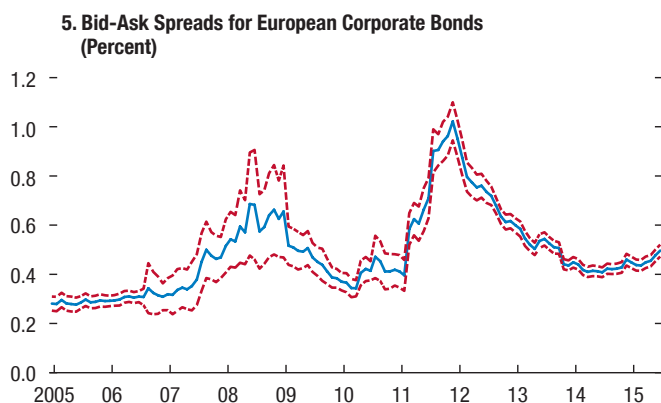
Note: The figure shows the imputed round-trip cost of U.S. corporate bonds, by credit rating.

Liquidity for European sovereign bonds appears to be similar to precrisis levels...



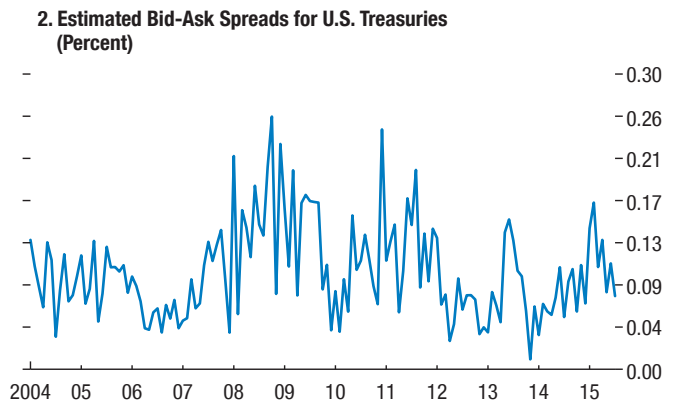
Note: The figure shows the effective spread of a two-year on-the-run government bond for the following countries: France, Germany, Italy, Netherlands, and Spain.

European corporate bonds are generally more liquid now...



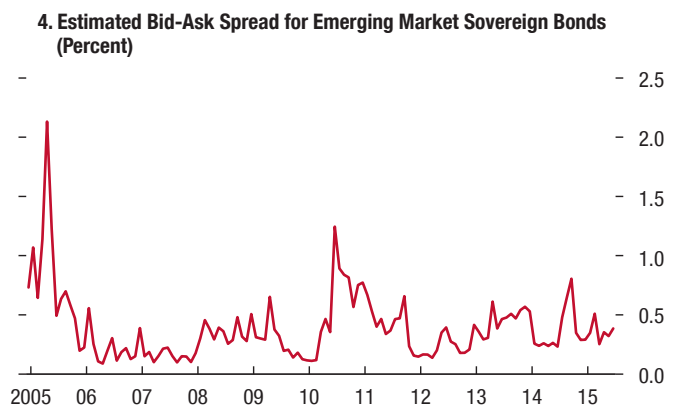
Note: The figure shows average bid-ask spreads for euro-denominated nonfinancial corporate bonds with a maturity greater than one year and all ratings from Belgium, France, Germany, Italy, Netherlands, and Spain. Dashed lines representing 95 percent confidence bands were added to account for increased sample coverage.

...while liquidity in the U.S. Treasury market has recently deteriorated.



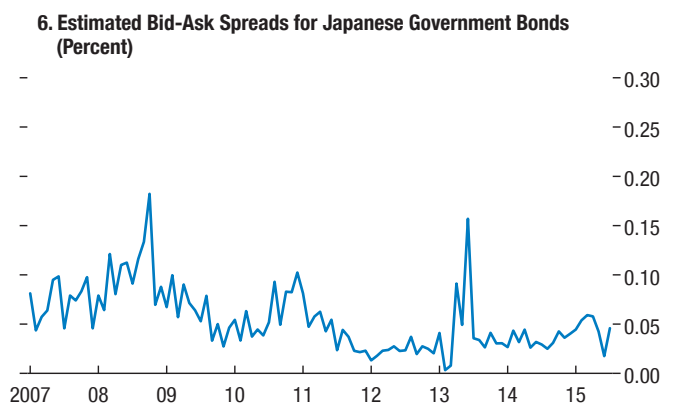
Note: Bid-ask spread, as a percent of price, for on-the-run 10-year U.S. Treasury bonds, estimated using the high-low spread suggested by Corwin and Schultz (2012).

...and the liquidity of emerging market sovereign bonds has been stable.



Note: Bid-ask spread, as a percent of price, for local currency government bonds from Brazil, India, Indonesia, South Africa, and Turkey, with a maturity of at least five years, estimated using the high-low spread suggested by Corwin and Schultz (2012).

...as are Japanese government bonds.



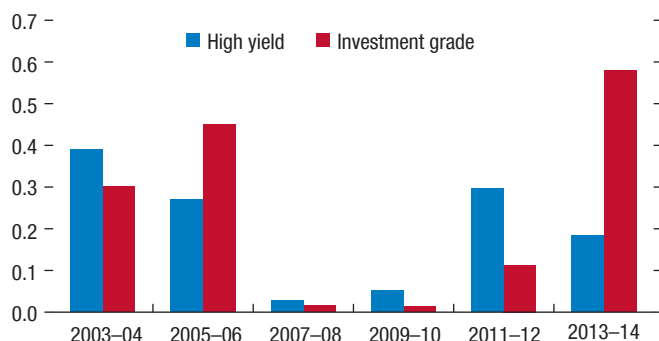
Note: Bid-ask spread, as a percent of price, for on-the-run 10-year Japanese government bonds estimated using the high-low spread suggested by Corwin and Schultz (2012).

Sources: Bloomberg, L.P.; FINRA Trade Reporting and Compliance Engine; MTS; and IMF staff calculations.

Figure 2.3. Bond Market Liquidity—Bifurcation and Price Impact of Transactions

The short-term resilience of liquidity has moved in opposite directions for investment-grade and high-yield U.S. corporate bonds.

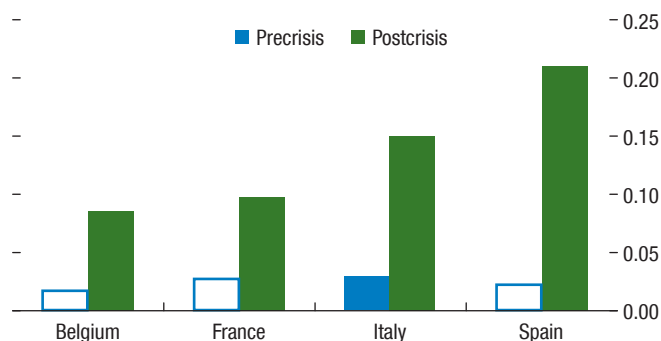
**1. Liquidity Mean Reversion Coefficient
(Regression coefficient)**



Note: The figure shows the coefficients of mean reversion of a measure of market liquidity—imputed round-trip cost—for corporate bonds by credit rating.

The price impact of trades has risen in some European countries.

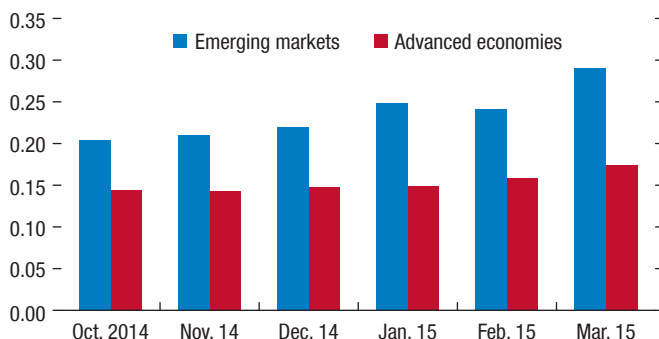
**2. Price Impact Coefficient, Five-Year Sovereign Bonds
(Coefficient for €100 million in volume; percentage points)**



Note: The figure shows the estimated price associated with a €100 million purchase of a five-year on-the-run government bond for the following countries: Belgium, France, Italy, and Spain. Solid bars indicate that the impact is statistically significant at least at the 10 percent level.

Quoted bid-ask spreads have increased faster for emerging market bonds in recent months.

**3. Bid-Ask Spreads for Investment-Grade Corporate Bonds
(Percent)**



Note: The figure shows the average bid-ask spread as a percent of bond par value.

Larger trades are less frequent than before the crisis.

**4. Large Transactions in the U.S. Corporate Bond Market
(Percent)**



Note: The figure shows the fraction of large trades in the U.S. corporate bond market as a percent of total transactions. A large trade is defined as larger than \$1 million.

Sources: Bloomberg, L.P.; Markit; MTS; Thomson Reuters Datastream; and IMF staff calculations.

Impact of reduced market making

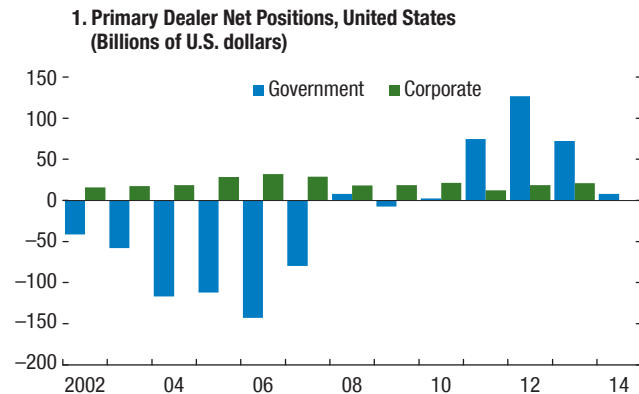
Can reduced market making adversely affect market liquidity? When dealers face constraints in the amount of balance sheet space they can allocate to corporate bonds, market liquidity for those assets deteriorates. To overcome the problem of two-way causality, episodes around U.S. Treasury auctions are examined. When the U.S. Treasury auctions its debt securities, primary dealers must bid for some of the issuance. Assuming that their balance sheet space allocated to fixed-income securities is limited, the auction becomes an exogenous

shock to their market-making ability in other markets. In fact, there is evidence that dealers take into their inventory an important share of the issuance, that it takes them several weeks to unload these holdings, and that they mostly do not hedge against them with futures (Fleming and Rosenberg 2008).¹⁹ The analysis in this chapter, based on daily data from 2002 to 2014, shows that on the day after a Treasury auction, aggregate

¹⁹The dates of the auctions are predictable, but their outcomes are not. See also Duffie (2012) for further considerations and Annex 2.2 for details on the data and method.

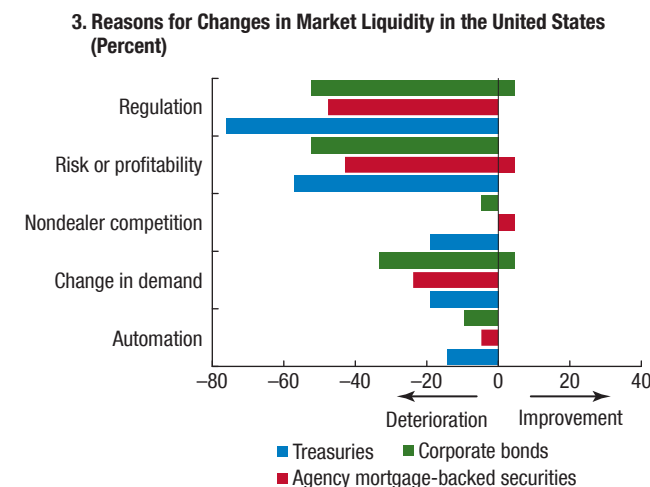
Figure 2.4. Trends in Market Making

Bond inventories owned by U.S. banks have declined...



Note: The figure shows net U.S. Treasury and corporate bond inventories held by primary dealers. Corporate bond figures are adjusted to exclude nonagency mortgage-backed securities and extend through 2013.

A survey of market makers in the United States suggests that dealer balance sheet constraints are a major worry.



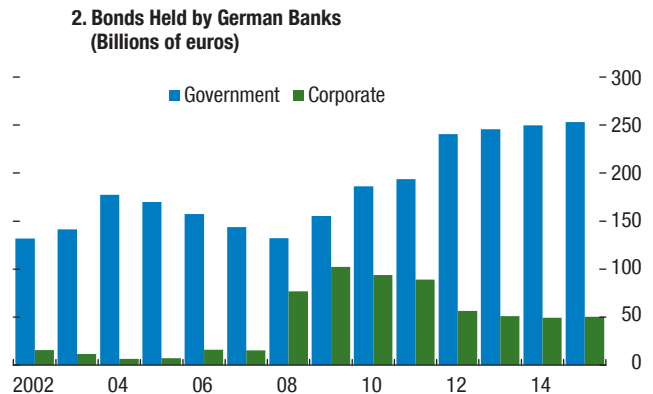
Note: Survey respondents indicating in top three reasons for change in market liquidity.

Sources: Deutsche Bundesbank; European Central Bank Survey on Credit Terms and Conditions in Euro-Denominated Securities Financing & OTC Derivatives Markets, December 2014; Federal Reserve Bank of New York; Federal Reserve Senior Credit Officer Opinion Survey on Dealer Financing Terms, June 2015; Haver Analytics; and IMF staff calculations.

market liquidity drops by nearly 13 percent in high-yield bonds but negligibly for investment-grade bonds (Figure 2.5).²⁰ The same analysis shows that the effect of this measure of banks' balance sheet space has significant explanatory power after 2010, but none for the period before the financial crisis (between 2002 and 2006). This finding suggests that banks now may face tighter

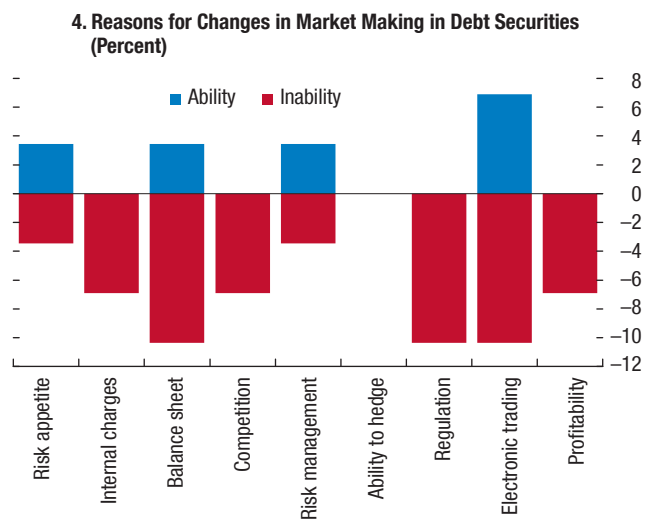
²⁰When monthly averages are used instead of daily data (to reduce noise in the data) the statistical significance is increased for both investment-grade and high-yield bonds, but the effects are estimated to be smaller, suggesting they are temporary in nature. See Annex 2.2.

...but for German banks, bond inventories remain high.



Note: Total domestic bonds (in gross terms) held by German banks. Data for 2015 are as of March.

A survey of the euro area suggests that lower risk appetite and higher balance sheet constraints are hurting bond market makers.



Note: Survey respondents indicating in top three reasons for change in their ability to provide market liquidity.

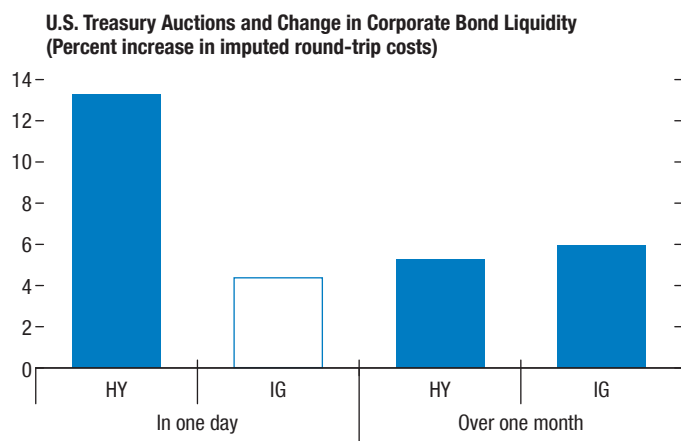
balance sheet constraints for market making compared with the precrisis period.

Monetary policy and market making

An analysis of changes in collateral policies supports the notion that central banks can improve liquidity by facilitating market making. One way central banks can relax market makers' funding constraints for certain securities and thereby improve the market liquidity of those assets is to include the instruments in the list of eligible collateral for repurchase operations (repo).

Figure 2.5. Dealers' Balance Sheet Space

U.S. Treasury debt auctions briefly reduce primary dealers' balance sheet space. As a result, aggregate market liquidity drops for corporate bonds.



Sources: FINRA Trade Reporting and Compliance Engine; U.S. Treasury Department; and IMF staff estimates.

Note: The figure shows the estimated increase in imputed round-trip costs of corporate bonds, in one day (or one month) with one debt auction by the U.S. Treasury. See Annex 2.2 for details. HY = high-yield corporate bonds; IG = investment-grade corporate bonds. Solid bar indicates that the impact is statistically significant at the 10 percent level.

Doing so lowers the cost of holding the instrument as a liquidity buffer asset and can also stimulate issuance in the primary market. To assess the impact of changes in the collateral framework, the analysis focuses on a series of events in which the ECB broadened the eligibility of collateral either by reducing the rating threshold for securities issued in euros, or by accepting securities issued in U.S. dollars, British pounds, and Japanese yen.²¹

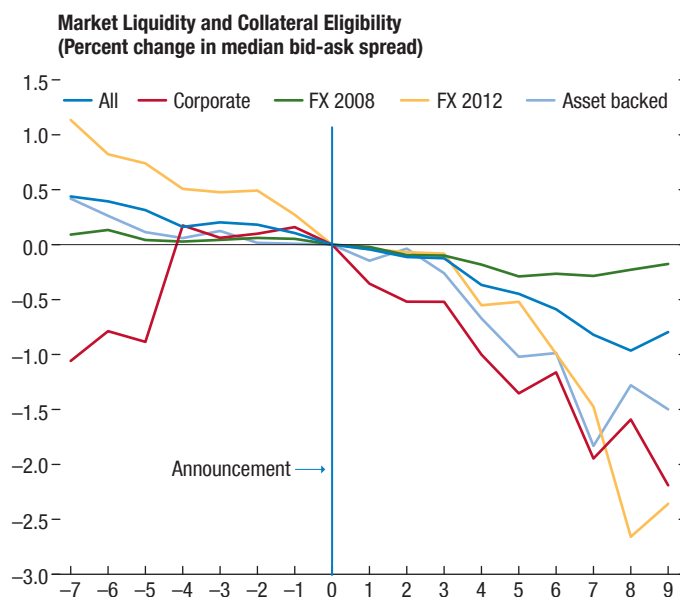
When a bond is included in the ECB's list of eligible collateral for credit operations, the liquidity of the security improves (Figure 2.6). For instance, when the ECB in 2008 started accepting European bonds issued in foreign currencies and lower-rated bonds, bid-ask spreads fell by as much as 0.35 percentage points following the announcements. The impact was even larger for decisions lowering the rating threshold.²² Although the increase in liquidity is persistent for at least the first two weeks, these announcements did not seem to have had a permanent impact on bonds' liquidity.

²¹The authors thank the ECB/DGM/MOA for providing data on eligible securities.

²²This may be explained by the fact that, relative to securities with a higher rating and denominated in other currencies, securities with lower ratings are less liquid to begin with, because some investors have strict investment guidelines regarding the rating of assets in which they may invest.

Figure 2.6. Central Bank Collateral Policies

Increasing the range of assets eligible to be posted as collateral for central bank credit increases market liquidity.



Sources: Bloomberg, L.P.; European Central Bank; and IMF staff estimates.

Note: The figure shows the percent change in liquidity for bonds that become eligible as collateral, before and after the announcement. The frequency is daily, and liquidity is measured by quoted bid-ask spreads. See Annex 2.2 for details. FX = foreign currency.

Event Studies of Search Costs

Impact of trade transparency

Some studies find that a rise in trade transparency has a small positive effect on bond market liquidity, but for most other assets the literature suggests a negligible or ambiguous effect. On the one hand, greater trade transparency should improve market liquidity because it increases competition, facilitates the valuation of assets, helps enforce rules against unfair trading practices, and improves risk sharing among dealers. On the other hand, increased transparency may erode the willingness of market makers to carry large inventories because it hampers their ability to unwind large positions.²³ Empirical work on posttrade transparency

²³Increased trade disclosure may discourage market making because dealers will not be able to unwind their positions after a large trade. Once a large trade becomes public information, other traders will be able to predict the market maker's behavior and extract price concessions. The same reasoning applies to equity markets and has ultimately led to the growth of "dark pools"—registered stock trading systems in which the size and price of trades are not disclosed to other participants.

(the disclosure of completed trades) in corporate bonds finds either a positive effect or no effect on price discovery, liquidity, and trade activity (Bessembinder and Maxwell 2008). However, some studies of the equity markets find that pretrade transparency (disclosure of the limit-order books and quotes) reduces liquidity in the equity market (Madhavan, Porter, and Weaver 2005).

For corporate bonds traded in the United States, enhanced transparency has had a positive impact on liquidity—especially for large transactions of lower-rated bonds. Again, the U.S. corporate bond market provides a suitable event study: the Financial Industry Regulatory Authority (FINRA) started collecting data on all bond transactions in 2002 but disseminated that information only gradually. The event study here examines the reaction around four dissemination phases to test whether liquidity improved after transactions data became public (see Annex 2.2 for details).²⁴ In the first two phases (2a and 2b), the bonds for which transactions data were disseminated were of higher credit quality (at least BBB rating), whereas those in the fourth phase (3b) were speculative grade. Contrary to expectations and views expressed by market participants, the study finds that when the data for large transactions of bonds of lower credit quality were released (phase 3b), market liquidity improved significantly (Figure 2.7).²⁵ The result suggests that, in this instance, the improvement in price discovery caused by transparency outweighed the potential costs for market makers.

Impact of the EU ban on uncovered credit default swaps

The EU's ban on indirect short selling of sovereign debt via uncovered sovereign credit default swaps (SCDS) reduced the liquidity of those assets (Figure 2.7). Beginning November 1, 2012, the EU banned uncovered CDS positions in EU sovereign debt and required disclosure of short positions in European sovereign bonds. Such restrictions reduce the ability of investors to find counterparties for trades and the abil-

ity of market makers to hedge. An analysis of a sample of SCDS contracts shows that in the three months after the ban, EU SCDS contracts became substantially less liquid.²⁶

The EU's ban also reduced liquidity in the European sovereign bond market. This chapter compares liquidity—as measured by quoted bid-ask spreads—for a sample of sovereign bonds three months before and after the ban. The findings indicate that liquidity in EU sovereign bonds declined after the ban. The decrease in liquidity for sovereigns was larger for countries with low credit risk (that is, low CDS spreads). Thus, the negative effect on liquidity in the derivatives market (for uncovered CDS on sovereign bonds) spilled over to the cash market (for the sovereigns themselves). The result is in line with predictions from Chapter 2 of the April 2013 GFSR and findings in ISDA (2014), and it is consistent with studies that find a detrimental effect on liquidity and price discovery from temporary bans on short selling in equity markets (Boehmer, Jones, and Zhang 2013; Beber and Pagano 2013).²⁷

Monetary policy and scarcity effects

Quantitative easing in the United States at first improved liquidity in the market for mortgage-backed securities (MBS), but then degraded it (Figure 2.8). Since November 2014, Federal Reserve purchases on the secondary market have had a detrimental effect on market liquidity. The effect indicates that the scarcity associated with large central bank purchases then dominates any positive effects (Box 2.1). The magnitude of the impact is, however, relatively small, suggesting that any adverse effects on market liquidity represent a small cost of quantitative easing. The results also point to the increasing importance of capital market depth and liquidity for monetary policy operations in a low-interest-rate environment.²⁸

²⁶The results show that liquidity decreases significantly for SCDS contracts affected by the ban, relative to other SCDS, when measured by Markit's composite liquidity indicator, market depth, number of valid quotes, and number of dealers quoting the contract. Results on quoted bid-ask spreads estimate a decline that is not statistically significant. See Annex 2.2.

²⁷However, ESMA (2013b) does not find a significant impact on SCDS or sovereign bond market liquidity and ESMA (2013a) estimates a decline in SCDS bid-ask spreads.

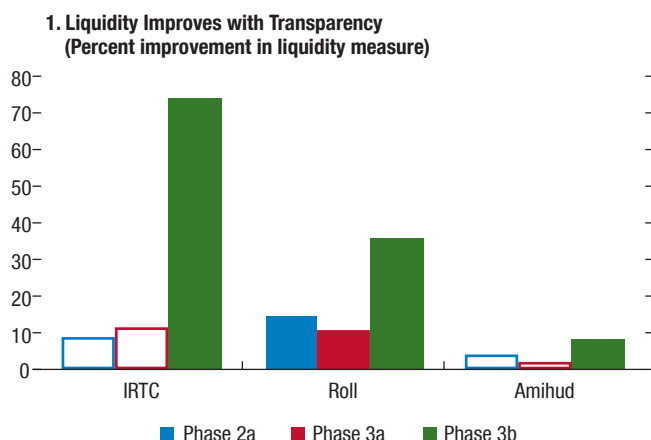
²⁸Gagnon and others (2011) report that in the early stage of the Federal Reserve's large-scale asset purchase programs, older and less liquid Treasury securities were trading at a negative premium compared with more recently issued Treasury securities. Prices went up and yield spreads narrowed after the Federal Reserve started purchasing such bonds. Similarly, Krishnamurthy and Vissing-Jorgensen (2012) find evidence of a decrease in the spread between agency and Treasury bonds' yields, a proxy for the liquidity premium, following

²⁴FINRA is the nongovernmental U.S. organization that self-regulates securities firms. The data dissemination dates for the four phases studied are March 3, 2003 (phase 2a); April 14, 2003 (phase 2b); October 1, 2004 (phase 3a); and February 7, 2005 (phase 3b). Data were graciously provided by FINRA.

²⁵Asquith, Covert, and Pathak (2013) report similar findings for turnover and price dispersion; and Edwards, Harris, and Piwowar (2007) find a reduction in trading costs after dissemination. See Bessembinder and Maxwell (2008) for a survey of results.

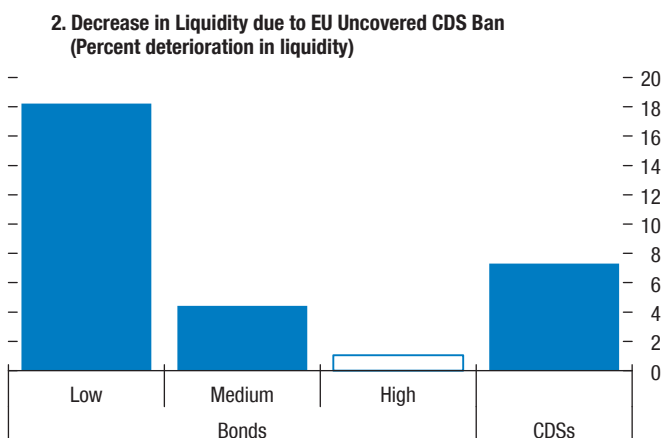
Figure 2.7. Regulation and Market Liquidity: Two Examples

Enhanced posttrade transparency, in some cases, improves market liquidity.



Note: The figure shows estimated change in liquidity three months before and after trade dissemination. Dissemination dates are March 3, 2003 (phase 2a); April 14, 2003 (phase 2b, not shown); October 1, 2004 (phase 3a); and February 7, 2005 (phase 3b). A positive value means improved liquidity. Solid columns mean statistical significance at least at the 10 percent level. See Annex 2.2 for details. Amihud = Amihud's (2002) price impact; IRTC = imputed round-trip cost; Roll = Roll's (1984) price reversal.

The European sovereign CDS ban was followed by a deterioration in the liquidity of EU sovereign CDSs and bonds.



Note: The figure shows the estimated deterioration in liquidity in sovereign bonds and sovereign CDS contracts that can be attributed to the EU ban on uncovered CDS on EU sovereign debt. The effect for bonds is broken down according to the credit risk of the issuer: low, medium, and high signify CDS spreads around the 25th, 50th, and 75th percentiles. Solid columns mean statistical significance at least at the 10 percent level. See Annex 2.2 for details. CDS = credit default swap.

Sources: FINRA Trade Reporting and Compliance Engine; Markit; and IMF staff estimations.

Investor base

Empirical evidence indicates that the decline in the heterogeneity of the investor base may have contributed to a deterioration in liquidity. It is difficult to test for this effect because, when market liquidity deteriorates for a particular asset, some holders may decide to sell it. To overcome this problem, the exercise examines an exogenous shock to the demand for some corporate bonds that may have affected banks' willingness to invest.²⁹ According to a rule adopted in the United States in June 2012 and made effective in January 2013, banks would have to decide for themselves whether a security is investment grade rather than use credit agency ratings. Because U.S. commercial banks are prohibited from investing in below-investment-grade bonds, the rule narrowed the investor base for bonds at the low end of the rating agencies' investment grade (BBB– for Standard

the Federal Reserve's purchases of agency mortgage-backed securities. The liquidity premium of the securities not targeted by quantitative easing was not affected.

²⁹The exercise uses the change in regulation only as an example of an exogenous shock to the investor base and should not be understood as a quantification of the positive or negative effects of this aspect of the Dodd-Frank Act.

& Poor's ratings). In turn, the narrowing of the investor base should raise dealers' inventory costs for those bonds and reduce market making. Indeed, data indicate that the effect took place at the time of the announcement, with the liquidity of BBB– bonds subsequently deteriorating relative to other bonds.

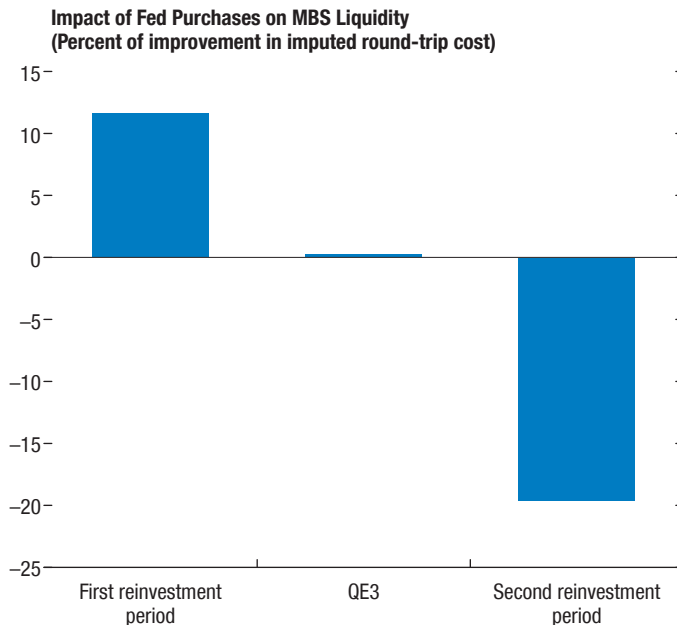
In sum, changes in market making, market structure, regulation, and monetary policy in recent years have had an impact on market liquidity. The observed decline in market making has probably contributed to the reduction in market liquidity in some market segments. Enhanced transparency regulations appear on net to have boosted market liquidity, whereas restrictions on CDS in the EU seem to have reduced it. On the whole, monetary policy in recent years is likely to have had a positive impact on market liquidity. The proliferation of small issuances has likely lowered liquidity in the bond market.

Econometric Evidence for Risk Appetite and Other Cyclical Drivers

How much has market liquidity been affected by cyclical factors in the postcrisis period? A linear regression

Figure 2.8. Fed Purchases and Mortgage-Backed Securities Liquidity

Outright purchases improved liquidity of MBS during the first reinvestment program (October 2011–November 2012), had no effect during QE3 (December 2012–October 2014), and was recently decreasing market liquidity (November 2014–March 2015).



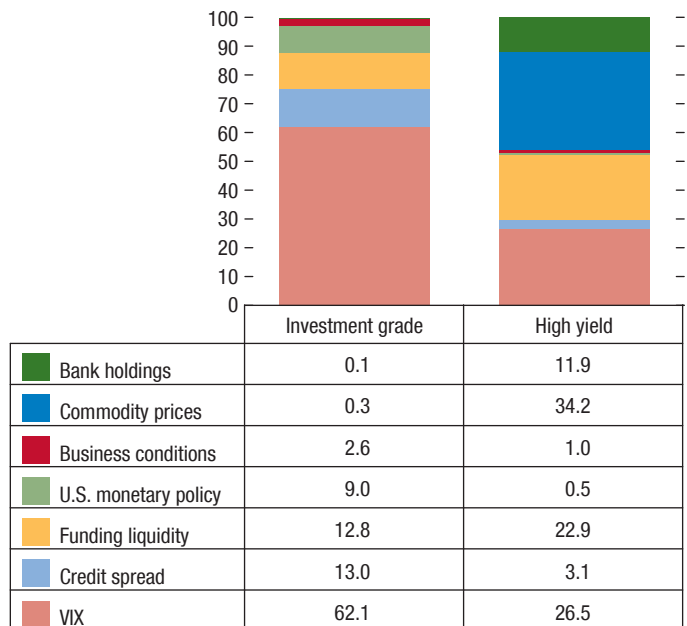
Sources: Federal Reserve Bank of New York; FINRA Trade Reporting and Compliance Engine; and IMF staff estimates.

Note: The figure shows the estimated improvement in liquidity (reduction in round-trip costs) in MBS securities per billion dollars of securities purchased by the Federal Reserve. The effect is normalized by the average imputed round-trip cost in the sample. Solid columns mean statistical significance at least at the 10 percent level. See Annex 2.2 for details. Fed = Federal Reserve; MBS = mortgage-backed security; QE = quantitative easing.

model of market liquidity for both high-yield and investment-grade U.S. corporate bonds since 2010 is used to examine this question. This approach does not, however, overcome the problem of two-way causality. The model includes the credit spread as a proxy for credit conditions; the TED spread (difference between the three-month London interbank offered rate based on the U.S. dollar and the three-month T-bill secondary market rate) as a measure of funding liquidity; corporate bond holdings by large commercial banks as a proxy for inventories; the estimated shadow monetary policy rate for the United States; commodity price changes as a control for the volatility of some important underlying assets; and the Chicago Board Options Exchange Volatility Index (VIX) as a measure of overall uncertainty, which is negatively related to risk appetite.

Figure 2.9. Main Drivers of Market Liquidity

Risk appetite has been the main driver of investment-grade U.S. corporate bond market liquidity since 2010, whereas funding liquidity seems more important for high-yield bonds.

Contributions to Market Liquidity of U.S. Corporate Bonds
(Percent)

Source: IMF staff estimates.

Note: The figure and table show the unique contribution of each variable (normalized by total unique contributions) in predicting the variance of aggregate market liquidity by type of bond since 2010. R^2 for investment grade = .79 and R^2 for high yield = .42. See Annex 2.2 for details. The decomposition follows the commonality coefficients approach described in Nathans, Oswald, and Nimom (2012). VIX = Chicago Board Options Exchange Market Volatility Index.

Risk appetite and funding liquidity seem to be the main drivers, but indirectly the results point to an important role for monetary policy. In fact, the combined contribution of the TED spread, the VIX, and unconventional monetary policy account for most of the liquidity behavior of investment-grade bonds and, to a lesser extent, of high-yield bonds (Figure 2.9). For investment-grade bonds, the cyclical factors explain almost 80 percent of the total variation of aggregate market liquidity, whereas for high-yield bonds the model explains slightly more than 40 percent.

Liquidity Resilience, Liquidity Freezes, and Spillovers

The chapter so far has examined the extent to which changes in various market conditions in recent years

may have eroded the market liquidity of securities, especially bonds. Such erosion has negative implications for the efficiency of capital allocation and for economic growth. From a financial stability point of view, however, the main concern about liquidity is not its level but the risk of disruptive drops in liquidity (“freezes”) across markets, and policymakers can help reduce the risk of such events and mitigate their severity if they occur.

This section provides empirical evidence on structural and cyclical factors associated with the resilience of liquidity to shocks. It briefly discusses event studies to examine the role of structural factors and then implements an econometric approach (“regime switching”) to measure the likelihood that aggregate market liquidity suddenly evaporates.³⁰ Although the focus is on corporate bonds traded in the United States, European sovereign bonds and the foreign exchange market, including emerging market currencies, are also examined. The section ends with an analysis of spillovers of liquidity freezes.

Liquidity Regimes and Resilience

Structural factors

Various structural factors are associated with the degree of liquidity resilience in markets. The analysis shows that a lower presence of market makers, a broader range of smaller and more risky bonds, large mutual fund holdings, and concentrated holdings by institutional investors are all associated with higher vulnerability of liquidity to external shocks (see event studies in Box 2.3). Higher leverage at financial firms and their greater use of short-term funding are typically associated with higher liquidity risk (Acharya and Viswanathan 2011). But the feedback loops between leverage and market illiquidity may have been weakened by the postcrisis decline in capital market participation by banks and hedge funds (Figure 2.10). Unfortunately, data limitations prevent a quantitative assessment of these factors and their overall impact from being made.

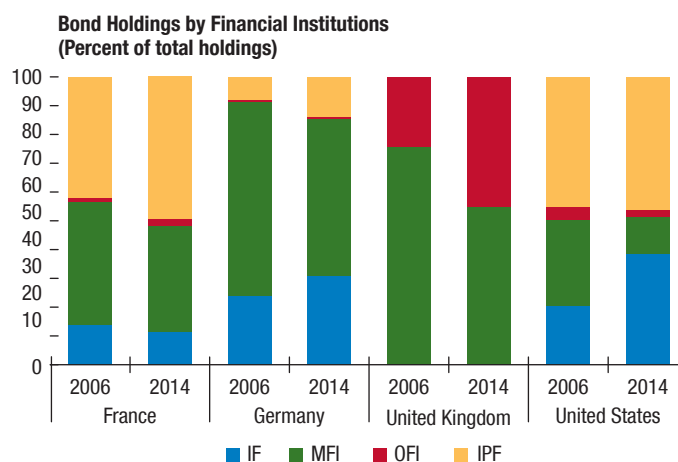
Cyclical factors

Empirically, market liquidity tends to abruptly switch between different states (Figure 2.11; Flood, Liechty,

³⁰In this section, aggregate market liquidity is defined as a measure of market liquidity averaged across all securities in an asset class.

Figure 2.10. Financial Sector Bond Holdings

Bond holdings by investment funds have been growing in various advanced economies.



Sources: European Central Bank; Board of Governors of the Federal Reserve System; and IMF staff calculations.

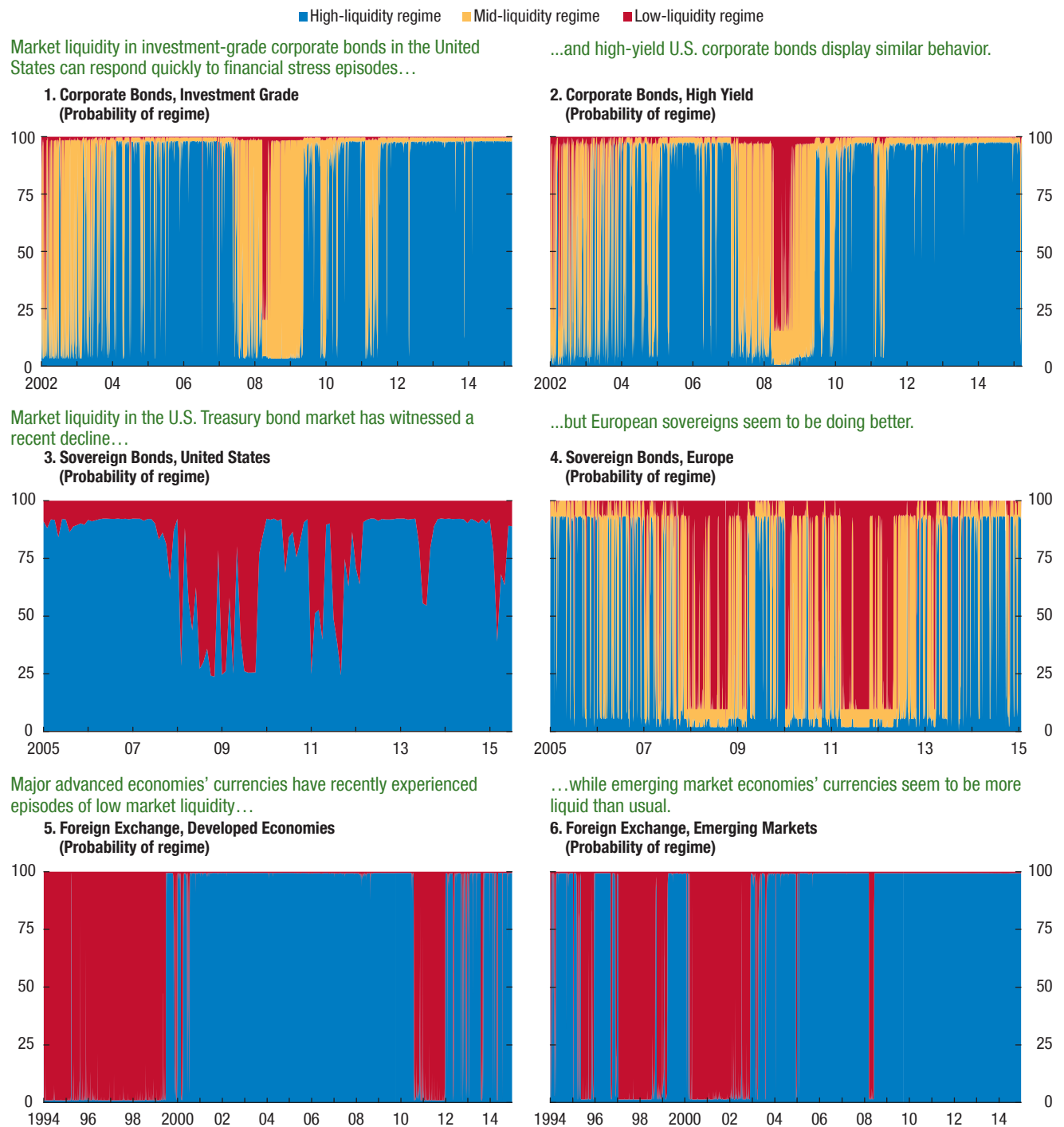
Note: Bond holdings in European countries refer to long-term debt securities; bond holdings in the United States refer to corporate and foreign bonds. Data for the United Kingdom do not discriminate among nonbank financial institutions. IF = investment funds excluding money market mutual funds (MMMFs); IPF = insurance and pension funds; MFI = monetary financial institutions (including MMMFs and, for the United States, securities brokers and dealers); OFI = other financial institutions.

and Piontek 2015). To study the importance of cyclical factors for the resilience of market liquidity, a regime-switching model is used in which liquidity may take on two or more regimes (for example, low, medium, and high). In this approach, the resilience of liquidity is measured by the one-day-ahead or one-month-ahead probability of a given market being in a low-liquidity regime. The model uses aggregate measures of market liquidity for corporate bonds traded in the United States, U.S. Treasury bonds, European sovereign bonds, and foreign currencies (Figure 2.11).³¹

To some extent, liquidity resilience in the corporate bond market can be predicted by cyclical factors

³¹Figure 2.11 shows estimates of one-day-ahead probabilities of a given market being in the low-liquidity regime, except U.S. Treasury bonds for which, because of data constraints, one-month-ahead probabilities are presented. The determination of such regimes is, however, asset specific. In other words, the regimes are not comparable across assets but only depict the estimated state of market liquidity in one day or one month's time relative to the asset's historical behavior. For instance, the liquidity of currencies has improved compared with the levels in the late 1990s. In particular, the average frequency of developed economies' currencies being in the low-liquidity regime declined from greater than 99 percent during 1995–99 to 34 percent in the past five years. See Annex 2.3 for details.

Figure 2.11. Probability of Liquidity Regimes



Sources: Bloomberg, L.P.; FINRA Trade Reporting and Compliance Engine; MTS; Thomson Reuters Datastream; and IMF staff estimates.

Table 2.2. Determinants of Low-Liquidity Regime Probability in the U.S. Corporate Bond Market

	One-Day Ahead		One-Month Ahead	
	U.S. Corporate Bonds		U.S. Corporate Bonds	
	Investment Grade	High Yield	Investment Grade	High Yield
U.S. Business Conditions	.	—**	—**	—**
VIX	+***	+***	.	.
Moody's Credit Spread	+***	+***	+***	.
TED Spread	+***	+***	.	.
Dealers' Holdings	—***	—***
Treasury Auctions	.	.	+**	+**
Fed Quantitative Easing	—**	.	—**	.

Sources: Board of Governors of the Federal Reserve System; FINRA Trade Reporting and Compliance Engine; Haver Analytics; Thomson Reuters Datastream; the United States Department of the Treasury; and IMF staff calculations.

Note: The table shows the estimated sign of ordinary least squares (OLS) estimates of a regression of the probabilities of being in the low-liquidity regime on a set of macroeconomic and financial variables for both investment-grade and high-yield corporate bonds. When the estimate is not statistically different from zero, a "." is used. "..." means the variable in the first column was not included. See Annex 2.3 for details on methodology and data. ***, **, * denote significance at the 1, 5, and 10 percent levels, respectively.

(Table 2.2).³² These factors include business conditions, financial volatility, and risk appetite (as measured by the VIX); the price of credit risk; and, to some degree, monetary policy measures. The current level of liquidity also matters for liquidity resilience.³³ The analysis summarized in Table 2.2 shows that high-yield bonds seem to be especially sensitive to business conditions and credit market developments, whereas unconventional monetary policy only affects the liquidity of investment-grade bonds.³⁴ However, an analysis of the response of market liquidity to changes in the VIX over time does not suggest that liquidity is now more sensitive to financial volatility compared with the precrisis period.

Evidence from the U.S. bond market indicates that when inventories at dealers are low or when dealers' ability to make markets is impaired, aggregate liquidity is more likely to drop sharply. Measures of dealers' inventories or of their ability to make markets

are empirically associated with liquidity regimes. For instance, the ratio of total corporate securities to commercial banks' total assets is negatively associated with a low-liquidity regime in the corporate bond market. Similarly, when funding liquidity is low (that is, when the TED spread is high), the probability of the corporate bond market being in a low-liquidity regime increases (Table 2.2).

In the markets for foreign exchange and European sovereign bonds, business conditions in key advanced economies seem to be the main drivers of liquidity regimes (Table 2.3). The resilience of liquidity of foreign exchange markets in emerging market economies and smaller advanced economies seems to be driven by external conditions, and does not appear to depend on business conditions in those markets. This dependence on external conditions may be due to the fact that these markets are strongly influenced by global investors. Overall, unconventional monetary policy measures by advanced economy central banks have had a positive impact on the liquidity resilience of foreign currency markets, including those in emerging markets.³⁵

Given that the VIX is still at historical lows, the picture of benign market liquidity conditions may be deceiving. Cyclical factors like global uncertainty and risk aversion can change quickly, for example, as a result of a "bumpy" normalization of U.S. monetary

³²The results on liquidity regimes presented in this section rely on measures of the cost dimension of market liquidity such as imputed round-trip costs, Corwin and Schultz's (2012) high-low spread, quoted bid-ask spreads, or effective spreads. However, for U.S. corporate bonds, results were tested using alternative measures of liquidity such as Amihud's (2002) price impact and Roll's (1984) price reversal, with qualitatively similar results. The estimates for U.S. Treasury bonds and foreign currencies suggest only two regimes instead of three.

³³Bao, Pan, and Wang (2011) also find that normal-time liquidity can help predict crisis-time liquidity.

³⁴Although the VIX plays a broader role, its significance in this estimation is consistent with the finding that it is a key driver of mutual fund redemptions (see the April 2015 GFSR, Chapter 3)—and large mutual fund holdings are associated with higher liquidity risk (Box 2.3).

³⁵The behavior of equity markets is not analyzed here, but Flood, Liechty, and Piontek (2015) also identify three liquidity regimes for those markets and similar determinants for the probability of them being in a low-liquidity state.

Table 2.3. Determinants of Low-Liquidity Regime in the Foreign Exchange and European Sovereign Bond Markets

	Major AEs	FX Markets		European Sovereign Bonds
		Other AEs	EMs	Euro-6
U.S. Business Conditions	.	—***	—***	.
Major AE Business Conditions	—***	—**	—**	—***
Other AE Business Conditions
EM Business Conditions
VIX	+***	.	.	+***
Moody's Credit Spread	—***	+***	+***	.
Domestic Short-Term Interest Rate	—***	.	.	+*
Fed Quantitative Easing	—*	.	.	.
Major AE Quantitative Easing	.	—**	—***	.

Sources: Board of Governors of the Federal Reserve System; FINRA Trade Reporting and Compliance Engine; Haver Analytics; Thomson Reuters Datastream; the United States Department of the Treasury; and IMF staff calculations.

Note: The table shows the estimated sign of ordinary least squares (OLS) estimates of a regression of the probabilities of being in the low-liquidity regime on a set of macroeconomic and financial variables in the foreign currency and European sovereign bond markets. When the estimate is not statistically different from zero, a “.” is used. “...” means the variable in the first column was not included. Major advanced economies (AEs) = euro, Japanese yen, Swiss franc, and British pound. Other AEs = Australian dollar, Canadian dollar, Danish krone, New Zealand dollar, Norwegian krone, and Swedish krona. Emerging markets (EMs) = Brazilian *real*, Indonesian rupiah, Indian rupee, Russian ruble, South African rand, and Turkish lira. Euro-6 = Belgium, France, Germany, Italy, Netherlands, and Spain. ***, **, * denote significance at the 1, 5, and 10 percent levels, respectively. FX = foreign exchange.

policy, unexpected developments in the euro area, or geopolitical events. To illustrate, should the VIX, the TED spread, and other cyclical factors (excluding monetary policy variables) deteriorate in the same way they did between December 2006 and August 2008, the probability of the U.S. corporate bond market switching from a high-liquidity to a low-liquidity regime would rise to about 75 percent for investment-grade bonds and 96 percent for high-yield ones.

The fact that investors require higher returns on illiquid assets only during periods of stress indicates that they pay little attention to the possibility that liquidity can suddenly vanish during normal times (Table 2.4). In principle, when holding securities, investors require compensation for different types of risk, including the risk of sharp drops in liquidity. However, in the U.S. corporate bond market, bond returns react to liquidity shocks only when volatility is high and returns are low (that is, stress periods), and not in tranquil periods.³⁶ This suggests that during periods in which liquidity is abundant, investors tend to neglect the risk that liquidity may suddenly vanish. Moreover, the chapter finds significant evidence that illiquidity shocks from the equity market spill over to the high-yield market and cause bond returns to fall.

³⁶In principle, only large, systematic, and persistent shocks to liquidity should be priced (Korajczyk and Sadka 2008). Conceivably, such shocks are more frequent in the low-liquidity regime.

Table 2.4. Bond Returns and Liquidity Risk

	Investment Grade	High Yield
Constant Parameters		
Term Spread	+	+
Moody's Credit Spread	+*	+*
Equity Illiquidity	—	—*
Regime-Switching Parameters		
Regime 1 (tranquil period)		
Bond Illiquidity	+	—
Regime 2 (stress period)		
Bond Illiquidity	—***	—***

Source: IMF staff estimates.

Note: The table shows the estimated sign of the coefficients of a regression of monthly corporate bond excess returns (relative to 30-day U.S. Treasury bills) on the term spread, credit spread, and illiquidity measures for the equity and bond markets. The latter is based on imputed round-trip costs averaged across all securities. Equity illiquidity is based on the measure proposed by Corwin and Schultz (2012). The regression coefficients for the bond illiquidity measure are allowed to vary according to a regime-switching regression, while the rest are assumed constant. See Annex 2.3 for details. *, **, and *** signify statistical significance at the 10, 5, and 1 percent levels, respectively.

Spillovers

Market illiquidity and the associated financial stress can spill over to other asset classes. Liquidity shocks may propagate to other assets, including those with unrelated fundamentals, for a variety of reasons. These reasons include market participants' need to mark to market and rebalance portfolios, which can affect their ability to trade and hold other assets. The propagation of liquidity shocks (known as liquidity spillovers) could be amplified when market participants are

highly leveraged. In addition, when asset fundamentals are correlated, spillovers can be larger: investors may perceive a sharp price correction in certain assets as conveying information about the valuations of their own securities. As a result, they may start fire sales and cause liquidity to freeze up.

Empirically, liquidity spillovers are larger during stress periods, and spillovers have become more prevalent in recent years. When returns are low and more volatile, liquidity shocks tend to propagate from one asset class to others. A measure of liquidity spillovers over several asset classes, including emerging markets equities, shows considerable time variation—but spillovers have become more frequent since the crisis (Figure 2.12).³⁷ This increase in frequency is in line with concerns expressed about rising comovements in prices across asset classes (April 2015 GFSR, Chapter 1). Furthermore, total liquidity spillovers across assets rise in periods of financial market stress (that is, when asset returns are low, volatile, and display significant comovement). See Annex 2.3 for details on the methodology.

Although common factors may play a role in the comovement of liquidity across asset classes, shocks often propagate from the investment-grade bond market to other markets. Statistical analysis of temporal spillover patterns (so-called Granger causality) suggests that liquidity shocks to investment-grade bonds significantly affect liquidity in other asset classes but that those bonds' liquidity is not much affected by that of other classes. This outcome suggests that monitoring investment-grade corporate bonds as a source of liquidity spillovers should be part of the market surveillance toolkit.

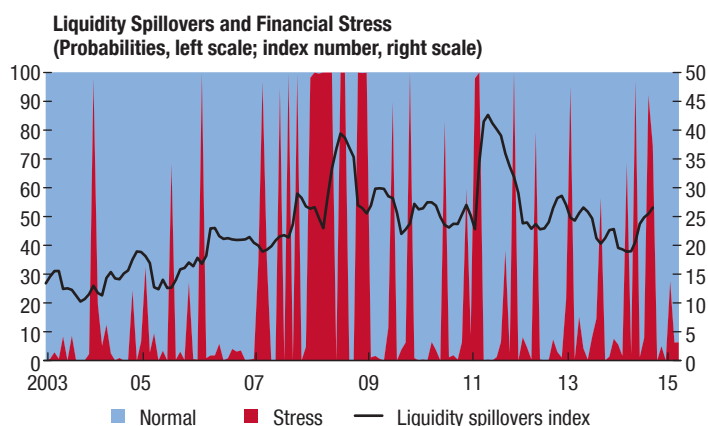
Summary of Findings on Liquidity Resilience, Liquidity Freezes, and Spillovers

Market liquidity can quickly disappear when volatility increases or funding conditions deteriorate, and monitoring day-to-day liquidity conditions has merit. In fact, having high liquidity today, all else equal, reduces the probability of being in a low-liquidity regime tomorrow, with the associated systemic stress repercussions.

³⁷The asset classes are equities in the United States, the EU, and emerging market economies; U.S. Treasury bonds; high-yield and investment-grade corporate bonds traded in the United States; and an index of market liquidity for the four major currency pairs (the U.S. dollar paired with the British pound, the euro, the Japanese yen, and the Swiss franc). The analysis controls for common factors.

Figure 2.12. Liquidity Spillovers and Market Stress

Liquidity spillovers across asset classes seem to intensify in periods of financial stress.



Sources: Bloomberg, L.P.; FINRA Trade Reporting and Compliance Engine; Thomson Reuters Datastream; and IMF staff estimates.

Note: The figure shows (1) the monthly average of an index of liquidity spillovers (measured as in Diebold and Yilmaz 2014) across the following asset classes: U.S. equities; U.S. Treasuries; U.S. high-yield corporate bonds; U.S. investment-grade corporate bonds; European equities; emerging market equities; and an index of liquidity in the foreign exchange market; and (2) probabilities of being in a low-return and high-volatility regime as given by a Markov-Switching Bayesian vector autoregression model of monthly returns for the same asset classes as in (1).

sions. Dealers' inventories and their overall balance sheet capacity are negatively associated with illiquidity spells. The regime-switching approach used in this chapter also finds that unconventional monetary policy can reduce the likelihood that markets will be in a low-liquidity regime. Furthermore, liquidity risk seems to be priced only in periods of financial stress.

Liquidity comovement across asset classes has increased in recent years. Spillovers are particularly pronounced during periods of financial stress. In those periods, asset returns are low and volatile, and the comovement of liquidity across asset classes is stronger. Even though common factors may generate some of these liquidity spillovers, shocks often originate in investment-grade bonds traded in the United States.

Policy Discussion

Market liquidity is prone to sudden evaporation, and the private provision of market liquidity is likely to be insufficient during stress periods; hence, policymakers need to constantly monitor liquidity developments and have a preemptive strategy in place to confront episodes of market illiquidity. Monitoring market

liquidity conditions using transactions-based measures, especially in the investment-grade bond market, should be part of regular financial sector surveillance. Although current levels of market liquidity are not clearly and significantly lower than they were before the crisis, that appearance may be an artifact of the extraordinarily accommodative monetary policies of key central banks.³⁸ The risk of a sudden reduction in market liquidity has been heightened by the larger role of mutual funds and by other structural changes combined with the impending normalization of monetary policy in advanced economies.

Regulatory changes aimed at curbing risk taking by banks can impair their capacity to make markets, but the evidence so far is not sufficient to support revisions to the regulatory reform agenda. Indeed, the reforms have made the core of the financial system safer. The empirical findings of this chapter suggest that constraints on dealers' balance sheets may impair market liquidity, and that these constraints have become tighter—but it is difficult to link such developments to specific regulatory changes. In particular, not enough time has passed to assess the impact of many Basel III innovations, such as the leverage ratio requirement, the net stable funding ratio, the increase in capital requirements, and restrictions on proprietary trading by banks.³⁹ Finally, independently of regulations, traditional market makers have also changed their business models by moving from risk warehousing (acting as dealers) to risk distribution (acting as brokers), in part because of technological changes and more efficient balance sheet management (see Goldman Sachs 2015).⁴⁰ These developments should continue to be monitored.

³⁸The long period of monetary accommodation by major central banks has further discouraged dealers from market making or risk warehousing. In a low-volatility and low-risk environment, it is often most profitable to act as a broker since the premium paid to warehouse risk is correspondingly low.

³⁹As argued by banks, it is possible that by linking capital requirements to all assets irrespective of risk, the Basel III leverage ratio requirement has lowered the attractiveness of high-volume, low-margin activities such as market making and collateralized lending. The net stable funding ratio, once fully implemented, could also have an adverse impact on market making by raising the relative cost of short-term repo transactions. The rise in capital requirements may also encourage banks to operate closer to the minimum required capital levels and, hence, render them unable or unwilling to take large trading positions.

⁴⁰Banks' changes in their business models following the financial crisis have also led them to focus more on their most profitable activities. Since market making is a high-volume, low-profit activity, banks have been reconsidering their presence in fixed-income and credit markets.

Trade transparency, standardization, and the use of equal-access electronic trading could dampen the impact of reduced market making at banks. For a variety of reasons, traditional market makers may have reduced their presence in the marketplace, but the emergence of new players and trading platforms may help fill the void. For example, in the United States, the standardization that will come from moving most index-CDS trading to swap execution facilities (Box 2.2) should enhance liquidity by introducing incentives for market-making activities and enhancing transparency.

Important obstacles to trade automation and the emergence of new market makers remain. New U.S. regulations for over-the-counter (OTC) derivatives markets require that trading platforms provide impartial and open “all-to-all” access. However, some interdealer platforms have resisted inviting nondealers to participate or have required high fees, which may act as a barrier to entry for alternative market makers.⁴¹

Smooth normalization of monetary policy is crucial. Given the empirical results on the direct and indirect effects of monetary policy on liquidity, it is important that normalization of monetary policy avoid disruptive effects on market liquidity. The empirical results on the effects in MBS markets suggest that liquidity in these markets will likely vary according to the modalities of the normalization (for example, whether it involves outright sales or simply allowing the securities in possession of the central bank to mature). Similarly, a “choppy” normalization process may lead to a sudden drop in risk appetite, with ensuing adverse effects on market liquidity. Although data constraints prevent a more in-depth evaluation of the market liquidity of emerging markets assets from being undertaken, the findings for emerging market foreign currency markets suggest that monetary policy actions in advanced economies greatly affect their resilience.

These general observations and the empirical results discussed in the chapter suggest the following policy options for strengthening market design, enhancing the role of central banks, improving

⁴¹Some platforms are reportedly insisting on posttrade identification of counterparties—even for centrally cleared trades—on order book trades, to which nondealers object because of the potential for information leakage.

financial market regulation, and reducing market liquidity risks.

On market microstructure design:

- *Reforming the design of markets should be encouraged.* Objectives would include creating incentives for instrument standardization,⁴² designing circuit breakers based on liquidity conditions rather than prices, and enhancing transparency.
- *Open access to electronic platforms should become the norm.* The analysis of the introduction of electronic platform trading of OTC derivatives underscores the importance of product standardization and of equal access to trading venues to allow buy-side firms to act as alternative market makers. However, the introduction of electronic platforms can attract new players, such as high-frequency trading firms, to the market, whose impact still needs to be further understood.
- *Restrictions on the use of financial derivatives should be reevaluated.* The analysis of the after-effects of the EU ban on uncovered CDS confirms the view expressed in the April 2013 GFSR that regulations on derivatives can distort markets and reduce liquidity in the associated cash market.

On the role of central banks:

- *Central banks should take into account the effects on market liquidity when making policy.* For example, to counteract the potential scarcity created by large-scale asset purchases, central banks could set up securities-lending facilities.
- *Central banks and financial supervisors should routinely monitor market liquidity in real time across several asset classes, but especially in the investment-grade bond market.* They should use a wide range of market liquidity measures with an emphasis on metrics derived from transactions-level data.
- *In periods of financial market stress, central banks could use various instruments, including their collateral policies, to enhance market liquidity.* In particular, they can do so by accepting, with appropriate haircuts, a wide range of assets as collateral for repo transactions.

⁴²The standardization of bond terms and conditions, such as call options and coupon and maturity payment dates, would reduce the effective dimensions of the market. Moreover, larger and more frequent borrowers could issue bonds in larger sizes and reopen old issues. See BlackRock (2014).

On the regulation and supervision of financial intermediaries:

- *Liquidity stress testing for banks and investment funds should be conducted taking into account the systemic effects of market illiquidity.* Liquidity stress testing can incorporate the externalities created by illiquid market conditions such as asset fire sales and funding risks (Box 2.4, and Chapter 3 of the April 2015 GFSR).
- *Liquidity mismatches in the asset management industry should be mitigated.* Liquidity mismatches characterize funds that invest in relatively illiquid and infrequently traded assets but allow investors to easily redeem their shares. The evidence presented in this chapter reinforces the recommendation of the April 2015 GFSR to consider the use of tools that adequately price in the cost of liquidity, including minimum redemption fees, improvements in illiquid asset valuation, and mutual fund share-pricing rules.

Conclusion

Even seemingly plentiful market liquidity can suddenly evaporate and lead to systemic financial disruptions. Therefore, market participants and policymakers need to set up policies in advance that will maintain market functioning during periods of stress. For example, the return to conventional monetary policy by the key central banks will inevitably boost volatility as market price discovery adjusts to new monetary conditions. The smooth adjustment of asset prices to their new equilibrium levels will require ample levels of market liquidity. In contrast, a low-liquidity regime would be more likely to produce market freezes, price dislocations, contagion, and spillovers.

This chapter explores developments in market liquidity and the role of liquidity drivers, with a focus on bond markets (Table 2.5). Structural changes, such as reductions in market making, appear to have reduced the level and resilience of market liquidity. Changes in market structures—including growing bond holdings by mutual funds and a higher concentration of holdings—appear to have increased the fragility of liquidity. At the same time, the proliferation of small bond issuances has likely lowered liquidity in the bond market and helped build up liquidity mismatches in investment funds. Standardization and enhanced transparency appear to improve securities liquidity.

Overall, current levels of market liquidity do not seem alarmingly low, but underlying risks are masked by unusually benign cyclical factors. On the one hand,

Box 2.4. Market Liquidity and Bank Stress Testing

Market illiquidity episodes can become systemic events when banks' balance sheets become impaired. Therefore, bank stress testing should take into account scenarios of market liquidity shocks. This box describes a stylized agent-based model approach to dynamic macro stress testing that can be used to obtain a prediction of market behavior under stress and simulate its impact on credit provision and economic growth.

Liquidity crises in one market can become systemic macroeconomic crises by damaging banks' balance sheets. When a market suddenly becomes illiquid, investors will require higher returns on their assets. As a result, asset prices of that market can drop dramatically. If banks own a large amount of assets in that market, a liquidity shock in that market can affect bank solvency, tightening bank regulatory constraints and limiting access to funding markets. Facing weakened balance sheets, banks react by unwinding their portfolio at distressed prices, withdrawing liquidity from financial intermediaries, or cutting back credit to the real economy, with negative consequences for financial stability and economic growth.

Building an integrated stress test for solvency and market liquidity is challenging. This is in part due to the difficulty in defining possible channels through which these interactions can occur. In addition, from a methodological point of view, it is difficult to analyze the effect of high-frequency changes in market liquidity with low-frequency information on bank solvency.

The model described here is an attempt to provide a stylized stress-testing framework of solvency and liquidity incorporating the interactions between banks, asset managers, and equity investors. The mechanism through which agents interact with one another is threefold. First, both banks and asset managers participate in the securities market to purchase or sell assets.¹ Second, banks can lend to each other in the credit markets. Third, banks interact with investors in equity markets through

capital injections or withdrawals. The shock on market liquidity comes from redemption pressures on asset managers. Banks are value investors, that is, they buy undervalued assets, and are subject to regulatory constraints. In normal times, their behavior stabilizes markets. But a large market liquidity shock reduces their capital buffers, weakens their balance sheets, and tightens regulatory constraints. Banks react by re-optimizing their balance sheets, thereby becoming positive feedback traders, amplifying market shocks, and constraining credit supply.

The model analyzes a baseline scenario and a market liquidity shock (Figure 2.4.1). It is calibrated on two levels. The micro approach works to individually calibrate agents to their specific behavior rules, reflecting heterogeneous optimization problems. The macro approach parameterizes the global variables shared by agents to fit the aggregate variable outcomes of all the agents' behaviors. In the baseline scenario, initial low credit growth depresses real GDP growth, increases credit risk and risk-weighted assets, lowers maximum available leverage, and erodes banks' capital adequacy ratios. As banks optimize over their credit supply, GDP growth recovers, asset prices return to fundamentals, banks' capital adequacy ratios increase, and the economy transitions toward the steady state.

In the market liquidity shock scenario, redemption pressures force asset managers to unwind their holdings of securities. This market shock generates a drop in asset prices and an abrupt surge in market volatility, which triggers a funding shock, morphs into a credit shock that softens GDP growth, and erodes banks' capital ratios.

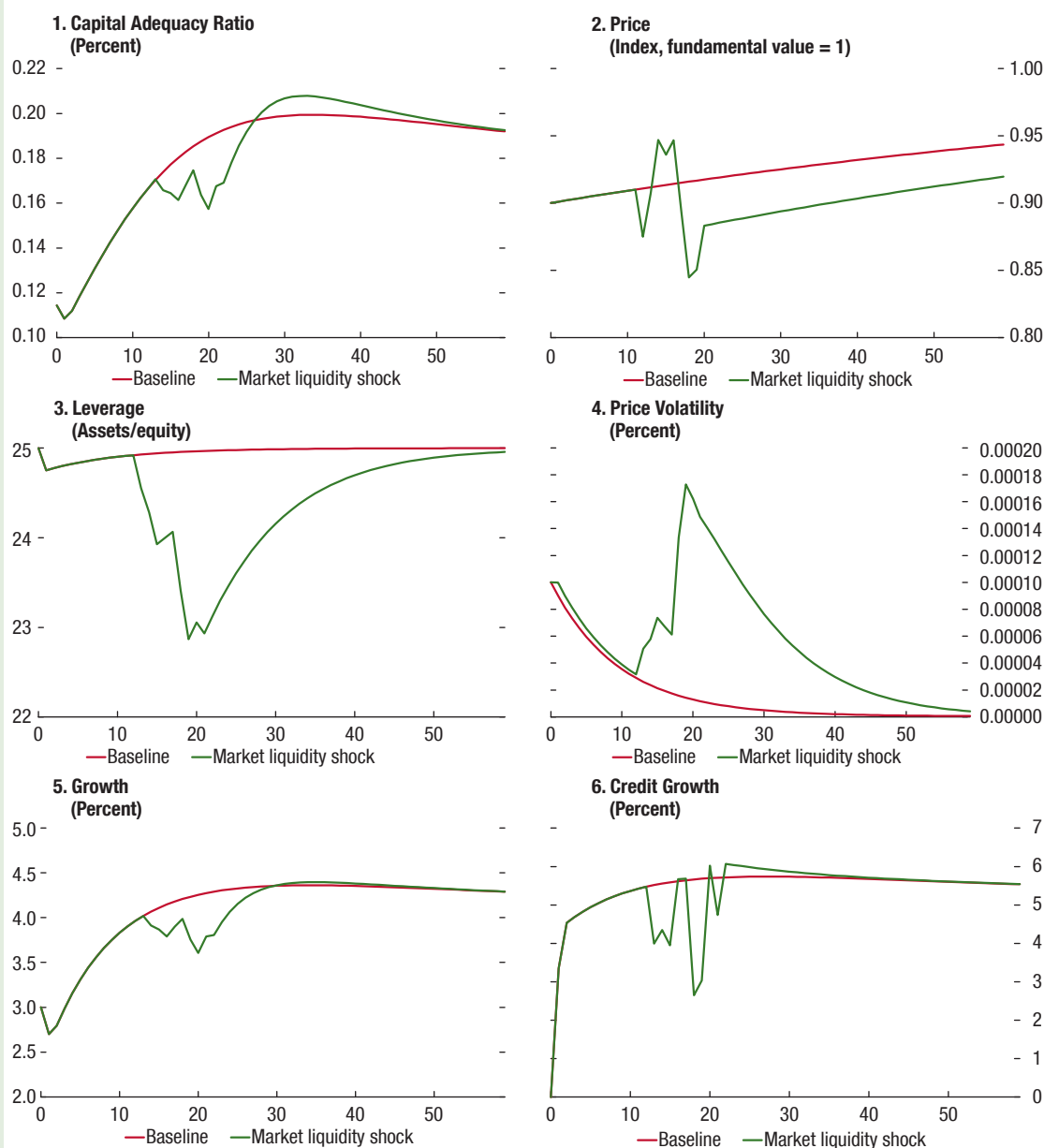
Overall, the model shows the mechanism through which a market liquidity event amplifies, spreads, and outlives the initial shock, affecting financial stability. Banks' deleveraging contributes to a downward spiral in asset prices triggering a fire sale mechanism, which further erodes their balance sheet capacity, weakens their capacity to sustain markets and provide credit, and depresses GDP growth. Banks' soundness, credit provision, and GDP growth remain subdued for a prolonged period because of feedback effects between the banking sector and the real economy.

The box was prepared by Laura Valderrama.

¹The model does not focus on high-quality liquid assets.

Box 2.4. (continued)

Figure 2.4.1. Stress Test of the Financial System and the Real Economy



Source: IMF staff estimates.

Note: This figure illustrates the dynamics of the banking sector, the securities market, and the real economy under a baseline scenario and a market liquidity shock scenario. The following variables are shown: *Capital adequacy ratio* of the banking system subject to a risk-based capital regulatory framework. *Price* reflects the market price of securities with a fundamental value of 1. *Leverage* denotes the equilibrium leverage of the banking system under a time-varying market-funding constraint that is tighter the higher the asset price volatility. *Price volatility* shows the volatility of the security, which follows a stochastic process with an autoregression coefficient of 0.9. *Growth* denotes GDP growth. *Credit growth* represents aggregate credit growth. The dynamics of the system are triggered by initial subdued credit growth at $t = 0$. Low initial credit growth depresses real GDP, increases credit risk, pushes up risk-weighted assets, lowers maximum available leverage, and erodes banks' capital adequacy ratios. As banks optimize credit supply, GDP growth recovers, asset prices trend up toward fundamentals, banks' capital adequacy ratios increase, and the economy shifts toward a steady state. The market liquidity shock is prompted by redemption pressure mounting on asset managers who are forced to sell their asset holdings over the time period t from 12 to 20. Asset managers' impaired liquidity leads to higher asset price volatility (market shock), decreases banks' maximum allowable leverage (funding shock), leads to a credit squeeze (credit shock), and depresses GDP growth (macro shock).

current liquidity levels partly reflect important cyclical drivers of liquidity, monetary accommodation, and risk appetite that are in a supportive phase: monetary policy is unusually benign, and investors in most advanced economies currently have a high appetite for risk. On the other hand, they are concealing the buildup of structural fragilities that can bring them down. When the cyclical factors at some point reverse—most likely in conjunction with the normalization of monetary policies in advanced economies—the resulting exposure to the underlying fragilities can produce a sudden deterioration in market liquidity and an increase in liquidity spillovers across asset classes. This chapter has made some progress toward a framework that helps anticipate these risks.

The chapter offers five main policy recommendations:

- During normal times, policymakers should ensure through preventive policies that liquidity is resilient. Moreover, they need to monitor liquidity developments with a policy strategy in hand to deal with episodes of market illiquidity.
- Market infrastructure reforms (equal-access electronic trading platforms, standardization) should continue with the goal of creating more transparent and open capital markets.
- Trading restrictions on derivatives should be reevaluated.
- In the process of normalization of monetary policy in the United States, good communication and attention to liquidity developments across markets will be important to avoid disruptions in market liquidity in both advanced and emerging market economies. Central banks should take market liquidity into account when conducting monetary policy.
- Regulators should develop measures to reduce liquidity mismatches and the first-mover advantage at mutual funds.

Table 2.5. Summary of Findings and Policy Implications

Characteristics	Markets	Findings	Tentative Policy Implications
<i>Improving the Level of Liquidity</i>			
Transparency	U.S. Corporate Bond	Posttrade transparency is beneficial to market liquidity.	Promote posttrade transparency.
Cost of Holding Inventory	U.S. Corporate Bond	Increase in dealers' inventory costs or reduced balance sheet space decreases their ability to provide market liquidity.	Encourage entry of new market makers by promoting standardization and equal access to trading venues.
Central Bank Purchases	U.S. MBS	Central bank purchases, over time, degrade market liquidity for the underlying asset.	Take into account market liquidity when implementing monetary policy.
Short-Sell Ban	CDS	Short-sell bans decrease market liquidity.	Consider revoking the ban.
<i>Improving the Resilience of Liquidity</i>			
Ownership by Mutual Funds and Concentration of Ownership	U.S. Corporate Bond	Ownership by mutual funds and concentration makes market liquidity evaporate more quickly during severe market downturns.	Contain liquidity risks associated with mutual fund ownership and redemption pressures.
Collateral Eligibility	European Sovereign Bond	Including an asset as eligible for collateral temporarily increases market liquidity.	During crisis, support market liquidity of certain markets by including the assets in collateral pools.
Cyclical Factors, including Monetary Policy	U.S. Corporate Bond; U.S. and EU Sovereign Debt; FX	Explains most of the behavior of the level of liquidity and an important part of the resilience of liquidity, when taken in conjunction with funding liquidity and risk appetite.	Reversal of current monetary stance should pay special attention to the possibility of a rapid deterioration of market liquidity.
Liquidity Regimes	U.S. Corporate Bond; U.S. and EU Sovereign Debt; FX	Market liquidity evaporates during crises.	Have a preemptive strategy to deal with liquidity dry-ups. Monitor liquidity in real time.
Liquidity Spillovers	U.S. Corporate Bond; U.S. Sovereign Debt; EME, EU, and U.S. Equity; FX	Market liquidity spillovers across asset classes increase in periods of financial stress and are now more elevated than before the financial crisis.	Monitor liquidity over a wide range of asset classes.

Source: IMF staff

Note: CDS = credit default swaps; EME = emerging market economy; EU = European Union; FX = foreign exchange; MBS = mortgage-backed securities.

Annex 2.1. Data and Liquidity Measures

The analyses in this chapter—both the ones at the security level and the aggregate ones—use several data sets:

- *U.S. corporate bond data*—The TRACE (Trade Reporting and Compliance Engine) data set contains trade-by-trade analysis for corporate bonds, structured products, and agency bonds traded in the United States since 2002.
- *Global corporate, agency, and sovereign bonds*—The Markit GSAC data set contains quote-by-quote information on four categories of bonds around the world (government, sovereign, agency, and corporate). The data set contains more than 40 percent of observations denominated in developing economy currencies and quote-level information for more than 950,000 bonds. The analysis uses the time periods of April–September 2013 and October 2014–March 2015 to document the “taper tantrum” and recent liquidity events.
- *European sovereign bonds*—The MTS data set contains the top of the order book for all European sovereign bonds traded on the MTS platform from 2005 to 2014. The MTS platform is an interdealer trading platform that trades more than 1,100 government bonds in 18 countries. For each security, the chapter observes quote-by-quote information of the top three bid and ask prices, as well as trades, generating more than 30,000 observations on an average day.
- *Over-the-counter derivatives*—High-level trading volume data were retrieved from the International Swaps and Derivatives Association *SwapsInfo* portal (<http://www.swapsinfo.org>). Credit default swap liquidity metrics, such as bid-ask spreads and number of quoting dealers, were retrieved from Markit (<http://www.markit.com>).
- *Quoted spreads and prices*—Information was also gathered on daily bid, ask, high, and low prices on bonds from Thomson Reuters Datastream and Bloomberg, L.P. for a series of bonds, currencies, and stocks, as well as transaction volumes, whenever available.
- *Ownership by institutional investors*—The data are sourced from Thomson Reuters eMaxx data set, which contains each institutional investor’s holdings of different fixed-income securities at the quarterly frequency. The sample covers 2008 and 2013.

Annex 2.2. Event Studies of Market Liquidity

The methodology employed in the event studies described in this chapter uses two main approaches: (1) a differences-in-differences approach using panel data and (2) simple cross-section regressions. The first approach can be implemented when it is possible to identify a specific change in regulation or policy that may have affected the behavior of a group of investors or financial intermediaries (the treatment group), while leaving the other group unaffected (the control group). The approach uses the following generic specification:

$$LIQ_{it} = \beta_0 + \beta_1 D_i + \beta_2 T_t + \beta_3 D_i \times T_t + \varepsilon_{it}$$

where the effect of a given determinant is measured with a dummy variable D_i , which takes value one if security i is affected by it, and zero otherwise, multiplied by another dummy variable T_t , which takes value one after the regulatory or policy change is either announced or implemented. The coefficient of interest is β_3 , which can be interpreted as the impact the regulatory change has on the treatment group, after removing all the possible aggregate trends that affect both the treatment and the control groups. The equation is estimated using panel fixed effects and robust standard errors. The approach is used to estimate the effect of the following episodes:

- *Increasing posttrade transparency*—Between 2003 and 2005, FINRA forced the disclosure of bond trades of different types of corporate bonds: March 3, 2003 (phase 2a), April 14, 2003 (phase 2b), October 1, 2004 (phase 3a), and February 7, 2005 (phase 3b).
- *Ban of uncovered European sovereign CDS*—The analysis estimates the impact of the November 2012 EU ban by measuring liquidity of about 80 sovereign CDS contracts three months before and after its approval (from August 1, 2012 to January 31, 2013). The metrics used are quoted bid-ask spreads, market depth, number of dealers quoting the CDS, number of quotes, and Markit’s liquidity score. The analysis is repeated using quoted bid-ask spreads for roughly 3,400 sovereign bonds from a variety of countries (including EU countries). Since credit risk may be an important time-varying determinant of bond liquidity, the chapter uses a specification with an interaction of the treatment effect with the value of the issuer’s CDS spread between May and July 2012.⁴³

⁴³The CDS spread is in logarithms because the effect of credit risk is likely not linear and the variable has fat tails.

- *Investor base and U.S. corporate bond liquidity*—The security-level analysis compares the imputed round-trip cost of U.S. corporate bonds rated as BBB–, relative to that of other bonds, six months before and after the adoption by the Office of the Comptroller of the Currency of a rule removing references to credit agency ratings as a standard for investment grade.
- *Outright purchases and MBS liquidity*—The analysis displayed in Figure 2.8 follows Kandrak (2014). The dependent variable is the imputed round-trip cost calculated using security-level TRACE data for 30-year MBS and the explanatory variable is the dollar value of outright purchases of each security, as reported by the Federal Reserve Bank of New York. The controls also include issuance and distance to coupon, sourced from JP Morgan.

The cross-section approach uses the following specification:

$$\Delta LIQ_i = \delta_0 + \delta_1 X_{i,t-1} + \mathbf{z}_i \Gamma + u_i,$$

where X_i is the value of the variable of interest before liquidity is affected by an exogenous shock (such as the global financial crisis or the taper tantrum), \mathbf{z}_i is a set of additional controls, and ΔLIQ_i is the change in liquidity of security i during the episode under consideration. The coefficient of interest is δ_1 and is estimated using a pooled ordinary least squares regression. Statistical inference is based on robust standard errors. The approach is used to study the following:

- *Ownership composition and concentration*—The study focuses on corporate bond liquidity and relates it to the types of investors and their concentration, as reported by eMaxx. It controls for ratings, age, total issue amount, and other bond-level characteristics.
- *Greater pretrade transparency and other bond characteristics*—The study measures the contribution to the change in liquidity of the number of dealers (pretrade transparency), issue size, credit rating, quote depth, time to maturity, and number of issues by the same issuer.

The impact of changes in the collateral framework is assessed by looking at changes in the bid-ask spread for aforementioned securities, available from Bloomberg, L.P. The analysis focuses on a series of events in which the ECB broadened the eligibility of collateral either by reducing the rating threshold for securities issued in euros (October 15, 2008, for all securities except asset-backed securities, and December 8, 2011, June 20, 2012, and July 9, 2014) or by accepting securities issued in U.S. dollars, British pounds, and Japanese yen as collateral (October 15, 2008, and September 6, 2012).

The analysis of the impact of market making on market liquidity uses time-series regressions of aggregate liquidity for U.S. corporate bonds on the frequency of U.S. Treasury auctions—an instrument for dealers' ability to make markets. The following equation is estimated for investment-grade and high-yield corporate bonds at the daily and monthly frequencies:

$$LIQ_t = \gamma_0 + \gamma_1 Auction_{t-1} + \Gamma_2 X_{t-1} + v_t$$

where *Auction* is a dummy variable that equals one in any day when there is at least one U.S. Treasury auction, and zero otherwise. X denotes a set of macroeconomic and financial variables as specified in Annex 2.3 except for the variable *Dealer's inventory*. The monthly variables are constructed by averaging the daily values over the month, including the dummy. The coefficient of interest is γ_1 . The effect in a day is computed by dividing the γ_1 from daily regressions by the average imputed round-trip cost. The effect over one month is computed by dividing the γ_1 from monthly regressions first by 30 and then by the average imputed round-trip cost. A similar specification is used in Figure 2.9, where imputed round-trip costs are regressed on the lagged VIX, credit spread, TED spread, business conditions index, commodity prices, and commercial bank holdings of corporate bonds, as well as on the U.S. shadow policy rate (sourced from Leo Krippner's webpage at the Reserve Bank of New Zealand).

Annex 2.3. Markov Regime-Switching Models for Market Liquidity and the Liquidity Premium

Data for U.S. corporate bonds and European sovereign bonds suggest the existence of three liquidity regimes—low, intermediate, and high liquidity. The probabilities of being in each of the three distinct liquidity regimes (low, intermediate, and high) for U.S. corporate bonds or European sovereign bonds are estimated using a Markov regime-switching model:

$$LIQ_t = \alpha_0^k + \varepsilon_t^k, \quad (\text{A.2.1})$$

where LIQ is the liquidity measure at either daily or monthly frequency, and k indicates the liquidity regime. The model allows both the level and the volatility of liquidity to change among the regimes and is estimated by the maximum likelihood method. Three trade-based measures are used to measure the market liquidity of U.S. corporate bonds: the imputed round-trip cost (IRTC), the Amihud measure, and the Roll measure.⁴⁴

⁴⁴All liquidity measures are available at a monthly frequency. The IRTC is also available at daily frequency. Results based on the Amihud and Roll measures are similar to those based on IRTC.

For European sovereign bonds, equally weighted effective spreads are used (aggregated over six euro area sovereign bonds—Belgium, France, Germany, Italy, Netherlands, and Spain).

A similar regime-switching behavior is also identified in the foreign exchange and U.S. Treasury bond markets, but only two regimes are found. Model (A.2.1) is estimated using equally weighted bid-ask spreads (normalized by mid prices) in three currency aggregates: the major advanced markets (euro, British pound, Japanese yen, and Swiss franc), other advanced markets (Australian dollar, Canadian dollar, Danish krone, New Zealand dollar, Norwegian krone, and Swedish krona), and emerging markets (Brazilian *real*, Indonesian rupiah, Indian rupee, Russian ruble, South African rand, and Turkish lira). For U.S. Treasury bonds, the Corwin and Schultz (2012) measure is used.

The probability of being in the low-liquidity regime can be explained by a set of lagged macroeconomic and financial variables. Following Acharya, Amihud, and Bharath (2013), we apply a standard logit transformation to the probability:

$$\log \left(\frac{\text{Probability} + c}{1 - \text{Probability} + c} \right)$$

where c is a constant added to accommodate the cases in which $\text{Probability} = 1$ or 0 . The explanatory variables are as follows:

- *Citigroup economic surprise index*—Measures the actual outcome of economic releases relative to consensus estimates at the daily frequency.
- *Business condition index*—Real business conditions are tracked using Aruoba, Diebold, and Scotti's (2009) index of business conditions at the monthly frequency.
- *VIX*—The Chicago Board Options Exchange Volatility Index, which measures the market's expectation of stock market volatility over the next month.
- *Commodity price inflation*—The daily (monthly) percentage change in the commodity price index from the Commodity Research Bureau for the daily (monthly) regressions.
- *Moody's credit spread*—The yield spread between Moody's Baa- and Aaa-rated corporate bonds.
- *TED spread*—The difference between the three-month London interbank offered rate (LIBOR) based on the U.S. dollar and the three-month T-bill secondary market rate (orthogonalized with respect to the credit spread).
- *Unconventional monetary policy*—The number of positive minus negative announcements by the Federal Reserve of large-scale asset purchases during the

previous 30 days. The monthly variable is constructed by averaging the daily values over the month.

- *Dealers' inventory*—Dealers' inventory is approximated by the U.S. commercial banks' holdings of total corporate securities in percent of their total assets.
- *U.S. Treasury auctions*—A dummy variable that equals one if there is a U.S. Treasury auction in any day. The monthly variable is constructed by averaging the daily values over the month.

The analysis estimates the liquidity premium for investment-grade and high-yield bond returns using the following Markov regime-switching model as in Acharya, Amihud, and Bharath (2013).

- Investment grade-bond returns (in excess of the 30-day T-bill return):

$$r_{IG,t} = \beta_{IG,0} + \beta_{IG,1} \text{TERM}_t + \beta_{IG,2} \text{CREDIT}_t + \beta_{IG,3} \text{Sillq}_t + \beta_{IG,4} \text{Billq}_{IG,t} + \varepsilon_{IG,t}$$

- High-yield bond returns (in excess of the 30-day T-bill return):

$$r_{HY,t} = \beta_{HY,0} + \beta_{HY,1} \text{TERM}_t + \beta_{HY,2} \text{CREDIT}_t + \beta_{HY,3} \text{Sillq}_t + \beta_{HY,4} \text{Billq}_{HY,t} + \varepsilon_{HY,t}$$

- Regime-dependent variance-covariance matrix:

$$\Omega_s = \begin{pmatrix} \sigma_{IG,s}^2 & \rho_s \sigma_{IG,s} \sigma_{HY,s} \\ \rho_s \sigma_{IG,s} \sigma_{HY,s} & \sigma_{HY,s}^2 \end{pmatrix}, \quad (\text{A.2.2})$$

where s is the regime, r_{IG} and r_{HY} are the returns on Barclay's investment-grade and high-yield corporate bond indices in excess of the 30-day T-bill return. TERM is measured by the difference between the monthly 30-year Treasury bond yield and one-month T-bill yield. CREDIT is Moody's credit spread measure. Sillq_t is a liquidity risk measure of the stock market based on Corwin and Schultz (2012). Billq_{IG} and Billq_{HY} are liquidity risk measures of investment-grade and high-yield corporate bonds, respectively, based on imputed round-trip costs, and their coefficients are assumed to differ across regimes.⁴⁵ Liquidity risk is measured by the residuals of autoregressive models of the liquidity measures.

The spillover analysis calculates an index of market-wide liquidity spillovers and relates it to regimes of high asset-returns volatility and comovement. Financial market stress is identified by running a regime-switching Bayesian vector autoregression (VAR) for monthly returns of equities in advanced and emerging market economies, U.S. and European sovereign bonds, high-yield and investment-grade corporate bonds, and com-

⁴⁵Allowing stock market liquidity risk to change across regimes does not qualitatively change results.

modities. Market liquidity spillovers are measured by decomposing the generalized forecast error variance for a VAR of liquidity measures in a 200-day rolling window and then calculating for each day the total contribution of each asset class to the other asset classes' market liquidity. See Diebold and Yilmaz (2014).

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SUMMARY

The corporate debt of nonfinancial firms across major emerging market economies quadrupled between 2004 and 2014. At the same time, the composition of that corporate debt has been shifting away from loans and toward bonds. Although greater leverage can be used for investment, thereby boosting growth, the upward trend in recent years naturally raises concerns because many financial crises in emerging markets have been preceded by rapid leverage growth.

This chapter examines the evolving influence of firm, country, and global factors on emerging market leverage, issuance, and spread patterns during the past decade. For this purpose, it uses large, rich databases. Although the chapter does not aim to provide a quantitative assessment of whether leverage in certain sectors or countries is excessive, the analysis of the drivers of leverage growth can help shed light on potential risks.

The three key results of the chapter are as follows: First, the relative contributions of firm- and country-specific characteristics in explaining leverage growth, issuance, and spreads in emerging markets seem to have diminished in recent years, with global drivers playing a larger role. Second, leverage has risen more in more cyclical sectors, and it has grown most in construction. Higher leverage has also been associated with, on average, rising foreign currency exposures. Third, despite weaker balance sheets, emerging market firms have managed to issue bonds at better terms (lower yields and longer maturities), with many issuers taking advantage of favorable financial conditions to refinance their debt.

The greater role of global factors during a period when they have been exceptionally favorable suggests that emerging markets must prepare for the implications of global financial tightening. The main policy recommendations are the following: First, monitoring vulnerable and systemically important firms, as well as banks and other sectors closely linked to them, is crucial. Second, such expanded monitoring requires that the collection of data on corporate sector finances, including foreign currency exposures, be improved. Third, macro- and microprudential policies could help limit a further buildup of foreign exchange balance sheet exposures and contain excessive increases in corporate leverage. Fourth, as advanced economies normalize monetary policy, emerging markets should prepare for an increase in corporate failures and, where needed, reform corporate insolvency regimes.

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Introduction

Corporate debt in emerging market economies has risen significantly during the past decade. The corporate debt of nonfinancial firms across major emerging market economies increased from about \$4 trillion in 2004 to well over \$18 trillion in 2014 (Figure 3.1). The average emerging market corporate debt-to-GDP ratio has also grown by 26 percentage points in the same period, but with notable heterogeneity across countries. Likewise, comparable firm-level measures of leverage show an upward trend, with some readings still below historical peaks (Figure 3.2). Greater emerging market corporate leverage can confer important benefits, such as facilitating productive investment, and thereby faster growth. However, the upward trend in recent years naturally raises concerns because many emerging market financial crises have been preceded by rapid leverage growth.¹

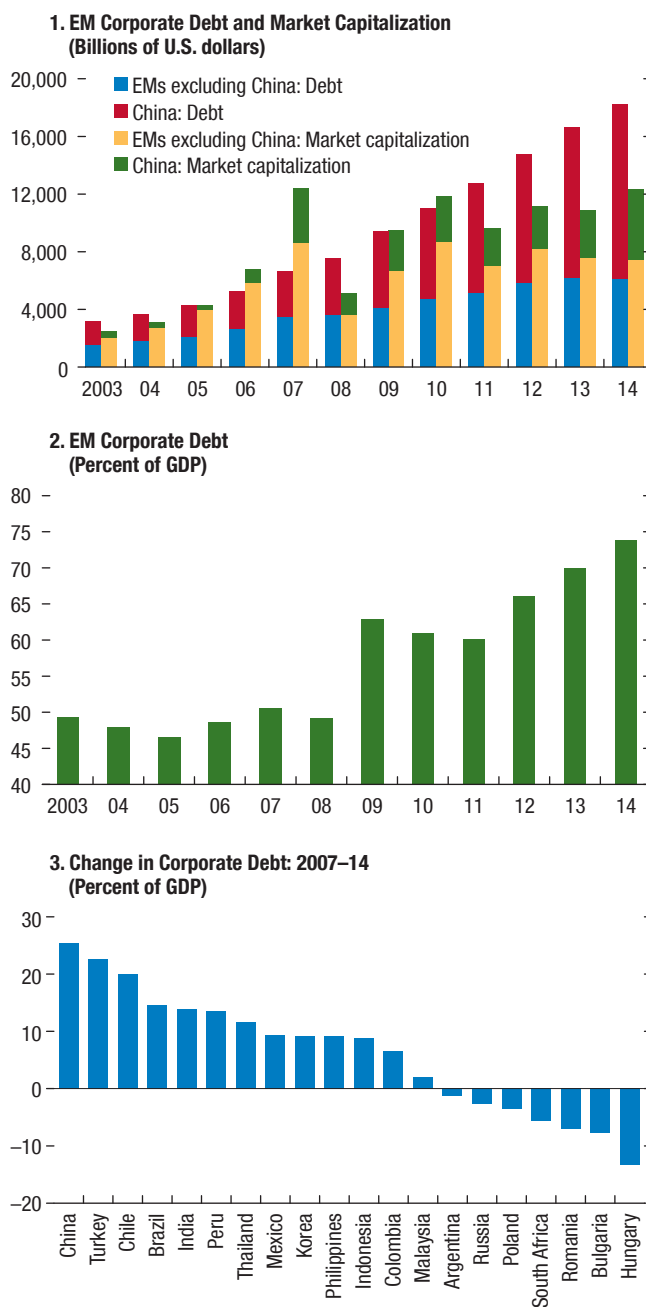
The composition of emerging market corporate debt has also changed. Although loans are still the largest component of that corporate debt, the share of bonds has been growing rapidly, from 9 percent of total debt in 2004 to 17 percent of total debt in 2014, with most of the increase materializing after 2008, including via offshore financial centers, as discussed in Shin (2013) and BIS (2014c) (Figure 3.3).²

The growth and changing nature of emerging market corporate debt has occurred amid an unprecedented monetary expansion in advanced economies and a shifting global financial landscape. Monetary policy has been exceptionally accommodative across major advanced economies. Firms in emerging markets have faced greater incentives and opportunities to increase leverage as a result of the ensuing unusually favorable global financial conditions. For example, the U.S. “shadow rate”—a useful indicator of the monetary policy stance when the federal funds rate is at the zero lower bound—dropped to about minus 5 percent in the first half of 2013 and is still negative

¹As noted in Mendoza and Terrones (2008), the buildup of corporate leverage is often associated with boom-bust cycles. On the link between rapid growth in credit to the private sector and financial turbulence more generally, see Schularick and Taylor (2012) and Elekdag and Wu (2011); see also BIS (2014a).

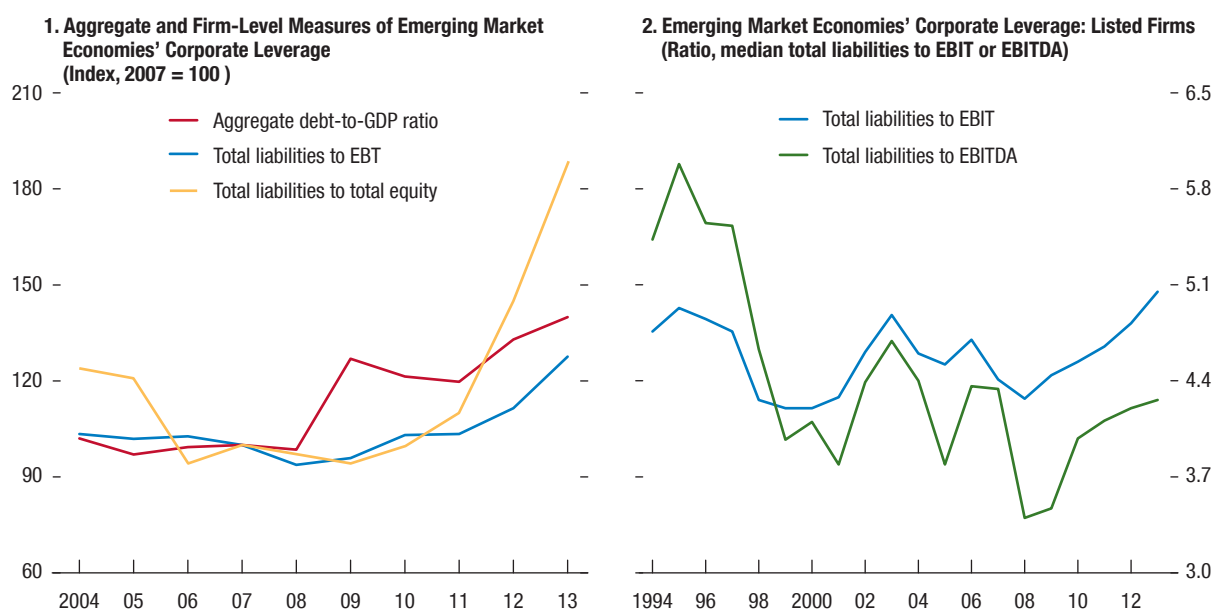
²The stock of outstanding bonds denominated in foreign currency has risen from \$168 billion in 2003 to \$855 billion in 2014, but their overall share has remained broadly stable (discussed below); see also Gelos (2003) and BIS (2014b).

Figure 3.1. Emerging Market Economies: Evolving Capital Structure



Sources: Ayala, Nedeljkovic, and Saborowski 2015; Bank for International Settlements; Dealogic; IMF, International Financial Statistics database; national authorities; and IMF staff calculations.

Note: EM = emerging market economy; figure depicts major EMs. Debt includes bank credit and bond financing. Credit by nonbanks is excluded, possibly leading to a significant underestimation of corporate debt in countries with large nonbanking sectors such as China. At the same time, in China, the bulk of fiscal borrowing occurs off budget through local government financing vehicles and is recorded as private credit, although most of it is fiscal (see Arslanalp and others, forthcoming).

Figure 3.2. Emerging Market Economies: Selected Leverage Ratios

Sources: Orbis; Thomson Reuters Worldscope; and IMF staff calculations.

Note: EBT = earnings before taxes; EBIT = earnings before interest and taxes; EBITDA = earnings before interest, taxes, depreciation, and amortization.

(Box 3.1). Another important recent development has been the decline in cross-border bank lending, largely driven by supply-side factors, specifically banks' efforts to strengthen their balance sheets and satisfy new supervisory and regulatory requirements (see Chapter 2 of the April 2015 *Global Financial Stability Report* [GFSR]).

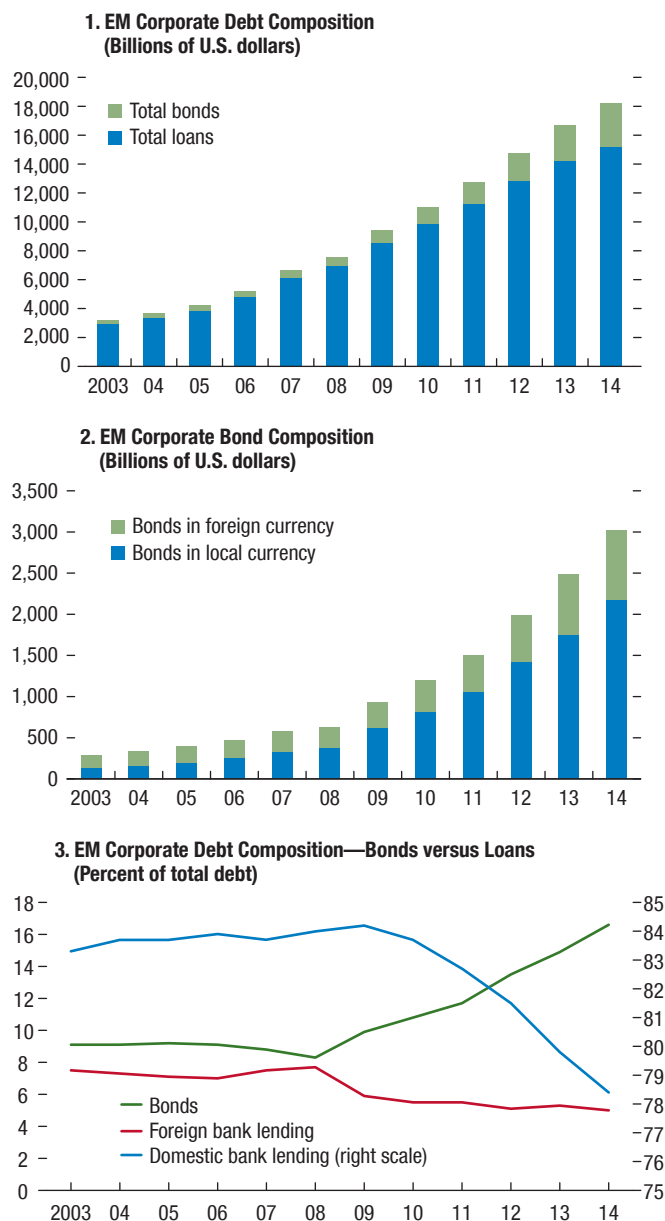
Accommodative global monetary conditions can encourage leverage growth in emerging markets through several channels. In line with Caruana (2012) and He and McCauley (2013), three transmission channels are worth highlighting (see also Bruno and Shin 2015). First, emerging market central banks set lower policy rates than they would otherwise in response to the prevailing low interest rates in advanced economies to alleviate currency appreciation pressures. Second, large-scale bond purchases in advanced economies reduce bond yields not only in their own bond markets, but also to varying degrees in emerging market bond markets through portfolio balancing effects. Likewise, accommodative monetary policies in advanced economies are typically accompanied by greater capital flows into emerging markets, seeking higher returns. Third, changes in policy rates

in advanced economies are promptly reflected in the debt-servicing burden on outstanding emerging market foreign currency-denominated debt with variable rates. Through these channels, expansionary global monetary conditions can facilitate greater corporate leverage through the relaxation of emerging market borrowing constraints owing to the widespread availability of lower-cost funding and appreciated collateral values.³

A key risk for the emerging market corporate sector is a reversal of postcrisis accommodative global financial conditions. Firms that are most leveraged stand to endure the sharpest rise in their debt-service costs once monetary policy rates in some key advanced economies begin to rise. Furthermore, interest rate risk can be aggravated by rollover and currency risks. Although bond finance tends to have longer maturities than bank finance, it exposes firms more to volatile financial market conditions (Shin 2014b). In addition, local currency depreciations

³Moreover, expectations of continued local currency appreciation are likely to have created incentives to incur foreign currency debt in certain regions and sectors.

Figure 3.3. Emerging Market Economies: Changing Composition of Corporate Debt



Sources: Ayala, Nedeljkovic, and Saborowski 2015; Bank for International Settlements; Dealogic; IMF, International Financial Statistics database; national authorities; and IMF staff calculations.

Note: EM = emerging market economy; figure depicts major EMs.

associated with rising policy rates in the advanced economies would make it increasingly difficult for emerging market firms to service their foreign currency-denominated debts if they are not hedged adequately.

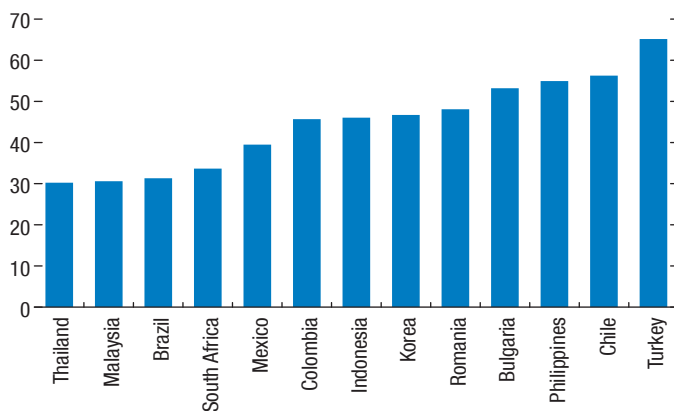
Corporate distress could be readily transmitted to the financial sector and contribute to adverse feedback loops. Greater corporate leverage can render firms less able to withstand negative shocks to income or asset values. This vulnerability has important implications for the financial system, in part because corporate debt constitutes a significant share of emerging market banks' assets (Figure 3.4). Therefore, shocks to the corporate sector could quickly spill over to the financial sector and generate a vicious cycle as banks curtail lending. Decreased loan supply would then lower aggregate demand and collateral values, further reducing access to finance and thereby economic activity, and in turn, increasing losses to the financial sector (Gertler and Kiyotaki 2010).

This chapter highlights the financial stability implications of recent patterns in emerging market corporate finance by disentangling the role of domestic and external factors. The focus is on nonfinancial firms' corporate leverage, bond issuance, and spreads. Key external factors include measures of global economic and financial conditions. Domestic factors considered include bond-, firm-, and country-level characteristics. Although the chapter does not aim to provide a quantitative assessment of whether leverage in certain sectors or countries is excessive, the analysis of the key drivers of leverage growth can still help shed light on potential risks.⁴

If rising leverage and issuance have recently been predominantly influenced by external factors, then firms are rendered more vulnerable to a tightening of global financial conditions. Similarly, a decline in the role of firm- and country-level factors in recent years would be consistent with the view that markets may have been underestimating risks. In contrast, if firms issuing foreign currency debt have been reducing their net foreign exchange exposure through hedging or other means, simply focusing on the volume of foreign currency bond issuance would tend to overstate risks related to local depreciations.

⁴Scenario analysis to assess emerging market corporate vulnerabilities has been discussed in various IMF studies, including Chapter 1 of the April 2014 GFSR and in the latest IMF *Spillover Report* (IMF 2015a); see also Chow (forthcoming).

Figure 3.4. Domestic Banks: Ratio of Total Corporate Loans to Total Loans in 2014
(Percent)



Sources: IMF, International Financial Statistics database; and IMF staff calculations.

This chapter addresses these issues by considering the following questions:

- How have corporate leverage and bond issuance in the emerging market nonfinancial sector changed over time and across regions, sectors, and firms? How have these funds been used? Has higher leverage or bond issuance been accompanied by an increase in net foreign exchange exposure?
- What is the relative role of domestic factors compared with that of external factors—such as accommodative global financial and monetary conditions—in the change in leverage, issuance, and corporate spread patterns? Is there evidence of a smaller role for firm- and country-level factors during the postcrisis period?

The chapter goes beyond existing studies by jointly analyzing firm, country, and global factors as determinants of emerging market corporate leverage, issuance, and spreads. Starting with Rajan and Zingales (1995), many papers have concluded that both firm- and country-specific factors influence corporate capital structure internationally.⁵ However, these papers do not focus on the way in which global financial

⁵Emerging market corporate capital structure, including leverage, has been studied in the context of Asia in IMF (2014a) and for central, eastern, and southeastern Europe in IMF (2015c). Kalemli-Ozcan, Sorensen, and Yesiltas (2012) present novel stylized facts using bank- and firm-level data, with a focus on advanced economies.

and monetary conditions may have influenced firms' capital structure decisions. Relatedly, some studies have examined recent developments in bond issuance by emerging markets, mostly relying on aggregated issuance data.⁶ The chapter builds upon the literature by examining how global factors affect firms' decisions to issue bonds while explicitly accounting for bond- and firm-specific characteristics using large, rich, and relatively underexploited databases.⁷ Finally, the chapter also considers emerging market corporate spreads; a novel feature of that analysis is the use of relatively unexplored data on secondary market corporate spreads.

The main results of the chapter can be summarized as follows:

- *The relative roles of firm- and country-specific factors as drivers of leverage, issuance, and spreads in emerging markets have declined in recent years.* Global factors appear to have become relatively more important determinants in the postcrisis period. In some cases, evidence of a structural break appears in these relationships, with a reduced role for firm- and country-level factors in the postcrisis period.
- *Leverage has risen relatively more in vulnerable sectors and has tended to be accompanied by worsening firm-level characteristics.* For example, higher leverage has been associated with, on average, rising foreign exchange exposures. Moreover, leverage has grown most in the cyclical construction sector, but also in the oil and gas subsector. Funds have largely been used to invest, but there are indica-

⁶For instance, Lo Duca, Nicoletti, and Vidal Martinez (2014) and Feyen and others (2015) focus on bond issuance data aggregated at the country and country-industry level, respectively. Likewise, Rodriguez Bastos, Kamil, and Sutton (2015) study issuance in five Latin American countries.

⁷This chapter is also related to a large literature on emerging market capital flows. Various studies find that unconventional monetary policy in advanced economies has had a significant impact on emerging market asset prices, yields, and corporate bond issuance (Chen and others 2014; Chen, Mancini-Griffoli, and Sahay 2014; Fratzscher, Lo Duca, and Straub 2013; Gilchrist, Yue, and Zakrajsek 2014; Lo Duca, Nicoletti, and Vidal Martinez 2014). IMF (2014b) identifies that global liquidity conditions drive cross-border bank lending and portfolio flows, but are affected by country-specific policies. Other studies find that the exit from unconventional monetary policy appears to have differentiated effects across emerging markets, depending on their initial conditions (Aizenman, Binici, and Hutchison 2014; Eichengreen and Gupta 2014; Sahay and others 2015); see also Nier, Saadi Sedik, and Mondino (2014).

Box 3.1. Shadow Rates

Shadow rates are indicators of the monetary policy stance and can be particularly useful once the policy rate has reached the zero lower bound (ZLB). A shadow rate is essentially equal to the policy interest rate when the policy rate is greater than zero, but it can take on negative values when the policy rate is at the ZLB. This property makes the shadow rate a useful gauge of the monetary policy stance in conventional and unconventional policy regimes in a consistent manner. Shadow rates are estimated using shadow rate term structure models, which take the ZLB into account, as originally proposed by Black (1995).¹

Although shadow rate models are not easy to estimate because of the nonlinearity arising from the ZLB, the literature began to estimate shadow rates with Japan's data by applying nonlinear filtering techniques (Ichiue and Ueno 2006, 2007). Recently, the shadow rates of other countries also have been estimated by many researchers (for example, Wu and Xia, forthcoming) and discussed by policymakers (for example, Bullard 2012).²

This box was prepared by Hibiki Ichiue.

¹In term structure models, interest rates of various maturities are represented as a function of a small set of common factors. This function is derived from a no-arbitrage condition.

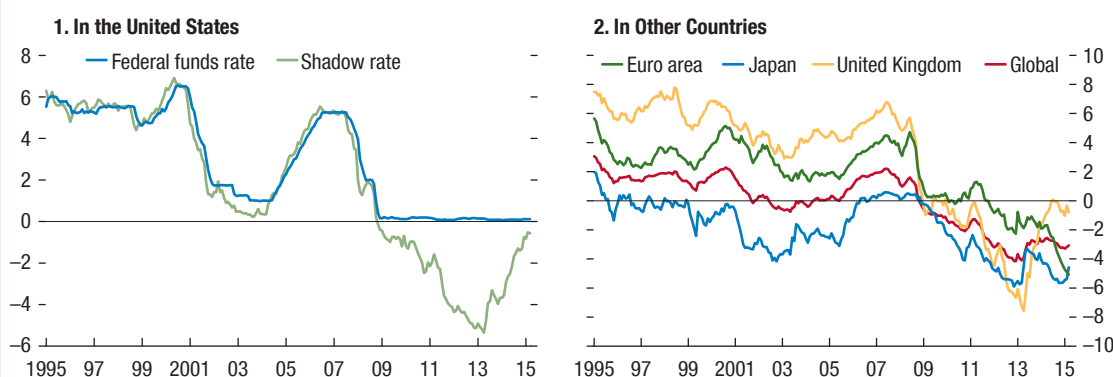
²There are limited papers that estimate shadow rates without using term structure models. Kamada and Sugo (2006) and

Estimated shadow rates reasonably reflect monetary policy events in unconventional policy regimes. The U.S. shadow rate estimated by Krippner (2014) turned negative in November 2008, when the Federal Reserve started the Large Scale Asset Purchases program (Figure 3.1.1, panel 1). The shadow rate further declined as the Fed adopted additional unconventional policies. However, it bottomed out in May 2013, when the Fed raised the possibility of tapering its purchases of Treasury and agency bonds, and has continued to increase since then. The current level of the shadow rate is only slightly negative. The shadow rate estimates in the euro area, Japan, and the United Kingdom are consistent with their respective monetary policies (Figure 3.1.1, panel 2). These observations support the utility of shadow rates, although their limitations should be recognized. The global shadow rate, which is calculated as the first principal component, has been virtually flat in recent years, reflecting that the tighter stances in the United States and the United Kingdom have been offset by accommodative stances in Japan and the euro area.

Lombardi and Zhu (2014) summarize multiple financial indicators, such as monetary aggregates.

Figure 3.1.1. Shadow Rates

(Percent)



Sources: Reserve Bank of New Zealand; and IMF staff calculations.

Note: The global shadow rate is the first principal component of the shadow rates of the four central banks (Bank of England, Bank of Japan, European Central Bank, and U.S. Federal Reserve).

tions that the quality of investment has declined recently. These findings point to increased vulnerability to changes in global financial conditions and associated capital flow reversals—a point reinforced by the fact that during the 2013 “taper tantrum,” more leveraged firms saw their corporate spreads rise more sharply.

- *Despite weaker balance sheets, emerging market firms have managed to issue bonds at better terms (lower yields, longer maturities) with many issuers taking advantage of favorable financial conditions to refinance their debt.* No conclusive evidence has been found that greater foreign currency-denominated debt has increased overall net foreign exchange exposures.

These results suggest that policy action is warranted to guard against the risks associated with the tightening of global financial conditions as monetary policy in advanced markets begins to normalize. The chapter makes the following five policy recommendations:

- Careful monitoring of vulnerable sectors of the economy and systemically important firms as well as their linkages to the financial sector is vital.
- The collection of financial data on the corporate sector, including foreign exchange exposures, needs improvement.
- Macroprudential policies can be deployed to limit excessive increases in corporate sector leverage intermediated by banks. Possible tools include higher capital requirements (for example, implemented via risk weights) for foreign exchange exposures and caps on the share of such exposures on banks’ balance sheets.
- Microprudential measures should also be considered. For instance, regulators can conduct bank stress tests related to foreign currency risks, including derivatives positions.
- Emerging markets should be prepared for corporate distress and sporadic failures in the wake of monetary policy normalization in advanced economies, and where needed and feasible, should reform insolvency regimes.

The Evolving Nature of Emerging Market Corporate Leverage

This section documents the main patterns of corporate leverage across emerging market regions and sectors. A formal empirical analysis focuses on

the changing relationship between corporate leverage and key firm, country, and global factors.

The Evolution of Emerging Market Corporate Leverage

Two complementary data sets indicate noteworthy differences in the evolution of emerging market leverage across regions and sectors.⁸

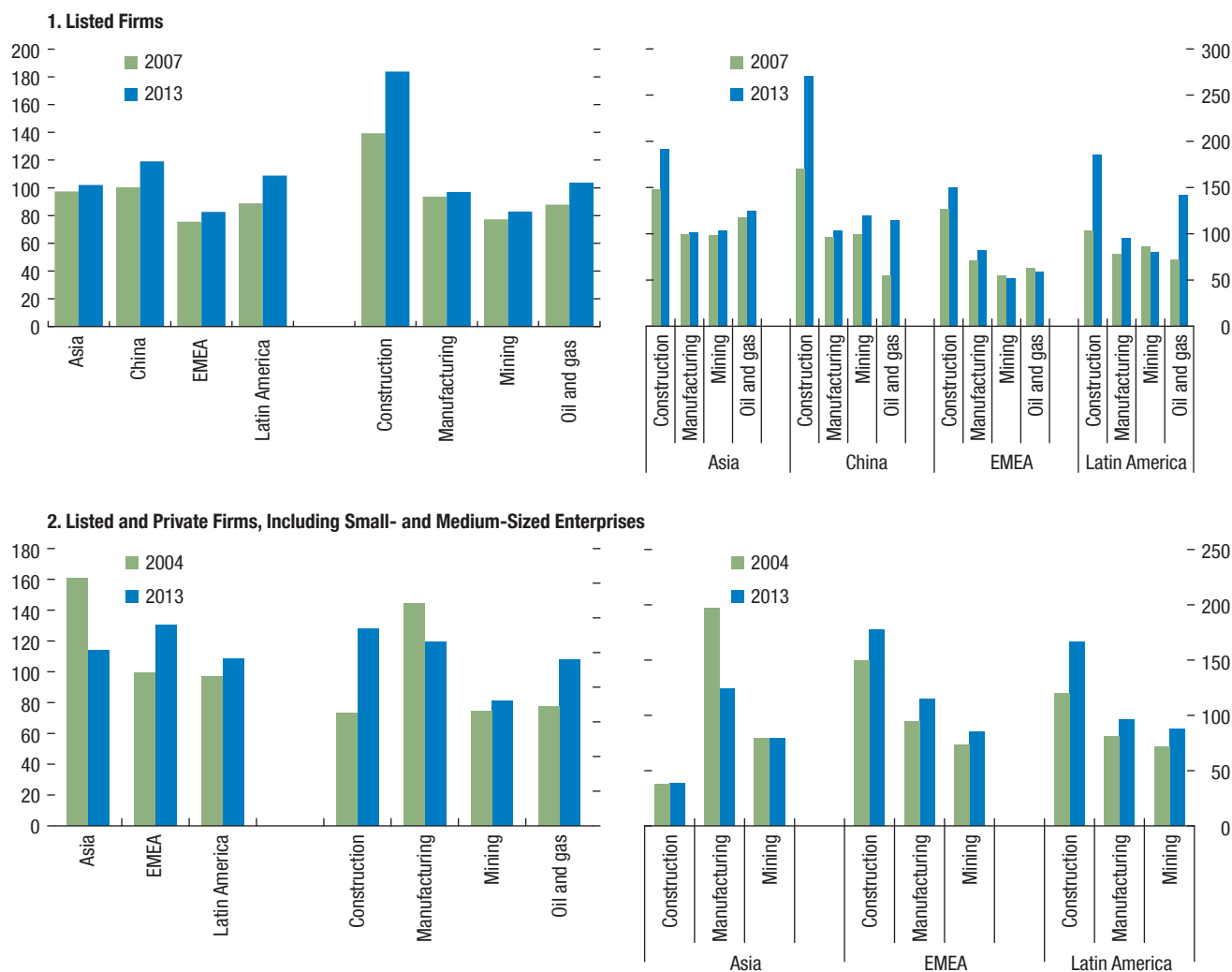
- For publicly listed firms, leverage has risen in emerging Asia; in the emerging Europe, Middle East, and Africa (EMEA) region; in Latin America; and across key sectors (Figure 3.5).
- The striking leverage increase in the construction sector is most notable in China and in Latin America. This increase relates to concerns expressed in recent years about the connection between global financial conditions, capital flows, and real estate price developments in some emerging markets (Cesa-Bianchi, Céspedes, and Rebucci 2015).⁹
- Leverage has grown in mining, and even more so in the oil and gas subsector. These sectors are particularly sensitive to changes in global growth and commodity price fluctuations. In particular, oil price declines can cut into the profitability of energy firms and strain their debt-repayment capacity (see Chapter 1 of the April 2015 GFSR).
- The patterns shift somewhat in relation to small- and medium-sized enterprises (SMEs). For instance, SME leverage seems to have declined in emerging Asia and in the manufacturing sector during the past decade. One reason for such contrasts is the differences in country composition across the two data sets. A key similarity across both data sets is the increase in construction-sector leverage, particularly across EMEA and Latin America.

Both firm- and country-specific factors appear, on average, to have deteriorated across emerging markets in the postcrisis period. At the country level, lower real GDP growth and higher current account and fiscal deficits are examples of worsening postcrisis macroeconomic conditions (Table 3.1). The

⁸One data set, Thomson Reuters Worldscope, contains publicly listed firms, which tend to be larger and have received greater attention. The other, Orbis, predominantly includes unlisted small- and medium-sized enterprises and has been relatively underutilized.

⁹See also <http://blog-imfdirect.imf.org/2014/06/11/era-of-benign-neglect-of-house-price-booms-is-over/>.

Figure 3.5. Emerging Market Economies: Corporate Leverage by Selected Regions and Sectors
(Percent; ratio of total liabilities to total equity)



Sources: Orbis; Thomson Reuters Worldscope; and IMF staff calculations.

Note: Total liabilities refer to total (nonequity) liabilities. Mining includes oil and gas. Panel 1 begins in 2007 to account for the relative scarcity of Chinese firms in the beginning of the sample period; a balanced sample is used to highlight trends across larger firms. The relative scarcity of data, particularly in the first few years of the sample, is the main reason Chinese patterns are not shown individually in the bottom panels. The regional breakdown of the oil and gas subsector is also excluded for similar reasons. EMEA = Europe, Middle East, and Africa.

International Country Risk Guide (ICRG) index summarizes these and other key macroeconomic fundamentals and corroborates the bleaker domestic conditions in 2010–13. Even though liquidity has edged up at the firm level since the crisis, profitability, solvency, and a measure of asset quality have deteriorated.

Firms that took on more leverage have, on average, also increased their foreign exchange exposures.

- Net foreign exchange exposures are indirectly estimated for listed firms using the sensitivity of their stock returns to changes in trade-weighted exchange rates (Box 3.2).¹⁰
- The estimated foreign exchange exposures highlight sectoral differences (Figure 3.6). Firms in nontradable sectors, such as construction, tend to have

¹⁰See also Acharya and others (2015).

Table 3.1. Worsening Emerging Market Firm-Level and Macroeconomic Fundamentals
(Percent, unless otherwise noted)

	Precrisis (2004–07)	Postcrisis (2010–13)
Firm-Level Fundamentals		
Profitability		
Return on Assets	3.6	3.3
Liquidity		
Quick Ratio	0.9	1.0
Solvency		
Interest Coverage Ratio	3.4	2.8
Asset Quality		
Tangible Asset Ratio	30.5	22.9
Macroeconomic Fundamentals		
Real GDP Growth	6.2	3.9
CPI Inflation	4.8	3.9
Short-Term Interest Rate	4.2	3.6
Current Account Balance ¹	0.6	–0.9
External Debt ¹	35.9	35.6
Fiscal Balance ¹	–0.9	–2.8
Public Debt ¹	38.1	39.2
ICRG (macroeconomic fundamentals summary) Index ²	38.7	38.2

Source: IMF staff.

Note: Historical averages of median firm-level fundamentals reported for all countries in the sample. Interest coverage ratio is EBITDA (earnings before interest, taxes, depreciation, and amortization) to interest expenses; the quick ratio is cash, cash equivalents, short-term investments, and accounts receivables to current liabilities; the tangible asset ratio is the ratio of fixed assets (which include property, plant, and equipment) to total assets.

¹Percent of GDP.

²The average of the International Country Risk Guide (ICRG) Economic and Financial Risk Ratings, which aim to provide an overall assessment of a country's economic situation and ability to finance its debt obligations, respectively. The ICRG index is fairly stable, indicating that small changes can be meaningful: the decline in the index between the two periods is about one-half standard deviation.

positive foreign exchange exposures, reflecting their need for imports. Firms in tradable sectors, such as mining, tend to have negative foreign exchange exposures, because exporting firms benefit from a depreciation of the local currency.¹¹ The evolution of foreign exchange exposures after the global financial crisis differs across regions. Outside of Asia, the fraction of firms with positive foreign exchange exposures increased across all sectors after the crisis.

- Interestingly, the construction sector, where leverage grew rapidly, is among the sectors perceived by stock markets in emerging market economies as having strongly increased their exposure to exchange rate fluctuations in recent years (Figure 3.7).

¹¹These results are consistent with the literature (for example, Bodnar and Gentry 1993; Griffin and Stulz 2001).

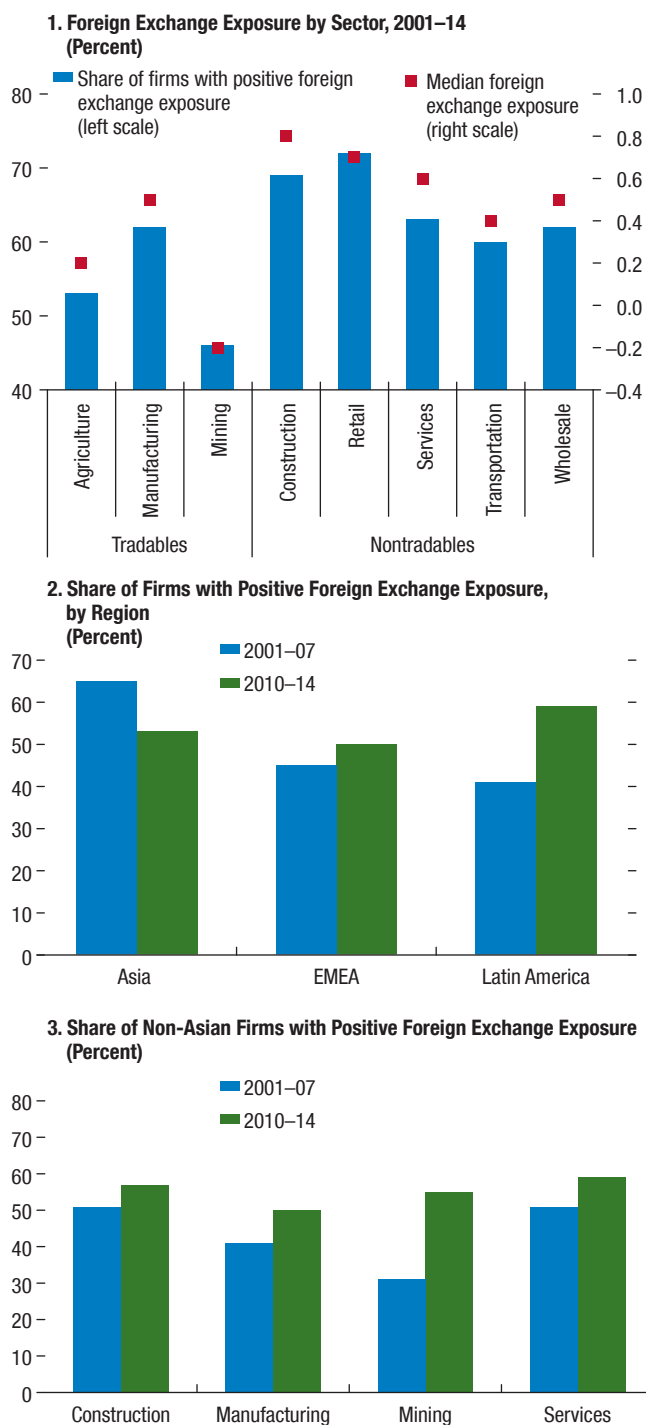
The data suggest a growing concentration of indebtedness in the weaker tail of the corporate sector. The share of liabilities held by listed firms is split according to a measure of their solvency, that is, the interest coverage ratio (ICR) (Figure 3.8). An ICR lower than 2 often means that a firm is in arrears on its interest payments. Note that the share of liabilities held by firms with ICRs lower than 2 has grown during the past decade, and is now greater than the 2008 level. The rise of corporate leverage amassed at the tail end of the distribution also raises concerns about China (Box 3.3).

Firm-Level Dynamics of Emerging Market Corporate Leverage

The empirical analysis focuses on the firm-level dynamics of emerging market corporate leverage. The corporate finance literature (focusing mostly on advanced economies) has converged to a set of variables that are considered reliable drivers of corporate leverage: firm size, collateral, profitability, and the market-to-book ratio. The literature's selection of these variables can be traced to various corporate finance theories on departures from the Modigliani-Miller irrelevance proposition, which holds that the specific proportions of debt and equity in a firm's capital structure are irrelevant to its market value (Box 3.4). Building on these studies, this chapter considers both domestic (firm-specific and macroeconomic) factors and global economic and financial conditions as potential determinants of corporate leverage. The focus is on the change in the leverage ratio.

The rise of global factors

The increase in emerging market corporate leverage appears to be closely associated with favorable global conditions. Econometric analysis confirms that firm- and country-specific characteristics are key determinants of emerging market corporate leverage growth: these terms have the expected signs and are statistically significant (Figure 3.9, panel 1). In particular, profitability, tangibility, and the measure of macroeconomic conditions are positively correlated with leverage growth. These positive relationships would imply that leverage should have declined given the deterioration in these determinants in the postcrisis period discussed above (Table 3.1). However, the fact that the opposite happened suggests that global

Figure 3.6. Foreign Exchange Exposures in Emerging Market Economies (Listed Firms)

Sources: IMF, Information Notice System; Thomson Reuters Datastream; Thomson Reuters Worldscope; and IMF staff estimates.
 Note: EMEA = Europe, Middle East, and Africa.

factors may be behind the rise in emerging market corporate leverage. Precisely identifying the role of individual global factors is difficult, however; therefore, the analysis initially captures global economic and financial conditions using time dummies—which can be thought of as unobservable global factors. The time dummies indeed suggest that global factors are becoming more important as drivers of emerging market corporate leverage growth in the postcrisis period.

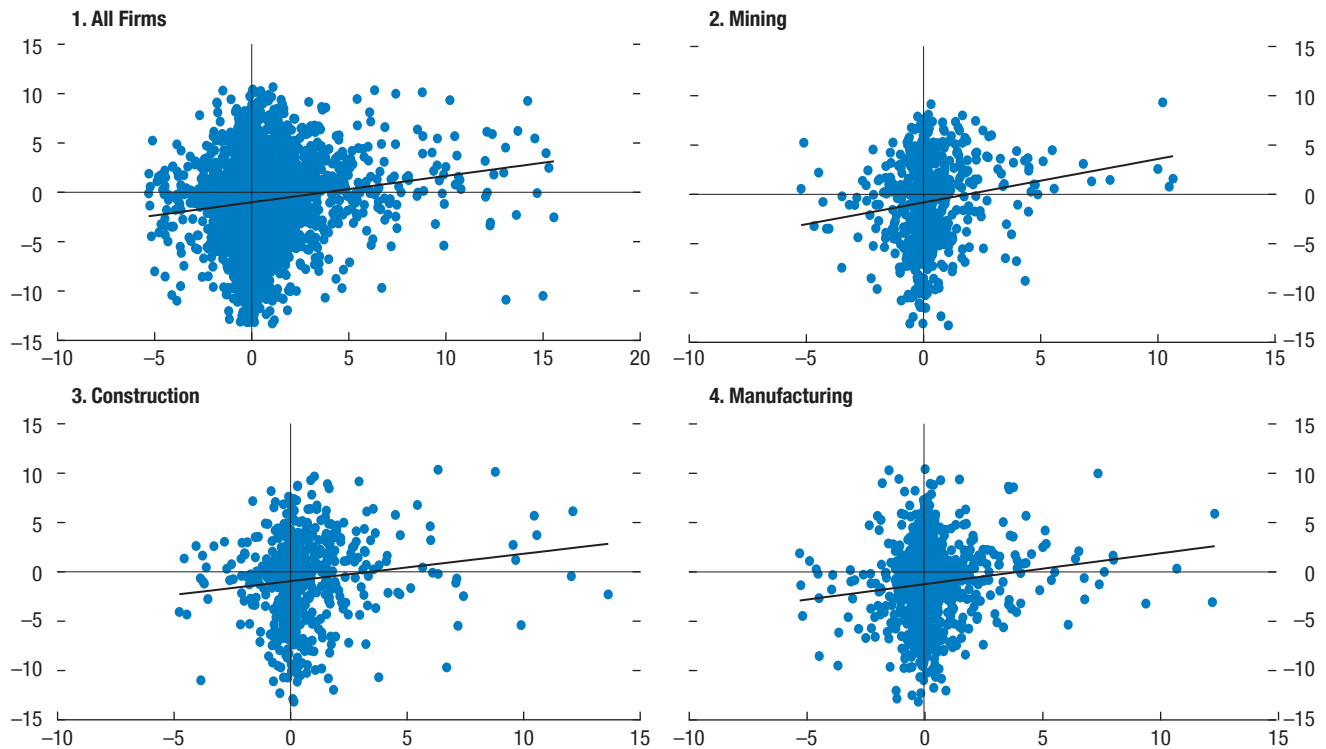
When specific global factors are considered, the inverse of the U.S. shadow rate and, to a lesser extent, global oil prices seem to be particularly associated with leverage growth. This result emerges when including various global factors simultaneously in the regression.¹² Further econometric analysis points to a greater role for global factors, in particular the shadow rate, in the postcrisis rise of leverage. Their influence during the period was examined through two complementary regression models. The first explicitly accounts for possible structural breaks, and suggests that the U.S. shadow rate became a more significant postcrisis determinant of emerging market leverage growth.¹³ The second model contrasts the precrisis (2004–07) and postcrisis (2010–13) periods, and finds a significant positive postcrisis correlation between the shadow rate and no significant role for country-specific factors.

The role of easier global financial conditions is corroborated through evidence on the relaxation of financing constraints. The relevance of relaxed financing constraints for leverage can be assessed by focusing on SMEs and weaker firms, which typically have more limited access to finance. Similarly, a closer look can be taken at sectors that are intrinsically more dependent on external finance (Rajan and Zingales

¹²In the baseline regression model, the inverse of the U.S. shadow rate and the change in global oil prices are the main global factors. The results hold if the U.S. shadow rate is replaced with the global shadow rate. The results are also robust to the inclusion of other global factors such as changes in the Chicago Board Options Exchange Volatility Index (VIX), global commodity prices, and global GDP, as well as other controls, and to GDP weighting (Annex 3.1). Although robustness of these alternative specifications is encouraging, longer time series would be needed to make more definitive statements on the precise relationship between emerging market leverage growth and specific global factors.

¹³The analysis of a longer sample (1994–2013) of listed firms reveals a positive and statistically significant correlation between the inverse shadow rate and emerging market leverage growth even after controlling for other global factors. Evidence based on this longer sample also confirms the presence of a postcrisis structural break.

Figure 3.7. Change in Foreign Exchange Exposures and Corporate Leverage, by Sector
(Percentage points)



Source: IMF staff estimates.

Note: The vertical axes depict the changes (from 2001–07 to 2010–14) in estimated foreign exchange exposure and the horizontal axes depict the changes in the leverage ratio (total liabilities to market equity) for listed firms. The slopes are statistically significant at least at the 5 percent level. The results are robust to outliers and to other measures of leverage.

1998). Evidence indicates that leverage for all these types of firms is more responsive than for other firms to prevailing global monetary conditions. Moreover, in countries that have more open capital accounts and that received larger capital inflows, firms' leverage growth tends to be more responsive to global financial conditions.

How have firms been using borrowed funds?

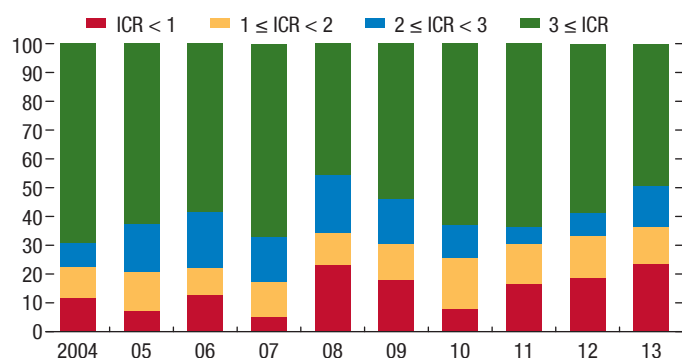
Estimates based on listed firms' balance sheets suggest that greater borrowing has been used more for net investment than for the accumulation of cash (Figure 3.10).¹⁴ The results also suggest that in the postcrisis

period, financing availability has become more important than profitability in driving investment. For example, during 2010–13, the relationship between investment and leverage strengthened, but it weakened for cash flows, and became statistically insignificant for a forward-looking measure of profitability (Tobin's Q). Possibly, the more favorable postcrisis global financial conditions relaxed financing constraints, allowing more debt-financed capital expenditure for less profitable projects.¹⁵

¹⁵As in Magud and Sosa (2015), the classic Fazzari, Hubbard, and Petersen (1988) model—which builds on the standard Q theory of investment—is augmented by a measure of leverage. In addition to leverage growth, the other main determinants of investment are Tobin's Q (to capture marginal profitability and growth opportunities), cash flow measures (a proxy for financing constraints), and the cost of capital. A positive and statistically significant cash flow coefficient suggests that firms face financial constraints because they would need to rely on internal funds to finance investment projects. Estimates using the full and precrisis (2004–07) samples reveal that all variables are statistically significant and have the expected signs.

¹⁴Although these estimates are indicative, it is possible, for example, that net investment in any one year may have been financed with working capital or retained earnings (captured in the "other" term), including from earlier years. The close association between changes in leverage and investment are confirmed by firm-level investment equations. As expected, the level of leverage is negatively associated with investment (see also IMF 2015d).

Figure 3.8. Corporate Liabilities and Solvency
(Percent; solvency measured using the ICR)



Sources: Thomson Reuters Worldscope; and IMF staff estimates.

Note: The figure shows the share of liabilities held by firms according to their interest coverage ratio (ICR). The ICR is a measure of firms' solvency, calculated as the ratio of earnings (before interest and taxes) to interest expenses.

Summary

Overall, the relative role of global factors as key drivers of emerging market corporate leverage dynamics has increased in recent years. The evidence shows some signs of elevated corporate exposure to a potential worsening in global financial conditions. The buildup in leverage in the construction sector and the related rise in net foreign exchange exposure as well as growing concentration of indebtedness in the weaker tail of the corporate sector provide particular reasons for concern. However, the growth in leverage appears to have fostered investment, although investment projects may have become less profitable more recently.

Emerging Market Corporate Bond Finance

The growth in emerging market corporate leverage has been accompanied by a change in its composition. In particular, the importance of bond finance has grown rapidly in recent years. Therefore, this section examines the role of firm, country, and global factors in explaining patterns of bond issuance to help determine whether the patterns are associated with rising vulnerabilities.

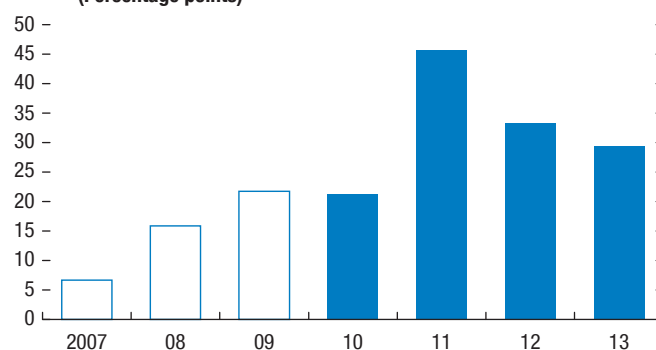
Emerging market corporate bond issuance has risen sharply since 2009, becoming an increasingly important source of corporate financing in those economies. Starting from a low base, the share of corporate finance accounted for by bonds has nearly doubled since the crisis, and totaled more than \$900

Figure 3.9. Key Determinants of Emerging Market Economies' Corporate Leverage

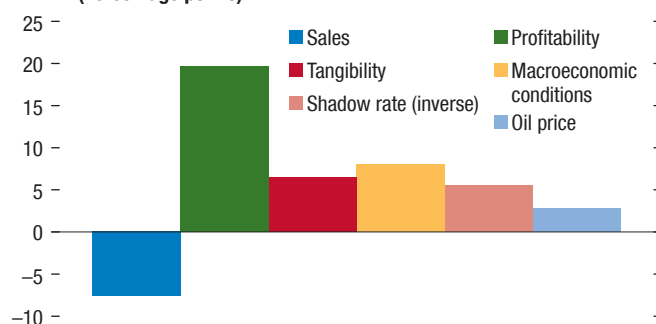
1. Determinants of Leverage Growth

Baseline Determinants	Expected Sign
Firm Level	
Sales	+/-
Profitability	+
Tangibility	+
Country Level	
Macroeconomic Conditions	+
Global	
Shadow Rate (inverse)	+
Oil Prices	+

2. The Changing Relationship between Leverage and Global Factors (Percentage points)



3. Specific Determinants of Leverage Growth (Percentage points)

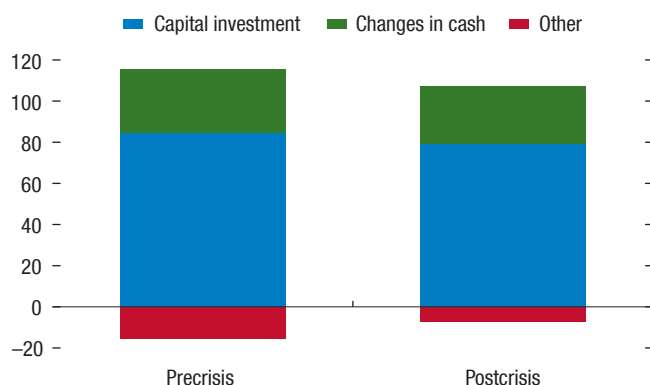


Sources: Orbis; and IMF staff calculations.

Note: Sample period: 2004–13. An empty bar (panel 2) denotes that the time dummy is not statistically significant at the 10 percent level. The standardized coefficients (panel 3) are statistically significant at the 1 percent level. Firm-level variables are lagged; sales and tangibility are changes. See Annex 3.1 for further details.

billion in 2014 (Figure 3.11, panel 1). Likewise, issuance via subsidiaries in offshore financial centers has increased significantly since the crisis, driven primarily by borrowers headquartered in Brazil and China

Figure 3.10. Leverage, Cash Holdings, and Corporate Investment
(Percent contributions to the change in debt as a share of total assets)



Sources: Thomson Reuters Worldscope; and IMF staff calculations.

Note: “Other” refers to other net assets and retained earnings. All variables were normalized by lagged total assets. Firms with an increase in leverage above the first quartile of the leverage distribution were included.

(McCauley, Upper, and Villar 2013; see also Shin 2013; Avdjiev, Chui, and Shin 2014).¹⁶ Issuance is most notable in the oil and gas sector (with a sizable foreign exchange component) and in construction, especially since 2010.¹⁷ Although China has been an important part of this development, the uptrend in issuance is broad based across emerging markets. In particular, emerging markets other than China have on average returned to the rapid pace of issuance observed before the global financial crisis. Within countries, however, the postcrisis growth in access has not been even. One-third of emerging markets have seen aggregate increases in the total amount issued alongside *declines* in the total number of issuers. To a significant extent, the growth in international bond issuance can be traced to the decline in cross-border lending, which in turn appears to be largely driven by a retrenchment on the part of banks (Chapter 2 of the April 2015 GFSR).

A shift to bond financing has benefits and drawbacks from both firm and macroeconomic perspectives. A key benefit of greater access to bond finance is that

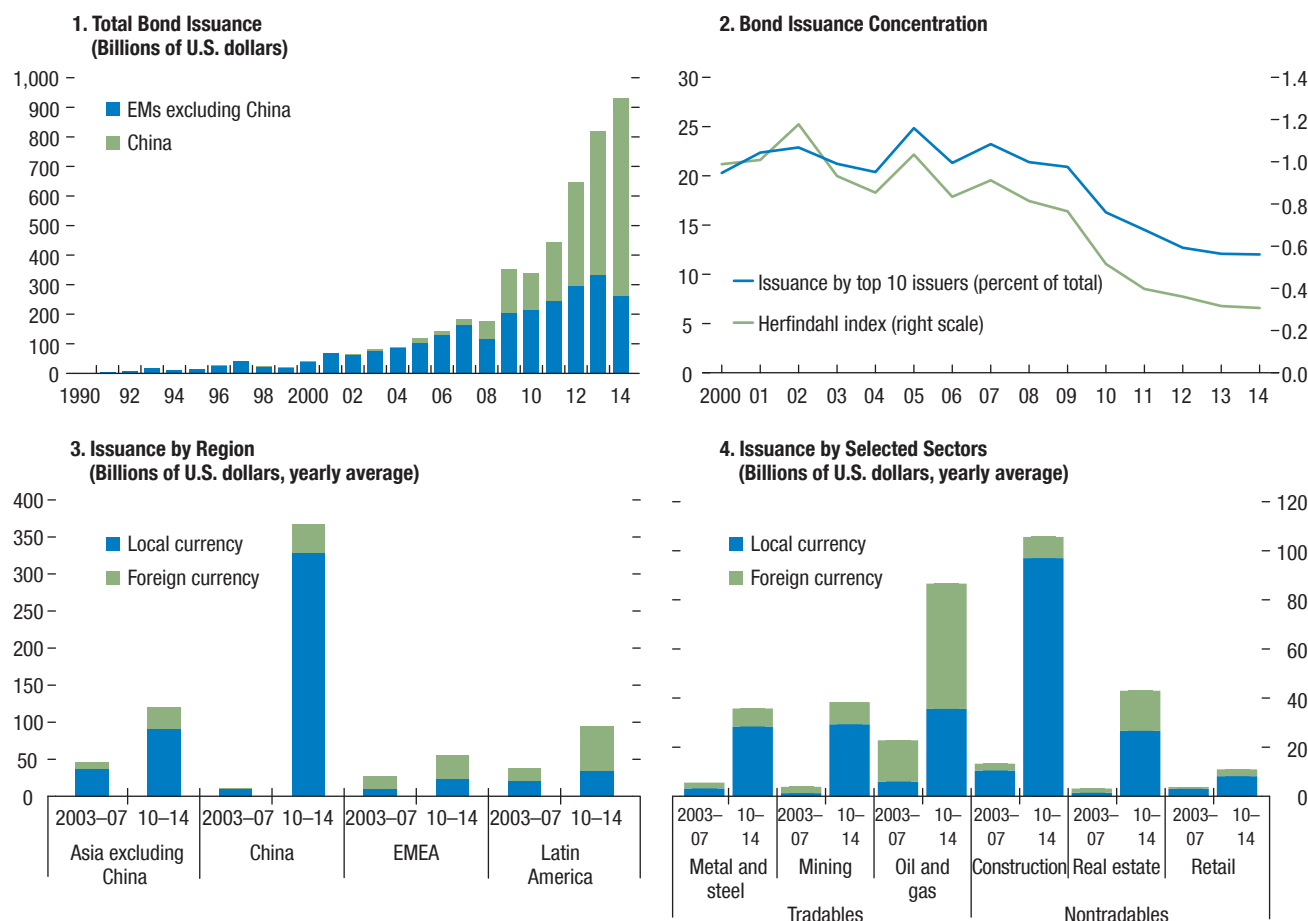
it can provide financing to the real economy even when banks are distressed, but it also exposes companies to more volatile funding conditions. Since bond financing is unsecured, it does not entail the macroeconomic amplification mechanisms associated with collateral valuations (whereby an economic downturn depresses collateral values, thus constraining borrowing capacity and investment even more [Kiyotaki and Moore 1997]).¹⁸ Compared with cross-border bank lending, the participation by international investors in local markets can also have advantages in dampening the impact of global financial conditions—for example, if foreign lenders want to withdraw, part of the balance of payments impact is cushioned by bond valuation effects. On the other hand, bond financing tends to be associated with weaker monitoring standards due to a larger pool of bond investors who may “choose” not to monitor the business activities of the bond issuers. This can create incentives for excessive risk-taking behavior by firms. Moreover, the growing intermediation through bond mutual funds can entail its own risks, as extensively discussed in Chapter 3 of the April 2015 GFSR.

The share of bond issuance denominated in euros has grown appreciably in recent years (Figure 3.12). Although foreign currency issuance continues to be dominated by U.S. dollar bonds, the rise in euro denominations likely reflects expectations of tighter U.S. monetary conditions and more accommodative monetary policy by the European Central Bank, and associated exchange rate expectations. For all emerging markets, the share of bonds issued in foreign currency has declined by more than 10 percentage points relative to the precrisis period. However, that reading is mainly driven by the sharp rise in bond issuance by China, which is predominantly in local currency. Although firms in some emerging markets, such as Colombia, Malaysia, the Philippines, Russia, and Thailand, have issued relatively more in local currency, firms in many other emerging markets have increased their bond financing in foreign currency. However, tentative evidence indicates that listed firms that have issued in foreign currency do not appear to have raised their foreign exchange exposures, possibly because of higher exports,

¹⁶The general trends discussed in this section, are, however, robust to the use of alternative notions of nationality, such as issuers’ nationality of risk, country of incorporation, or ultimate parent nationality.

¹⁷Although currency mismatches are likely to be smaller in the oil and gas sector than in other sectors to the extent that export receipts are denominated in dollars, this sector is still vulnerable to oil price declines (see, for example, BIS 2015).

¹⁸In line with this, the effects of banking crises on the economy are found to be worse than in other types of crises (see Cardarelli, Elekdag, and Lall 2011; Giesecke and others 2014).

Figure 3.11. Bond Issuance by Regions and Sectors

Sources: Dealogic; and IMF staff calculations.

Note: Nationality is based on a firm's country of risk. The general trends in these charts are robust to alternative notions of nationality, such as issuer's nationality of incorporation or ultimate parent nationality. A lower value of the Herfindahl index value indicates a lower degree of concentration. EMs = emerging market economies; EMEA = Europe, Middle East, and Africa.

increased hedging, or a substitution of foreign currency bank loans.¹⁹

The financial conditions of issuing firms appear to have broadly deteriorated in recent years. Since the crisis, bonds have been issued by more leveraged and less profitable firms on average (Figure 3.13). Indices of solvency (ICR) and liquidity (quick ratio) have also generally deteriorated among issuing firms.²⁰ Since 2010, firms have used bond issuance

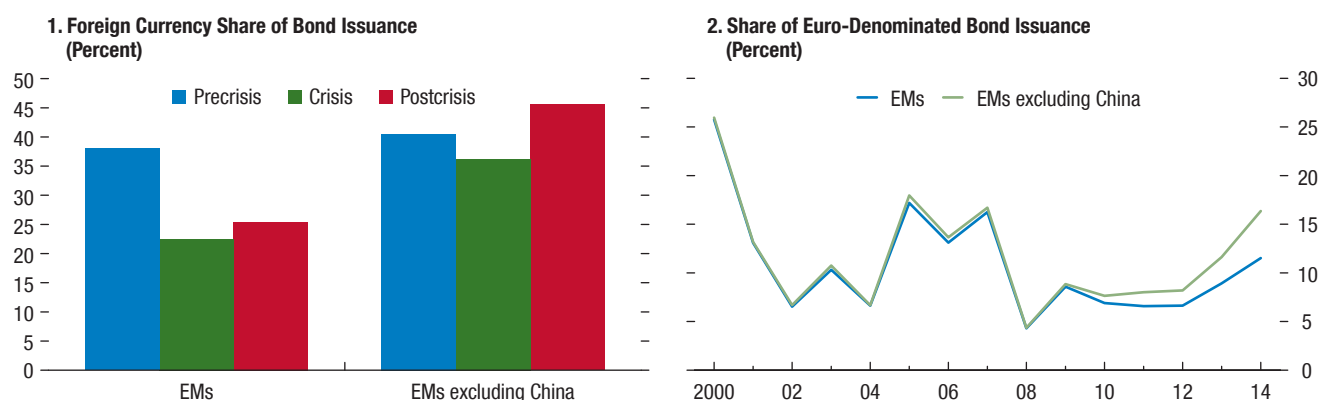
¹⁹The correlation between foreign currency bond issuance and the change in foreign exchange exposure is statistically insignificant in the postcrisis period; however, the sample of firms considered was relatively small.

²⁰See Fuertes and Serena (2014) for a description of balance sheet trends in a broad range of emerging markets for firms tapping international bond markets.

less for investment and more to refinance debt, most likely to take advantage of the favorable financing conditions (see also Rodríguez Bastos, Kamil, and Sutton 2015).²¹ Indeed, the share of issuers reporting refinancing as their intended use of proceeds has been rising.

Emerging market firms have managed to issue at better terms (Figure 3.14). Average maturity at issuance for domestic and external bonds has generally lengthened by more than one year relative to the precrisis average, mitigating rollover risk for

²¹The fact that firms report lower use of proceeds for investment purposes is not inconsistent with the information presented earlier that more leverage had been associated with higher investment (for example, firms may have used proceeds to pay off bank debt while increasing their overall leverage and investment).

Figure 3.12. Bond Issuance: Currency Composition

Sources: Dealogic; and IMF staff calculations.

Note: EMs = emerging market economies. Precrisis: 2003–07, crisis: 2008–09, postcrisis: 2010–14. Nationality is based on a firm's country of risk. The general trends in these charts are robust to alternative notions of nationality, such as issuer's nationality of incorporation or ultimate parent nationality. The share of euro-denominated bond issuance (panel 2) is computed relative to the total amount of dollar and euro issuance.

borrowers at the expense of increased duration risk for investors. Yields to maturity have also fallen. The fact that firms have been able to issue at better terms against a background of worsening balance sheets suggests that global factors may have played an important role in facilitating firms' access to finance.

Changes in firms' access to bond markets

The role of firm-level factors in explaining issuance since the crisis has decreased (Figure 3.15). In line with the literature, the analysis indicates that larger, more-leveraged, and seasoned-issuer firms have a greater tendency to issue bonds.²² Although higher real GDP growth is related to a higher probability of issuance, macroeconomic variables are generally not reliable predictors of firm-level bond issuance.²³ Although

the inverse of the U.S. shadow rate is generally not statistically significant over the entire sample, in the postcrisis period it is a key determinant of the change in the postcrisis probability of issuance.²⁴ In line with this result, using country-level data focusing on the composition of emerging market corporate leverage, Ayala, Nedeljkovic, and Saborowski (2015) conclude that global factors have taken center stage in explaining changes since the crisis (Box 3.5).²⁵

Changes in bond maturity

The crisis seems to have brought about a structural change in the relationship between bond maturity and its determinants. Regression analysis shows that bond- and firm-level characteristics, as well as global factors, are important determinants of bond matu-

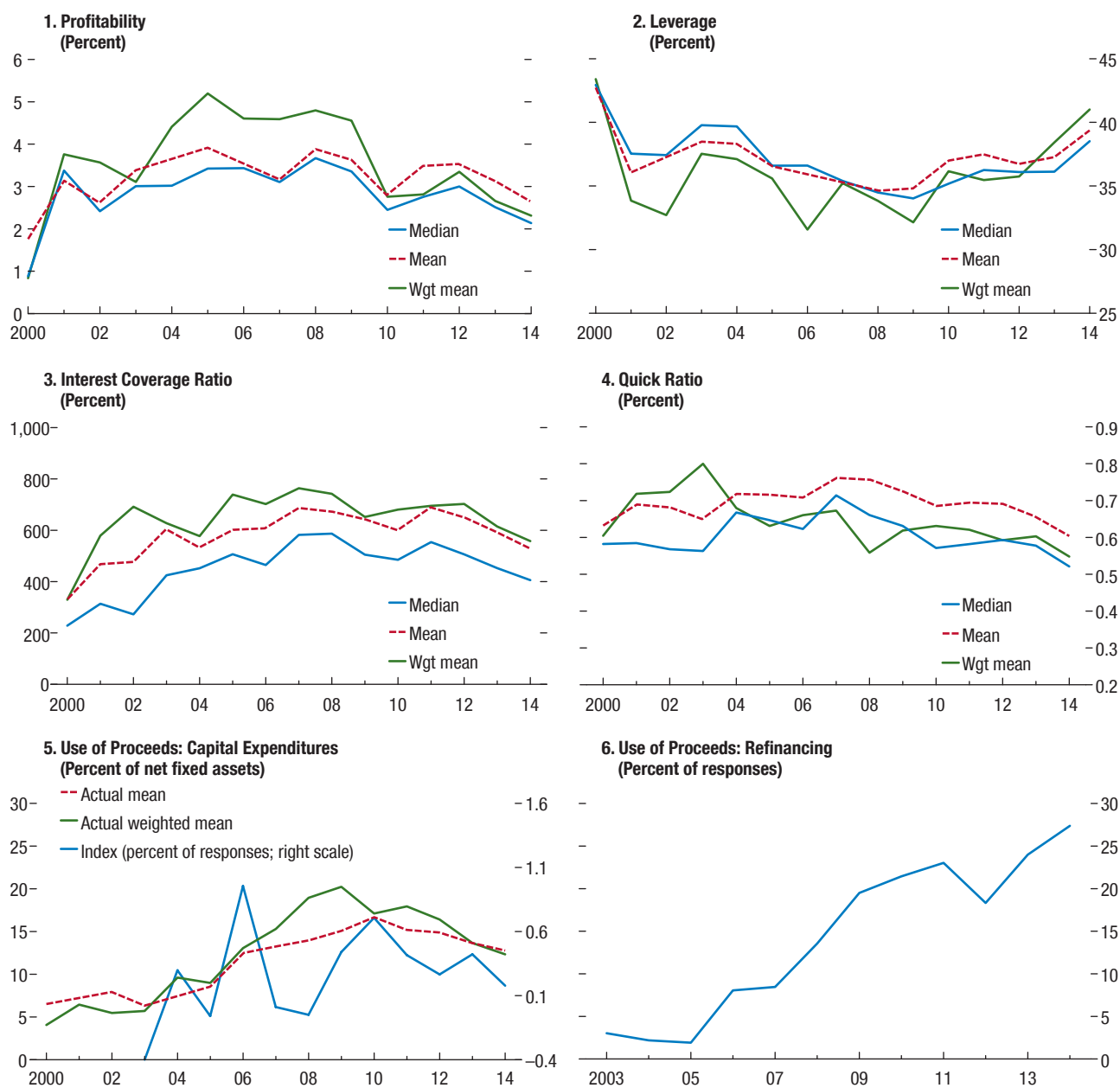
²²Using firm-level data, a pooled probit model was used to estimate the probability of bond issuance controlling for firm characteristics as well as macroeconomic and global factors (see Annex 3.2). These results are consistent with the notion that issuing a bond entails significant fixed costs (Borensztein and others 2008). To the extent that it serves as a proxy for healthier financial conditions, profitability might be expected to have a positive influence on the decision to issue bonds. However, profitable firms may use internal funds instead of external financing. The findings in the empirical literature are mixed (Borensztein and others 2008; Didier, Levine, and Schmukler 2014).

²³Using aggregate data and spanning a broader set of emerging markets, Feyen and others (2015) find that issuance is greater in countries with higher per capita GDP, growth, or current account deficits. Lo Duca, Nicoletti, and Vidal Martinez (2014) show that

domestic financial variables such as the domestic interest rate, equity returns, and equity volatility are not statistically significant when global factors are included. Policies to promote bond market development may have also played a role in greater issuance, for example, the Asian Bond Market Initiative, an initiative of 12 central banks in the Asia-Pacific region administered by the Bank for International Settlements.

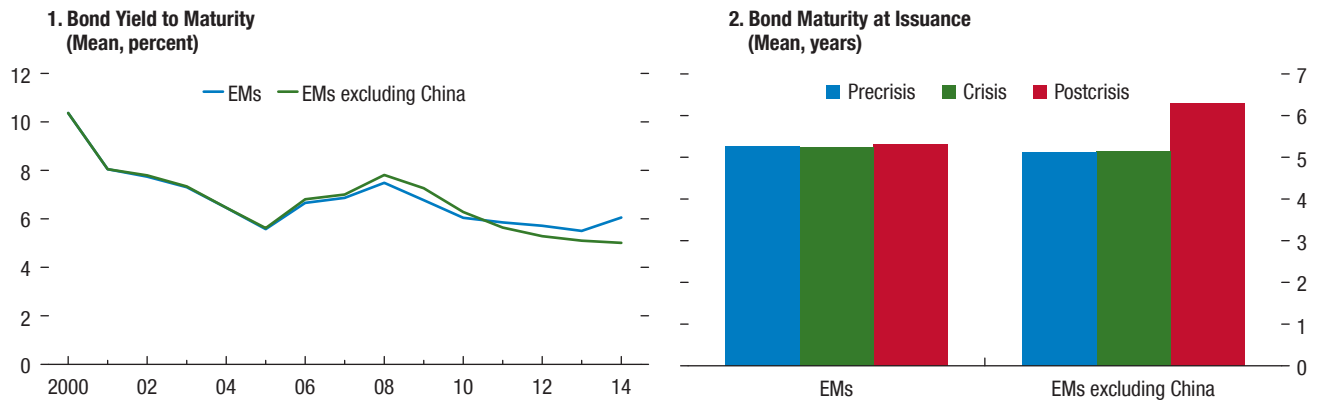
²⁴The VIX (used to capture global investor sentiment) is negatively related to the probability of crisis over the full sample period. However, the relationship is no longer statistically significant in the postcrisis period. More generally, similar results are obtained when estimating the probability of first-time bond issuance.

²⁵Also in line with these results, Lo Duca, Nicoletti, and Vidal Martinez (2014) and Feyen and others (2015) find, using aggregate issuance data, that global monetary conditions have had a significant positive effect on emerging market corporate issuance during the postcrisis period.

Figure 3.13. Deteriorating Firm-Specific Fundamentals for Bond-Issuing Firms

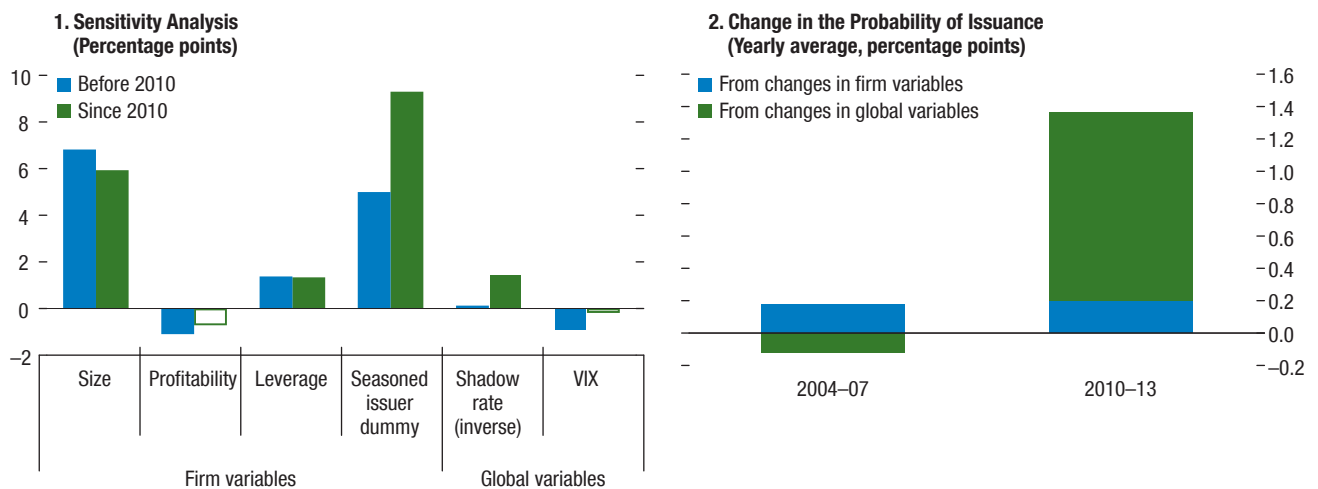
Sources: Bloomberg, L.P.; Dealogic; and IMF staff calculations.

Note: Profitability is the return on assets. Leverage is total debt to total assets. Interest coverage ratio is EBITDA (earnings before interest, taxes, depreciation, and amortization) to interest expenses. Liquidity is measured by the quick ratio (cash, cash equivalents, short-term investments, and receivables to current liabilities). All variables correspond to the year prior to issuance. Nationality is based on the country of risk. Listed and nonlisted firms are included (although coverage is limited for the latter). Panel 5 shows the actual capital expenditures in percent of net fixed assets on the year of issuance. Index constructed based on intended use of proceeds as reported to Dealogic, as percentage of total responses per year. The index in panel 6 includes the categories "Refinancing," "Debt repayment," and "Restructuring." Wgt mean = mean weighted by deal value.

Figure 3.14. Bond Issuance: Yields and Maturity

Sources: Dealogic; and IMF staff calculations.

Note: Precrisis: 2003–07, crisis: 2008–09, postcrisis: 2010–14. Nationality is based on a firm's country of risk. These general trends are robust to alternative notions of nationality, such as issuer's nationality of incorporation or ultimate parent nationality. EMs = emerging market economies.

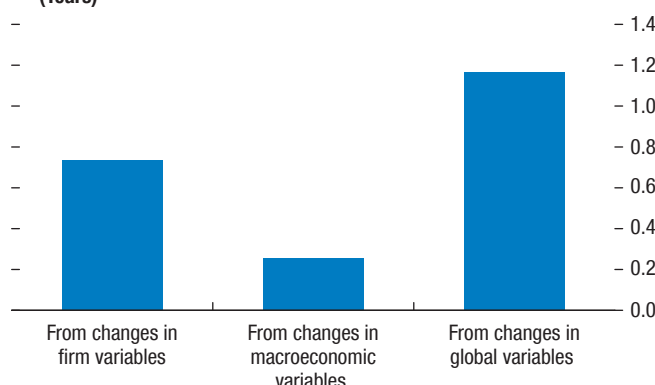
Figure 3.15. Factors Influencing the Probability of Bond Issuance

Sources: Bloomberg, L.P.; Thomson Reuters Worldscope; and IMF staff calculations.

Note: The shaded bars denote statistical significance at least at the 5 percent level. The probability of issuance is estimated using a pooled probit model with a time trend and country and sector dummies. Standard errors are clustered at the country level. Nationality is based on firms' country of risk. The attribution analysis shown in panel 2 is computed using the coefficients of the pre- and postcrisis estimates and is not standard because of the nonlinear nature of the probit model. The analysis decomposes the average yearly change in probability of issuance into that explained by changes in firm or global variables. For each annual change, all variables are kept at their initial mean, except firm- and global-level variables, which are assigned their initial and end-period means to obtain their contributions. The pre- and postcrisis contributions are obtained by averaging yearly contributions for 2004–07 and 2010–13, respectively. The calculation is done for nonseasoned issuers and for the median country and sector fixed effects. A seasoned issuer is a firm that has issued before. See Annex 3.2. VIX = Chicago Board Options Exchange Volatility Index.

Figure 3.16. Factors Influencing Bond Maturity**1. Bond Maturity at Issuance**

Variable	Expected Sign	Estimates
Issuance in Local Currency	–	– **
Investment Grade	+	+ **
Firm Size	+	+ ***
Profitability	+	–
Leverage	–	– **
Inverse Shadow Rate ¹	+	+ **
VIX	–	– ***
Currency Depreciation	–	– **
Size of Government Debt	+	+ **

2. Changes in Maturity at Issuance, 2009–13 (Years)

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

Note: The baseline specification estimates bond maturity at issuance as a function of bond, firm, macro, and global factors, with country and sector fixed effects and a time trend. Firm factors include a measure of size (total assets), profitability (return on assets), and leverage (debt-to-assets), all at the year prior to issuance. Bond factors include dummies for bond currency denomination; investment grade; and put, call, and sink options. Global factors are the VIX and the inverse shadow rate (three-month average prior to issuance) interacted with a postcrisis dummy. Macro factors include the government debt and exchange rate depreciation relative to the U.S. dollar. Standard errors are clustered at the country level. Nationality is based on country of risk; Chinese firms are excluded. VIX = Chicago Board Options Exchange Volatility Index. See Annex 3.2. ** and *** denote statistical significance at the 5 and 1 percent levels, respectively.

¹Refers to the coefficient in the postcrisis period.

rity.²⁶ In particular, larger and less leveraged firms, firms in countries with smaller government debt-to-GDP ratios and with depreciating exchange rates, and companies facing lower investor uncertainty (measured by the Chicago Board Options Exchange Volatility Index [VIX]) tend to issue at longer maturities.²⁷ Favorable global financial conditions have been a key determinant of the lengthening of maturity in the postcrisis period. Indeed, in recent years, accommodative U.S. monetary policy explains more of the recent lengthening in maturities than do firm characteristics (Figure 3.16).²⁸ Moreover, U.S. shadow rate fluctuations have a greater impact on maturity for external issuances and for non-investment-grade issuances.

²⁶Fuertes and Serena (2014) and Shin (2014a) document a lengthening in maturities for external bond issuances by nonfinancial corporations and nonbank financial corporations in a broad range of emerging markets.

²⁷The finding that maturities tend to be longer in countries with larger government debt is in line with the idea that a large, liquid government bond market can have a positive effect on the development of corporate debt markets.

²⁸Feyen and others (2015) show that global factors have an impact on maturity structure of emerging market financial and nonfinancial corporate bond issuance. The specification in this section is similar to theirs, but it focuses only on nonfinancial firms and controls for firm-level characteristics, as is standard in the literature (Annex 3.2).

Summary

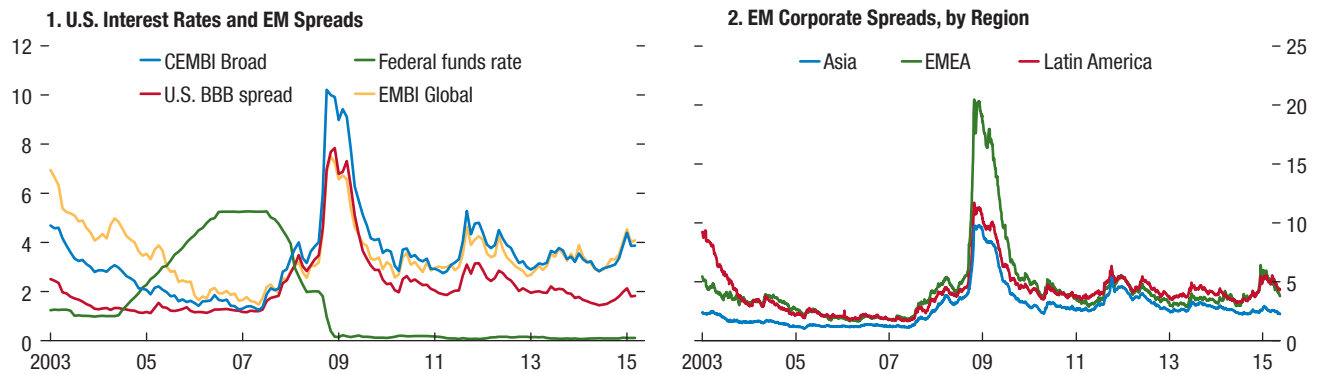
Global factors seem to have become relatively more important determinants of bond issuance and maturity in the postcrisis period. Emerging market corporate bond issuance has grown on a broad basis since 2009. The decline in the share of foreign currency issuance in emerging markets reflects activity in China, where firms have issued mostly in local currency. Despite weaker domestic fundamentals, emerging market firms have managed to issue bonds with lower yields and longer maturities.

Emerging Market Corporate Spreads

This section examines changes in the balance between domestic and global factors in the behavior of emerging market corporate spreads. Extending the approach of the preceding sections, it uses a price-based analysis in which spreads are linked to firm-level, country-level, and global characteristics. A novel feature of this analysis is the use of data on secondary market spreads.²⁹

²⁹The literature on emerging market corporate spreads mainly uses issuance-level launch yield data. The approach gives rise to endogeneity issues (Eichengreen and Mody 1998) because during poor market conditions, when secondary spreads rise, primary

Figure 3.17. Emerging Market Economies: Secondary Market Corporate Spreads
(Percent)



Sources: Bloomberg, L.P.; Federal Reserve Bank of St. Louis FRED Economic Data; and J.P. Morgan Chase.

Note: CEMBI = Corporate Emerging Markets Bond Index; EM = emerging market economies; EMBI = Emerging Markets Bond Index; EMEA = Europe, Middle East, and Africa.

In recent years, emerging market corporate spreads have been hovering above the average of the precrisis period (Figure 3.17). The secondary-market corporate (Corporate Emerging Markets Bond Index [CEMBI]) spreads move in unison with their sovereign counterpart (the Emerging Market Bond Index spread) and the U.S. BBB corporate spread (a gauge of global credit conditions), but inversely with the U.S. policy rate (the federal funds rate).³⁰ More recently, U.S. corporate and CEMBI spreads have been diverging, mainly because of relatively better U.S. economic conditions; corporate spreads also differ across some regions.

How has the relationship between spreads and fundamentals changed over time?

Regression analysis confirms that CEMBI spreads are closely linked to country-specific and global factors. Cross-country panel regressions reveal a strong statistical relationship between CEMBI spreads, leverage, and macroeconomic factors (Figure 3.18).

spreads do not rise proportionately (and can indeed sometimes fall), a reflection of the tendency for only the most creditworthy borrowers to remain in the market. Although Eichengreen and Mody (1998) and other studies attempt to correct for the bias, the model can be unstable if not properly specified. Only a few studies use secondary market data, and then only with a limited scope; for instance, Dittmar and Yuan (2008) and Zinna (2014) focus on the relationship between sovereign and corporate spreads.

³⁰The secondary-market spreads are from J.P. Morgan's CEMBI. The CEMBI tracks U.S. dollar-denominated debt instruments issued by emerging market firms; the spread is calculated against the U.S. Treasury yield.

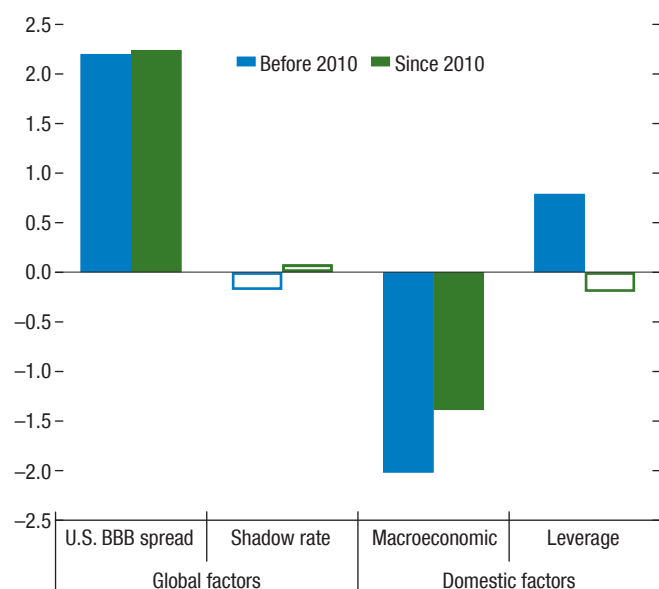
The behavior of emerging market corporate spreads is also closely linked to the U.S. corporate spread. Although not reported, similar results are found using individual-issuance-level data covering more than 1,000 issuances for 20 emerging markets from 1990 to 2015.

The empirical analysis suggests that the relationship between corporate spreads and their determinants has also changed, with domestic factors becoming less influential in the postcrisis period. For instance, the significantly positive precrisis correlation between spreads and leverage broke down since 2010. Furthermore, the negative correlation between spreads and country-level factors has also declined in the postcrisis period. This breakdown suggests firms would be relatively more susceptible to a worsening in global financial conditions—a case in point is the 2013 “taper tantrum” episode, in which spreads for more leveraged firms rose sharply (Box 3.6).

Policy Implications

Emerging markets should prepare for the eventual reversal of postcrisis accommodative global financial conditions because those conditions have become more influential determinants of emerging market corporate finance. Weaker firms and cyclical sectors, such as construction, are likely to be especially susceptible to such global changes. Once market access declines, elevated debt-servicing costs (resulting from the combination of higher interest rates and depreciating currencies) and

Figure 3.18. Emerging Market Economies: Effects of Domestic and Global Factors on Corporate Spreads
(Percentage points)



Source: IMF staff calculations.

Note: The figure is based on country-level panel regressions (see Annex 3.3 for details). The dependent variable is the CEMBI spreads for 20 emerging markets over December 2001–December 2014. Explanatory variables include global factors (U.S. BBB spread and the U.S. shadow rate) as well as domestic factors (macroeconomic conditions [based on the International Country Risk Guide index] and leverage [median across firms]). The bars show the effects of a one standard deviation increase in each variable on the CEMBI spread before 2010 and in the postcrisis period (2010–14). These effects are calculated by multiplying the estimated coefficient of regression by the standard deviation of the corresponding independent variable over all country-month observations. Nonshaded bars are statistically insignificant at the 5 percent level. CEMBI = Corporate Emerging Markets Bond Index.

rollover problems may hit some firms especially hard. Therefore, it is important to closely monitor sectors and systemically important firms most exposed to risks and the sectors and large firms closely connected to them, including across the financial system, and to prepare for contingencies. Emerging markets should also be prepared for the eventuality of corporate failures; where needed, insolvency regimes should be reformed to enable rapid resolution of both failed and salvageable firms. This section further discusses (1) measures that could be taken relatively quickly and that would help contain the further buildup of vulnerabilities or their impact, although they would not eliminate these vulnerabilities in the short term; (2) medium-term recommendations; and (3) actions to be taken in the event of large capital outflows.

Measures that could be taken now

Macroprudential measures could be used to limit risks from a further buildup of foreign exchange exposures and leverage in emerging markets with latent vulnerabilities. Potential instruments include higher bank capital requirements for corporate exposures, as well as risk weights and caps on the share of foreign currency exposures on banks' balance sheets. Active provisioning and increasing equity capital can also bolster financial system resilience. Where relevant, loan-to-value and debt-service-coverage ratios can be introduced to address risks related to commercial real estate.³¹ However, risks associated with market-based funding may prove difficult to manage. This may require an even greater emphasis on macroprudential measures to enhance the resilience of banks and other important nonbank classes of intermediaries (IMF 2014d). For example, securities regulators should adopt a macroprudential orientation in their supervision of asset managers and the funds they manage that have significant corporate bond exposures (see Chapter 3 of the April 2015 GFSR).

Microprudential and other tools can play a complementary role. Regulators can conduct bank stress tests related to foreign currency risks, including derivatives positions. Hedging foreign exchange exposures could also be more actively encouraged. Nevertheless, the hedges used by some corporations to limit their exposure risks may be compromised when most needed, so they should be assessed conservatively by regulators.³²

Financial turbulence in emerging markets could also have important implications for advanced economies. Some evidence indicates that if shocks from advanced economies generate financial volatility in emerging markets, significant “spillbacks” of that volatility to the advanced economies could ensue in periods of financial stress.³³ Such risks are particularly relevant for banks, mutual funds, and other investors in advanced economies that have increased their emerging market

³¹However, it should be recognized that corporate borrowers can substitute borrowing from unregulated financial institutions or in capital markets for domestic bank credit, especially in emerging markets in which capital markets are well developed and globally integrated.

³²As noted in Chui, Fender, and Sushko (2014), although derivatives with “knock-in, knock-out” features can insure against modest foreign exchange movements, they leave the firm exposed to large losses if the domestic currency were to depreciate sharply.

³³Spillbacks are often underestimated because they tend to flow through channels that are inadequately tracked owing to their complexity—for instance, in the financial sector. See *2014 Spillover Report* (IMF 2014a).

Box 3.2. Corporate Foreign Exchange Rate Exposures

Foreign exchange exposures are indirectly measured using stock returns. Following a seminal paper by Adler and Dumas (1984), the foreign exchange exposure of firm i is estimated as the value of β_i in the following augmented capital asset pricing model (CAPM):

$$R_{it} = \alpha_i + \gamma_i R_t^M + \beta_i R_t^{FX} + \varepsilon_{it}$$

in which R_{it} is firm i 's stock return, R_t^M is the market return, and R_t^{FX} is the percentage change

This box was prepared by Machiko Narita.

in the trade-weighted nominal exchange rate (an increase indicates an appreciation). A positive foreign exchange exposure means that the firm's return falls when its local currency depreciates. The value of β_i can be interpreted as firm i 's foreign exchange exposure net of financial and operational ("natural") hedging, after accounting for market conditions (Bartram and Bodnar 2005). The foreign exchange exposures are estimated for about 5,000 listed non-financial firms in 31 emerging market economies over 2001–14.

Box 3.3. Corporate Leverage in China

Corporate leverage is high in China. China has relied on investment to drive growth in recent years. The rapid increase in investment has been financed by credit, leading to a sharp increase in corporate debt. Total social financing, a measure of overall credit to the economy in China, has risen dramatically (32 percentage points of GDP) since the global financial crisis.¹ The credit-to-GDP ratio remains high and exceeds the level implied by economic factors and cross-country comparisons.²

External corporate debt has also risen, albeit from a low level relative to GDP, international reserves, and domestic credit. Onshore banks have served as intermediaries for corporate borrowing overseas through the provision of bank guarantees and letters of credit. Chinese firms have also taken advantage of low global interest rates through offshore bond issuance, which has increased substantially since 2010. Half of the debt issued abroad has been for operations in China. Since 2009, real estate developers have been the largest issuers of offshore bonds among nonfinancial firms.

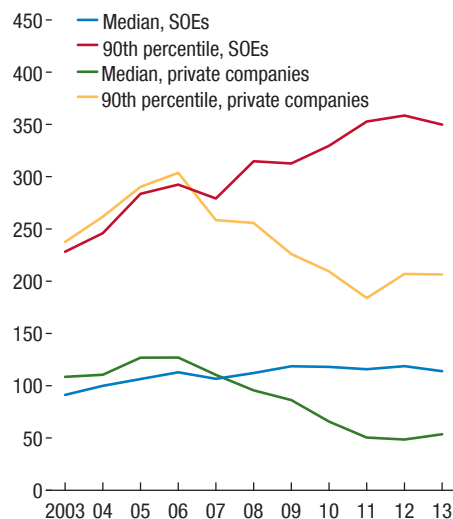
The increase in corporate leverage is largely concentrated at the tail end of the distribution of firms' liabilities, as well as in state-owned enterprises (SOEs) and the real

This box was prepared by Raphael Lam.

¹The Bank for International Settlements "credit gap" measure, defined as the gap between the credit-to-GDP ratio relative to its trend, is used to assess whether credit is greater than the levels implied by fundamentals (see Arslanalp and others, forthcoming).

²Offshore issuance is generally conducted by an offshore entity, and, as a result, the borrowing is not captured by official external debt statistics.

Figure 3.3.1. China: Leverage Ratios (Percent)



Sources: Wind Info Inc. database; and IMF staff estimates.
Note: SOE = state-owned enterprise.

estate sector (Chivakul and Lam 2015). Total liabilities of listed firms have risen dramatically and become more concentrated. Although the median leverage ratio—measured by the ratio of total liabilities to total equity—has largely stayed flat since 2006, leverage has significantly increased at the tail end (the 90th percentile) of the distribution of firms (see Figure 3.3.1). In addition, highly leveraged firms account for a growing share of total debt and liabilities in the corporate sector.

Box 3.3. (continued)

Across industries, most of the buildup in leverage was in the real estate and construction sector and, to a lesser extent, in mining and utilities. Across ownership types, SOEs—mainly local ones—account for a large share of increased borrowing. For instance, in the real estate and construction sector, only about 60 firms with high leverage ratios account for more than two-thirds of the sector's liabilities, a rise of nearly three times over the decade. This elevated concentration of debt in the most leveraged tail of the leverage distribution raises corporate vulnerabilities to shocks.

The high level of credit could weigh on China's growth and financial stability. The efficiency of the investment financed by credit has been falling, with a commensurate drop in corporate sector profitability. This situation makes servicing debt obligations more difficult. In particular, the interest coverage ratio has fallen in SOEs, which have contributed to the bulk of the rise in credit. At the same time, deleveraging by firms could weigh on growth, while mounting corporate defaults would have adverse effects on bank balance sheets and credit availability, and thereby further weaken growth.

The Chinese corporate sector is vulnerable to a slowdown in the real estate and construction sector. Sensitivity analysis finds that although on average

firms can withstand a moderate 1 percent interest rate increase, SOEs appear to be relatively exposed to an interest rate shock because of their low interest coverage and relatively higher leverage. Taking into account the value-added linkages of each sector to real estate and construction, a severe slowdown in the real estate sector (a 20 percent profit decline) would have a significant impact on the corporate sector, including a drop in the median interest coverage ratio to only 2½ times profits, with nearly 20 percent of firms in the real estate sector (accounting for 11 percent of total corporate debt) in financial distress.

In the future, some debt write-offs would help improve credit flow and investment efficiency and reduce risks in China. Write-offs—combined with the restructuring of viable companies and steps to facilitate greater tolerance of defaults, exit, and bankruptcy of nonviable firms—could reduce the burden on banks and allow them to reallocate credit to more efficient sectors. Banks can embark on rigorous quality assessments of their loan portfolios, setting the stage for addressing nonperforming loans and the potential need for bank recapitalization. Continuing reforms to promote capital market development would help provide an alternative financing channel for healthy firms.

exposures, warranting preparation for possible illiquidity in certain asset markets.

Medium-term measures

In the medium term, preventive policies could help avert the buildup of excessive risks. For example, consideration should be given to changes in the tax code that remove fiscal incentives in favor of debt or that encourage foreign currency debt.³⁴ Measures to reduce liquidity risks could be gradually phased in for domestic open-end mutual funds holding debt and offering daily redemptions (see Chapter 2 of this report and Chapter 3 of the April 2015 GFSR). In addition, governments can promote specific forms of financial deepening, such as development of a local investor base (both banks and nonbanks) to help dampen

global financial shocks. The move toward more flexible exchange rates may enable emerging markets to adjust more readily to shocks, could facilitate an independent monetary response to financial imbalances, and may discourage banks and corporations from building up large foreign exchange exposures in the first place.

Significant data gaps need to be addressed to enhance the effectiveness of surveillance. Data gaps prevent a full assessment of the financial stability risks posed by corporate balance sheets from being made. For instance, firm-level data on foreign currency exposures and the degree to which they are hedged are generally unavailable. Offshore bond issuance introduces another complication because the true external exposure of firms with cross-border activities may not be fully captured by using only residence-based statistics. Renewed global efforts by authorities to collect and provide better information on foreign currency corporate indebtedness and offsetting factors (such as hedges) are desirable (see IMF 2015b). Investing in

³⁴Other policies that may encourage rapid leverage growth, such as implicit or explicit government guarantees, should also be reconsidered.

Box 3.4. Firm Capital Structure, the Business Cycle, and Monetary Policy

This box summarizes the theoretical and empirical literature on capital structure.

The capital structure of a firm is defined as the mixture of debt and equity the firm uses to finance its operations. The term is often used in conjunction with various measures of borrowing such as the debt-to-equity ratio (one measure of the leverage ratio). In a seminal paper, Modigliani and Miller (1958) put forth the capital structure irrelevance proposition: the market value of the firm is independent of its capital structure.

Departures from the Modigliani-Miller proposition

Subsequent research has shown that the Modigliani-Miller proposition fails under a variety of circumstances.¹ This finding has led to three broad alternative theories of firms' decisions on their capital structure: The first is the trade-off theory in which firms issue debt until the benefits (tax incentives) and costs (bankruptcy) of debt are balanced. The second is the pecking order theory (Myers and Majluf 1984), which governs the order of financing sources and not the amount of debt a firm issues—firms prefer to finance themselves first by using internal funds, then by issuing debt, and last by issuing equity. The third is the market timing theory, in which managers are more likely to tap markets with the most favorable conditions (for example, during asset price rallies).

The role of business cycles

Another strand of the literature examines the aggregate determinants of corporate capital structure. Empirical papers provide differing evidence regarding the cyclical-ity of leverage.² For example, in Covas and Den Haan

(2011), firm-level leverage is procyclical. Fernández and Gulán (2015) find that leverage is countercyclical for emerging markets. With regard to theory, Hackbarth, Miao, and Morellec (2006) argue that leverage is countercyclical; Kiyotaki and Moore (1997) argue that it is procyclical, and Bhamra, Kuehu, and Strebulaev (2010) argue that these opposing views are reconcilable.

The role of monetary conditions

Monetary policy can be transmitted to the nonfinancial corporate sector through several channels, and thereby influence firms' capital structure. The traditional interest rate channel stimulates aggregate demand by lowering interest rates and thereby encouraging firms to borrow. Barry and others (2008) find that firm leverage increases when interest rates are low. Based on a survey of chief financial officers, Graham and Harvey (2001) report that the level of interest rates is one of the most important factors influencing the decision to issue debt.

In addition to the interest rate channel, many papers have investigated the credit channel (Bernanke 2007). The credit channel focuses on the change in the availability of credit and has two dimensions: (1) the balance sheet channel, which focuses on bank loan demand; and (2) the bank lending channel, which is more about the supply of bank loans (Kashyap, Stein, and Wilcox 1993). Bernanke, Gertler, and Gilchrist (1996) develop a model of the balance sheet channel, in which lower monetary policy rates raise equity prices and a firm's net worth, and thereby lower the cost of external (debt) financing. This generates a virtuous cycle (or financial accelerator) as firms use debt to finance investment, which boosts aggregate demand and raises equity prices again, allowing for even greater debt-financed investment.

This box was prepared by Ayumu Ken Kikkawa.

¹Such as taxes, transaction and bankruptcy costs, agency conflicts, adverse selection, and time-varying market opportunities, among others (Frank and Goyal 2003; de Mooij 2012).

²Many papers have looked at how other aspects of business cycles affect capital structures. Beaudry, Caglayan, and Schian-

tarelli (2001) and Baum and others (2006) find that at times of high macroeconomic volatility, firms' investment and financing decisions become more alike as uncertainty constrains managers' ability to make decisions based on firm-specific information.

reporting systems to help more effectively monitor the corporate sector—including foreign currency exposures—is therefore warranted.

Measures to address disruptive outflows

In the event of rapid capital outflows, macroeconomic and financial sector policies can be deployed. Worsening global financial conditions can induce

investors to reassess emerging market risks; therefore, the likelihood of sudden outflows is considerably higher in the presence of latent corporate sector vulnerabilities. In fact, mounting emerging market leverage has typically been associated with a subsequent reversal of capital flows (for instance, Mendoza and Terrones 2008; Elekdag and Wu 2011). In such a scenario, nontradable sectors are likely to be

Box 3.5. The Shift from Bank to Bond Financing of Emerging Market Corporate Debt

The role of bond market finance has grown notably as a share of corporate debt in emerging market economies since the global financial crisis. Although the development of equity markets picked up pace in the 1990s, private bond market development was initially limited to a subset of industries in a few emerging market economies. The recent boom allowed a wider set of borrowers to diversify their funding sources while also contributing to growing leverage and foreign exchange exposure. Ayala, Nedeljkovic, and Saborowski (2015) propose a measure of corporate debt at the country level that can be decomposed into local and foreign currency and into bank loans and bonds, and document that the share of bonds in total debt has, on average, grown since the crisis.

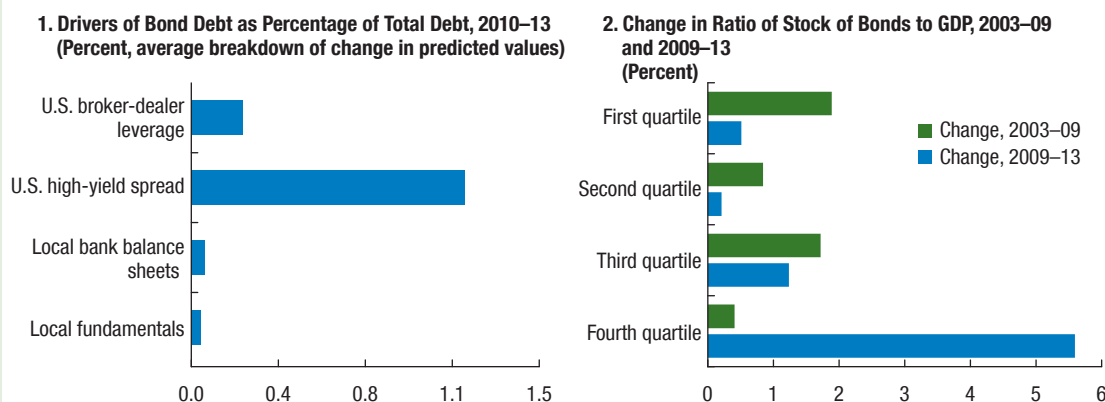
It is important to understand whether the factors that drove the boom in bond finance relative to bank loans were structural or cyclical. Ayala, Nedeljkovic, and Saborowski (2015) examine whether emerging markets that experienced the largest booms relative to bank lending were those with strong fundamentals or whether cyclical factors drove flows into the largest and most liquid markets.

This box was prepared by Christian Saborowski.

The empirical findings confirm that domestic factors do not explain much of the variation in growing bond shares during the postcrisis period. Macroeconomic and institutional variables are shown to be important determinants of bond market development throughout the sample period, but their relative role declined substantially during the postcrisis period as global factors took center stage. The search for yield in global financial markets (proxied by the U.S. high-yield spread) explains the bulk of the boom in bond finance relative to bank loans (Figure 3.5.1, panel 1).

The search for yield accounts for most of the increase in bond shares, with differences across emerging markets explained by market size rather than domestic factors. Dividing emerging markets according to the degree of bond market access in 2009 shows that the largest bond markets (fourth quartile) grew the most since the crisis (Figure 3.5.1, panel 2). Quartile regressions confirm that the impact of the U.S. high-yield spread on bond market shares was substantially larger for emerging markets with initially larger bond markets. This finding suggests that the bond market boom was mostly driven by favorable liquidity conditions, with investor interest in specific emerging markets dependent on market size and the associated ease of entry and exit.

Figure 3.5.1. Changes in the Stock of Bonds by Initial Quartile



Source: Ayala, Nedeljkovic, and Saborowski 2015.
Note: Quartiles in panel 2 defined by stock in 2009.

Box 3.6. Taper Tantrum: Did Firm-Level Factors Matter?

This box investigates the impact of the “taper tantrum” on corporate spreads across emerging market economies. On May 22, 2013, during testimony to Congress, the chairman of the U.S. Federal Reserve raised the possibility of tapering its purchases of Treasury and agency bonds. Following this “tapering talk,” there were sharp corrections in emerging market economies’ asset prices and a reversal of capital flows (Sahay and others 2015).

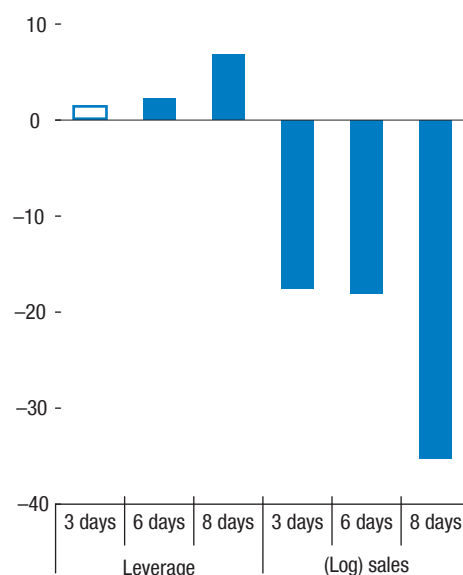
An event study is used to investigate how emerging market corporate spreads reacted to the tapering shock. Firm-level factors (leverage, size, profitability, and growth prospects) are used to explain the change in corporate credit default swap (CDS) spreads three, six, and eight days after May 21. The analysis covers 309 firms from 21 emerging markets.

Borrowing costs increased disproportionately for more leveraged and smaller firms following the tapering shock. Moreover, these effects tended to become stronger over time as investors digested fundamentals and differentiated across emerging market firms accordingly (Figure 3.6.1). For example, after eight days, a one standard deviation increase in the leverage ratio (corresponding to 16 percentage points) is associated with a 7 basis point increase (corresponding to an annualized rate of 3.3 percent) in the CDS spread. These effects are substantial, given that the firms experienced an increase in spreads of 18 basis points on average. In other words, a one standard deviation increase in the leverage ratio of a firm pushes up its borrowing cost by 40 percent relative to its average peer. In sum, the results suggest that when

This box was prepared by Ayumu Ken Kikkawa.

Figure 3.6.1. Effects of the Shock on Credit Default Swap Spreads

(Basis points; for one standard deviation increase)



Sources: Bloomberg, L.P.; and IMF staff estimates.

Note: The shaded bars denote statistical significance at least at the 10 percent level. The explanatory variables are leverage ratio (total debt to total assets), log sales, income-to-sales ratio, and Tobin's Q. Country and sector fixed effects are included.

search-for-yield effects reverse, firms with weaker fundamentals may disproportionately suffer from greater exposure to credit risk.

hit disproportionately. To dampen adverse macroeconomic consequences, the policy response could include, if warranted, exchange rate depreciation and the use of monetary policy and reserves. The public provision of emergency foreign exchange hedging facilities could also be considered. The combination of policies would be based on macroeconomic conditions, taking into consideration financial stability risks such as foreign exchange exposures. Fiscal policy may need to be adjusted depending on macroeconomic circumstances and available policy space. If the financial system comes under stress, liquidity provision may be required.

Conclusion

This chapter considers the evolving influence of firm-level, country-level, and global factors in driving leverage patterns, bond issuance, and corporate spreads. Three key results emerge from the investigation:

- The relative contributions of firm- and country-specific characteristics in explaining leverage growth, issuance, and spreads seem to have diminished in recent years. In contrast, global financial factors appear to have become relatively more important determinants in the postcrisis period.
- Leverage has risen more in sectors that are more vulnerable to cyclical and financial conditions, and it

has grown most in construction. Higher leverage has also been associated with, on average, rising foreign currency exposures.

- Despite weaker balance sheets, emerging market firms have managed to issue at better terms (lower yields, longer maturities); on the positive side, many issuers have taken advantage of favorable financial conditions to refinance their debt.

The expanded role of global financial factors during a period when they have been extraordinarily accommodative means that emerging markets must prepare for the adverse domestic stability implications of global financial tightening:

- Monitoring vulnerable and systemically important firms as well as banks and other parts of the economy closely linked to them is crucial.
- Such expanded monitoring requires that collection of data on corporate sector finances, including foreign currency exposures, be improved.
- Macroprudential policies can be deployed to limit excessive increases in corporate sector leverage. Possible tools include higher bank capital requirements (for instance, implemented via risk weights) for corporate foreign currency exposures and caps on the share of such exposures on banks' balance sheets. Managing risks associated with market-based funding may be challenging, however, potentially requiring an even greater emphasis on macroprudential measures to enhance the resilience of the financial system.
- Microprudential measures should also be considered. Regulators can conduct bank stress tests related to foreign currency risks.
- Finally, as advanced economies normalize monetary policy, emerging markets should prepare for an increase in corporate failures and, where needed, should reform corporate insolvency regimes.

Annex 3.1. Emerging Market Corporate Leverage: Data and Empirics

This annex discusses the data and the empirical methodology used to analyze the main determinants of emerging market corporate leverage. Data sources and definitions are summarized in Table 3.1.1.³⁵

The author of this annex is Adrian Alter.

³⁵Emerging market economies included in the analysis comprise Argentina, Bahrain, Brazil, Bulgaria, Chile, China, Colombia, Croatia, Egypt, Hungary, India, Indonesia, Jordan, Kazakhstan, Korea, Kuwait, Lebanon, Lithuania, Malaysia, Mauritius, Mexico, Morocco, Nigeria,

Measures of leverage

Leverage, or financial leverage, is the degree to which a company uses debt. Leverage is usually presented as a ratio, such as debt to capital. The broadest definitions of leverage consider total nonequity liabilities. An advantage of using total liabilities is that it implicitly recognizes that some firms can use trade credit as a means of financing, rather than purely for transactions (Rajan and Zingales 1995). Another benefit of using total liabilities is its availability. In contrast, debt may not be reported in larger data sets that include nonlisted firms.

Data

Although firm-level databases contain an abundance of information, they do have limitations, particularly in the context of emerging market corporate leverage. For example, data can vary greatly over the time period covered. Accounting standards and reporting requirements vary widely across countries, so it is important to use databases with harmonized definitions. Worldscope (Thomson Reuters) and Orbis (Bureau van Dijk) are two examples of such cross-country harmonized databases that provide annual firm-level balance sheet and income statement information. Worldscope contains publicly listed firms; the main advantage of the Orbis database is its wide coverage of both listed and nonlisted firms—including SMEs—which enrich the cross-sectional information in the data set. To avoid double counting, unconsolidated accounts are considered.³⁶ Firm-level data are merged with country-specific indicators of macroeconomic conditions and global factors. The firm-country-global data set used comprises more than 1 million active nonfinancial firms (with assets of more than \$1 million) and 4.3 million firm-year observations for 24 emerging market economies during 2004–13.

Methodology

Panel regressions link firm-level leverage growth with key firm- and country-specific as well as global determinants. For firm i , in sector s , country c , at time t ,

Oman, Pakistan, Peru, Philippines, Poland, Qatar, Romania, Russia, Saudi Arabia, Serbia, South Africa, Sri Lanka, Thailand, Turkey, Ukraine, United Arab Emirates, and Venezuela.

³⁶Orbis has the advantage of being more comprehensive, with millions of firms represented in the database, but more granular balance sheet data can be incomplete. For example, debt is not reported for many emerging market firms in Orbis. More detailed information on financial statements is even harder to come by.

Annex Table 3.1.1. Definition of Variables

Variable	Description	Source
Firm-Level Variables		
Leverage Metrics		
Ratio of Liabilities to Book Equity	Total liabilities divided by book equity	Orbis, Worldscope
Ratio of Liabilities to Book Assets	Total liabilities divided by book assets	Bloomberg, L.P., Orbis, Worldscope
Ratio of Liabilities to Market Equity	Total liabilities divided by market capitalization	Worldscope
Ratio of Liabilities to Market Assets	Total liabilities divided by the sum of total liabilities and market capitalization	Worldscope
Ratio of Debt to Book Assets	Total debt divided by book assets	Orbis, Worldscope
Ratio of Debt to Market Assets	Total debt divided by the sum of total liabilities and market capitalization	Worldscope
Ratio of Debt to EBIT	Total debt divided by earnings before interest and taxes	Orbis, Worldscope
Ratio of Debt to EBITDA	Total debt divided by earnings before interest, taxes, depreciation, and amortization	Orbis, Worldscope
Fundamental Variables		
Sales	Total sales (Worldscope code WC01001)	Orbis, Worldscope
Tobin's Q	Sum of market value of equity and book value of debt divided by book value of assets	Worldscope
Return on Assets	Net income divided by total assets	Bloomberg, L.P., Orbis, Worldscope
Return on Equity	Net income divided by shareholders' equity	Orbis, Worldscope
Interest Coverage Ratio	Earnings before EBITDA or earnings before EBIT divided by interest expense	Orbis, Worldscope
Tangibility	Tangible fixed assets (or net PPE in Worldscope) divided by total assets	Orbis, Worldscope
Tradable and Nontradable Sectors	Tradable sectors: agriculture, mining, and manufacturing; nontradable sectors: construction, transportation, communications, utilities, wholesale/retail trade, services	
Seasoned Issuer Dummy	Dummy equal to 1 if firm has issued a bond before a given year	Bloomberg, L.P., Dealogic
Firm Size Definitions		
Size	Total assets in logs	Bloomberg, L.P., Orbis, Worldscope
Very Large ¹	Operating revenue ≥ \$130 million; total assets ≥ \$260 million; employees ≥ 1,000	
Large ¹	Operating revenue ≥ \$13 million; total assets ≥ \$26 million; employees ≥ 150	
Medium ¹	Operating revenue ≥ \$1.3 million; total assets ≥ \$2.6 million; employees ≥ 15	
Small	Not included in any of the categories listed above	
Bond-Level Variables		
Local Currency	Dummy equal to 1 if bond is denominated in country of risk's local currency	Bloomberg, L.P., Dealogic
External	Dummy equal to 1 if market type is not domestic	Dealogic
Investment Grade	Dummy equal to 1 if rating is equal to or higher than BBB	Bloomberg, L.P.
Call/Put/Sink	Dummy equal to 1 if maturity type includes call/put/sink option	Bloomberg, L.P.
Country-Level Variables		
ICRG Economic and Financial Risk Rating	The average of ICRG Economic and Financial Risk Ratings, following Bekeart and others (2014)	PRS Group
Corporate Spread	J.P. Morgan CEMBI Broad	Bloomberg, L.P.
Ratio of Government Debt to GDP	General government debt-to-GDP ratio	WEO
Exchange Rate	EM currency per U.S. dollar	WEO
Financial Openness Index	The Chinn-Ito index (KAOPEN) is an index measuring a country's degree of capital account openness.	http://web.pdx.edu/~ito/Chinn-Ito_website.htm
Financial Development Index	Index that summarizes information regarding financial institutions (banks and non-banks), and financial markets across three dimensions: depth, access, and efficiency	Sahay and others (2015)
Financial Integration	Total portfolio investment liabilities from an emerging market economy toward a subset of advanced economies (euro area, Japan, United Kingdom, and United States) scaled by nominal GDP	CPIS
Exchange Rate Regime	De facto exchange rate regime classification, in which a higher value indicates greater exchange rate flexibility	Ilzetzki, Reinhart, and Rogoff (2008)
Global-Level Variables		
VIX	Chicago Board Options Exchange Market Volatility Index	Datastream
U.S. BBB Spread	Bank of America Merrill Lynch U.S. Corporate BBB Option-Adjusted Spread [©]	FRED [®]
U.S. Shadow Rate	Estimated from a term-structure model (see Krippner 2014)	RBNZ
U.S. Real Shadow Rate	The U.S. shadow rate minus the approximately one-year-ahead U.S. inflation forecast (Blue Chip Economic Indicators)	RBNZ, Haver Analytics
U.S. GDP Growth	Annual average growth rate	WEO
Global Shadow Rate	Principal component of the shadow rates of the euro area, Japan, and United States	RBNZ and authors' calculations
Commodity Price Index	Commodity price index	WEO
Global Real GDP Growth	Global real GDP growth	WEO

Source: IMF staff.

Note: CEMBI = Corporate Emerging Markets Bond Index; CPIS = Coordinated Portfolio Investment Survey; EBIT = earnings before interest and taxes; EBITDA = earnings before interest, taxes, depreciation, and amortization; EM = emerging market economy; EMBI = Emerging Markets Bond Index; FRED = Federal Reserve Economic Data; ICRG = International Country Risk Guide; PPE = property, plant, and equipment; RBNZ = Reserve Bank of New Zealand; WEO = *World Economic Outlook*.

¹At least one of the criteria is met.

a general specification of the regression model can be written as follows:

$$\Delta \text{Leverage}_{isc,t} = \beta_1 \text{FIRM}_{isc,t-1} + \beta_2 \text{MACRO}_{c,t} + \beta_3 \text{GLOBAL}_t + \theta \text{INTERACTION}_{isc,t} + \text{OTHER},$$

in which the dependent variable, $\Delta \text{Leverage}$, is the change in the ratio of total liabilities to book equity. The term *FIRM* includes measures of size (sales), profitability (return on assets), and asset tangibility (to reflect collateral availability and asset quality). *MACRO* refers to, among others, the ICRG Economic and Financial Risk Rating, which captures country-level macroeconomic factors.³⁷ The *GLOBAL* factors include the oil price index, the U.S. shadow rate, a proxy for monetary policy conditions in advanced economies, the change in the VIX (a proxy for investors' sentiment and global risk aversion), and global GDP growth. Various interactions between the shadow rate and firm-, sector-, or country-specific characteristics are captured with the term *INTERACTION*. The panel regressions include firm fixed effects (*OTHER*), and standard errors are clustered at the country level.

Main Results

Estimation results suggest a statistically significant relationship between the inverse of the U.S. shadow rate and emerging market corporate leverage growth: a 1 percent decrease in the shadow rate is associated with about 2 percentage point faster leverage growth.

The results remain broadly consistent when other leverage ratios (such as net total liabilities to book equity, total liabilities to total assets, or total debt to total assets) are considered. Subsample analysis is also conducted, and the impact of the shadow rate on leverage is larger (and still statistically significant) during 2010–13. For another robustness check, the models are estimated with standard errors clustered at the country and sector levels, and the results remain broadly unaltered.

³⁷Other macro controls include the financial development index (Sahay and others 2015), which captures the financial sector's depth, access, and efficiency; the financial openness index (Chinn and Ito 2006), which measures the degree of capital account openness; and financial integration, which is proxied by total portfolio liabilities to advanced economies, net capital flows, and the exchange rate regime.

Annex 3.2. Bond Issuance Analysis

This annex describes the data and the firm-level regression models used to examine the determinants of the probability of emerging market corporate bond issuance and bond maturity at issuance.

Data

Data on emerging market nonfinancial corporate bond issuance were obtained from Dealogic and Bloomberg, L.P. (see Table 3.1.1). In Dealogic, nonfinancial firms are identified if their general industry classification flag differs from government or finance. In Bloomberg, L.P., nonfinancial firms are identified as corporations excluding financials. Coverage differs across the two data sources, but country aggregates and general trends are similar. Issuers' nationality was determined based on country of risk, which depends on (in order of importance) management location, country of primary listing, country of revenue, and reporting currency of the issuer.

Each data set was used according to its comparative strength. For instance, Dealogic data were used to span a broader set of countries (40 emerging markets) and a longer period (starting in 1980), and to compare different notions of firm nationality (country of incorporation, country of risk, and parent nationality of operation). Bloomberg, L.P., allowed firm's balance sheet information for the year before issuance to be obtained, but, because of data downloading limitations, such information was obtained for only 20 major emerging markets, starting in 1990.

For the analysis of the probability of bond issuance, balance sheet data on issuers and nonissuers are required. For this purpose, two matching exercises were conducted. First, with the help of Bureau van Dijk representatives, issuers in the Dealogic database were matched to the corresponding firm-level balance sheet data in the Orbis database using information on the issuer company name, industry sector, and country of incorporation. The final sample was restricted to listed firms. Second, issuers in the Bloomberg, L.P., database were matched to Thomson Reuters Worldscope. The two merged data sets are complementary given that their coverage differs substantially.

Probability of bond issuance

The probability of issuance at the firm level is modeled as a function of firm and macroeconomic characteristics,

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global factors, and bank lending conditions. A probit model is estimated with standard errors clustered at the country level, with country and sector dummies, as well as a time trend. The baseline model is estimated using the Bloomberg, L.P.–Thomson Reuters Worldscope matched database described above. The full sample begins in 1995. The postcrisis estimation starts in 2010, but the findings are robust to starting in 2009. For an additional robustness check, the exercise is repeated using the Dealogic–Orbis matched database, also described above. The model takes the following form:

$$\text{Prob}(\text{Issuance}_{it} = 1) = F(\alpha + \beta_1 \text{firm}_{it-1} + \beta_2 \text{macro}_{it-1} + \beta_3 \text{bank}_{it-1} + \beta_4 \text{global}_{it} + \varepsilon_{it}),$$

in which *Issuance*, a dummy variable, is 1 if firm *i* issued at least once in a given year *t*.

A wide range of macroeconomic (*macro*) and bank lending (*bank*) variables are considered, including rule of law index; exchange rate regime; real GDP growth; per capita GDP; ICRG political, financial, and economic indexes; inflation; inflation volatility; current account and fiscal balances; external, public, and corporate debt; exchange rate changes; and domestic and cross-border bank claims to the private sector. However, these variables are generally not statistically significant.

Firm (*firm*) characteristics are generally robust across time and databases considered.

Global (*global*) factors included are the inverse shadow rate and the VIX. A higher VIX reading is related to a lower probability of issuance over the entire sample.

Bond Maturity at Issuance

The analysis of bond maturity at issuance excludes Chinese firms, and includes bonds issued both domestically and externally. Issuances are related to bond- and firm-level, macroeconomic, bank lending, and global variables. The model is estimated using ordinary least squares with standard errors clustered at the country level, and it includes country and sector dummies, as well as a time trend. The model takes the following form:

$$\text{Maturity}_i = \alpha + \beta_0 \text{bond}_i + \beta_1 \text{firm}_i + \beta_2 \text{macro}_i + \beta_3 \text{bank}_i + \beta_4 \text{global}_i + \varepsilon_i$$

in which *Maturity* is each bond's maturity at issuance measured in years. Bond characteristics (*bond*)

include dummies for local currency denomination; investment grade; and put, call, and sink options. Firm-level variables (*firm*) include size, profitability, leverage, and a dummy for firms that have issued in the past. All bond and firm characteristics (except for profitability) are significant with the expected sign. As above, a wide range of macroeconomic and bank-level variables are considered but are generally not statistically significant.

Global controls include the inverse shadow rate and the VIX. Bonds tend to be issued with shorter maturity in times of financial uncertainty (measured by the VIX). The inverse shadow rate is not significant over the entire sample, but becomes strongly statistically significant in the postcrisis period (defined as starting either in 2009 or 2010). The addition of interaction terms shows that the effect of the inverse shadow rate on maturity was stronger for bonds issued in foreign currency and for non-investment-grade bonds.

Annex 3.3. Regression Analysis of Determinants of Emerging Market Corporate Spreads

This annex describes the data and the country-level regression model used to examine determinants of emerging market corporate spreads.

The regression model takes the following form:

$$\text{spread}_{it} = \alpha_i + \beta_1 \text{global}_t + \beta_2 \text{domestic}_{it} + \beta_3 \text{post}_t + \beta_4 \text{post}_t \times \text{global}_t + \beta_5 \text{post}_t \times \text{domestic}_{it} + \varepsilon_{it}$$

in which *spread* denotes the corporate spread of emerging market country *i* in month *t*. This analysis uses secondary market spread data, which are not susceptible to endogeneity of issuance decisions. The term *global* is a vector of a U.S. corporate spread and real shadow rate. The term *domestic* is a vector of a macroeconomic fundamentals index (the ICRG risk rating), and a leverage indicator (debt-to-book assets, the median of firms within each country). These variables are demeaned. The term *post* is a postcrisis dummy that takes the value of one from January 2010 onward. End-of-month market variables are used for 20 emerging markets; the previous year's leverage is used.

The results are generally robust to using a global real shadow rate or the U.S. one-year real Treasury rate instead of the U.S. real shadow rate.

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