Financial instability far from over, says IMF

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If the IMF's *World Economic Outlook* (WEO) report issued on Tuesday, in which it again revised down its forecasts for global growth, could be accurately described as gloomy, then the *Global Financial Stability* report issued the following day was even gloomier.

Pointing to financial market turbulence in the first two months of the year, during which oil prices plummeted and bank shares experienced sharp declines, the report stated that over the past six months financial stability risks had increased. It cited economic developments, falling commodity prices and concerns over the direction of China's economy as the underlying causes.

Delivering the report, José Viñals, the head of the IMF's monetary and capital markets department, said a key question it addressed was "whether the turmoil over the past months is now safely behind us, or is it a warning signal that more needs to be done? I believe it is the latter: more needs to be done to secure global stability."

The threats to financial stability are across the board. The IMF said banks in advanced economies were now safer but "they came under significant pressure from financial markets at the start of the year, as the economic outlook weakened and became more uncertain."

In the euro area, market pressures highlighted long-standing issues and banks needed to "urgently tackle elevated nonperforming loans" and address overcapacity in some banking sectors.

In emerging markets, the sharp fall in commodity prices had exacerbated risks for both corporate and government debt and these countries faced "a difficult combination of slower growth, tighter credit conditions and volatile capital flows." So far, they had been able to withstand this difficult environment because of buffers accumulated during boom years but "buffers are depleting, with some countries running out of room to maneuver."

The report also warned that, as the health of the corporate sector in emerging markets deteriorated, this could make refinancing pressures "more acute" with possible spillover effects for governments as many weaker corporate debtors were state-owned.

It also raised specific concerns about the level of Chinese debt. Corporate health in China was declining due to lower growth and profitability and this was reflected in the rising share of debt held by firms that do not earn sufficient to cover their interest payments. The report said "debt at risk" had risen to 14 percent of the total debt of Chinese companies, more than tripling since 2010.

In its *Fiscal Monitor Report* on government debt, also issued on Wednesday, the IMF said public debt ratios had increased in most countries, with the largest increase taking place in emerging market and middle-income countries. Debt ratios in 2015-2016 were now expected to exceed the levels reached at the beginning of the global financial crisis.

However, advanced economies were not immune from this trend. They were now facing "the triple threat of low growth, low inflation and high public debt" and this combination of factors "could generate downward spirals where economic activity and prices decline—leading to increases in the ratio of debt to GDP—and further, self-defeating attempts to reduce debt."

The IMF said unless policymakers delivered additional measures to reduce risks and support growth, market turmoil could recur and "create a pernicious feedback loop of fragile confidence, weaker growth, tighter financial conditions and rising debt burdens." This could tip the global economy into "economic and financial stagnation." It estimated that world output could be lowered by almost 4 percent over baseline forecasts over the next five years, an amount "roughly equivalent to foregoing one year of global growth."

The main focus of the IMF policy prescriptions is that governments should provide a boost to aggregate demand by increasing spending on infrastructure and other projects and do so in a coordinated manner. However, there is absolutely no sign that such measures are even being contemplated, apart from some stimulus measures by the Chinese government in recent months that have provided at least a temporary economic boost.

Following the issue of the WEO, some of its implications are being drawn out. In an article published on Wednesday, *Financial Times* columnist Martin Sandbu said the "harsh searchlight" of the report left policymakers with nowhere to hide. IMF chief economist Maurice Obstfeld may have couched his analysis in the "measured language of technical economics, but nobody should be fooled: this is a stark warning that the world has taken a turn for the worse, and a stern rebuke of politicians who have, at best, allowed this to happen, and at worst, contributed to it with misguided policies."

Sandbu said the IMF had gone a long way towards condemning the policy approach to the weak recovery from the global financial crisis. "The global investment decline, and the trade downturn it has caused, mean more demand stimulus is needed."

Behind such remarks are the growing fears in ruling circles of social and political upheaval in the event of another financial crisis or major economic downturn.

These concerns are being fueled by the recognition that there is a deepening hostility among broad masses of the population to the political establishment and a realization, as reflected in the Panama Papers tax scandal, that as the ruling elites impose never-ending austerity, they are engaged in criminal activities to salt away vast fortunes.

Significantly the WEO pointed to a series of non-economic factors including "political discord" which could have considerable spillover effects on economic activity.

While pointing to the worsening economic and financial situation, the IMF and other major institutions can offer no policy prescriptions.

There was a revealing incident at the press conference conducted by Obstfeld as he delivered the WEO report on Tuesday.

Pointing out that he had been coming to such meetings for 20 years, one journalist noted that he had heard the same themes endlessly repeated: monetary policy had to be placed on sound foundations, fiscal measures should be employed and structural reforms should be implemented to increase productivity.

Given that monetary policies, based on quantitative easing had largely run their course, a growing number of governments had no room for fiscal stimulus, and structural reforms took a long time to have any effect, the journalist asked: what did the IMF propose to do to meet the immediate situation?

He received no answer.