1) More tightening expected in many countries

2) Stagflation threats loom globally; energy crisis intensifies in Europe

3) Vulnerable EMDEs could face defaults and difficult restructurings

4) Global housing risks intensifying; China property market near crisis
Worldwide Inflation Has Reached Multidecade Highs

Note: Based on realized y/y headline inflation in 76 countries
Euro Area FCIs at levels last seen in March 2020 whereas in the US & other AEs close to historical averages…

Financial Conditions: Advanced Economies
(Standard deviations from the mean)

… meanwhile among some EMs, FCIs have reached March 2020 levels, too.

Financial Conditions: Emerging Markets
(Standard deviations from the mean)
2022 Has Been A Particularly Bad Year for Risk Assets

**Sell-Off in Risk Assets and Jump in Volatility**

**Risk Asset Returns**
(Percent return, by quarter)

---

**Equities**
- Euro area
- US
- EM ex. China
- China

**Bonds (Total return)**
- US Treasuries
- US Investment grade
- US High yield
- EM Hard Currency
- EM Local Currency (USD)

---

**Risk Asset Returns**
(Percent return, by quarter)
Persistent Inflation Prompted Central Banks to Act More Aggressively

AE and EM central banks have dramatically synchronized monetary tightening...

Number of Central Banks changing policy rates (net)

...so that correlation among global interest rates has been increasing.

Co-movement of G10 sovereign yield changes at 2-year tenor
(Proportion of variance explained by common factor)

Note: Proportion of G10 daily interest rate changes excluding Japan explain by a common factor, based on rolling 1-year principal component analysis.
Dollar has Strengthened on the Back of Fed Tightening

*Interest rate differentials have driven USD to historic highs*

Euro and Yen Exchange Rates vs Dollar since 2020
(EUR and GBP left scale, JPY right scale)

*EM currencies have also depreciated, but with marked regional differences*

Emerging Market Regional Currencies
(2022 percent return versus US dollar)

Brazil
Chile
Mexico
Latin America
Poland
Hungary
CEEMEA
India
Malaysia
China
Asia
Spectre of Stagflation Has Repriced Markets, But More Downside Risk Remains

**Rising rates and earnings downgrades have driven markets down...**

Components of S&P 500 valuation
(y/y percent growth, left scale; percent)

- Expected Earnings, y/y within next 12 months, lhs
- US Treasuries 10y, rhs

**...but a falling risk premium has blunted the selloff**

S&P 500 Equity Index Returns Decomposition
(percent)
Real Yield Curves Are Still Fairly Flat

The market expects the Fed to begin cutting rates next year

US Term Structure of 1y Forward Rates
(Percent, based on government bonds)

Euro Area Term Structure of 1y Forward Rates
(Percent, based on swaps)

In Europe, nominal yields expected to plateau at ~2%

Real rates remain relatively low in US and in Europe
Investors Expect Inflation to Remain Elevated

**In AEs, household inflation expectations remain high**

Household Expectations, 1 year horizon
(Latest, Share Of Respondents, Percent)

**While in Euro Area, inflation options point to bimodal inflation expectations**

Option-Implied Distributions of Various Inflation Outcomes in the Euro Area, 1 year horizon
(Probability density)
Intraday Gilt Market Interventions of The Bank of England in September and October 2022

UK Gilt Yields
(Percent, basis points)

- Gilts (lhs)
- Inflation linked Gilts (lhs)
- 2Y yield (rhs)
- 30Y yield (rhs)

Mini Budget Announcement
Abolishment Tax Cut
New Chancellor
Economic Package Reversal
New PM
Former PM resigned

21-Sep 28-Sep 5-Oct 12-Oct 19-Oct
Euro Area Under Pressure from Energy Crisis and Fragmentation

Rising energy prices threaten to tip the continent into recession
European Energy Prices and Headline Inflation
(Prices in Euro, left scale; percent, right scale)

Peripheral euro area sovereign spreads have narrowed from their peaks
German 10-Year Yields and Sovereign Spread
(Basis points, left scale; percent, right scale)

TPI announcement has helped to contain disorderly widening of spreads
EMs are expected to begin easing in 2023...

Historical and Market-Implied Policy Rates across Regions
(Percent)

[Graph showing rates across different regions, with lines for Latin America, Asia, CEE, and US.

Note: CEE reflecting the average of Poland, Czech Republic and Hungary.

...but term premia remain elevated due to global uncertainty

Change in Five-year Term Premia since January 2020
(Basis points)

[Graph showing changes in term premia for different regions.

Note: CEE reflecting the average of Poland, Czech Republic and Hungary.
Serious Sovereign Debt Risks In Many Vulnerable EMDEs

While large issuers have shown resilience, many lower-rated issuers now trade at distressed levels.

Emerging market Sovereign Spreads  
(Basis points)

Frontier markets face challenging re-financings, with ~20 names at high risk of (or already in) default.

Hard- Currency Bond Maturities and Spreads  
(Billions of US dollars)
FTX Bankruptcy Fallout Seems for now Contained Within Crypto

**Price of crypto assets has plunged**

Price of Bitcoin and Ethereum (in USD)

<table>
<thead>
<tr>
<th>Date</th>
<th>BTC Price (USD)</th>
<th>ETH Price (USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jul 1</td>
<td>30,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Aug 1</td>
<td>25,000</td>
<td>1,800</td>
</tr>
</tbody>
</table>

**And market capitalization dropped dramatically**

Market Capitalization of Crypto Market (USD Billion)

<table>
<thead>
<tr>
<th>Date</th>
<th>Crypto Market Cap (USD Billion)</th>
</tr>
</thead>
<tbody>
<tr>
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</tr>
<tr>
<td>Aug 1</td>
<td>800</td>
</tr>
</tbody>
</table>

**But there has been little contagion to other risky assets**

MSCI Equity Indices and Bitcoin (Jul 1, 2022=100)

<table>
<thead>
<tr>
<th>Date</th>
<th>MSCI World Index</th>
<th>MSCI EM Index</th>
<th>Bitcoin</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jul 1</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Aug 1</td>
<td>90</td>
<td>90</td>
<td>90</td>
</tr>
</tbody>
</table>

Source: CoinGecko
Global Housing Markets May Come Under Further Pressure

**Stretched housing valuations relied on low rates to maintain affordability**

Price-to-Income Ratio, 2000:Q1–21:Q4  
(Index, 2015 = 100)

Prices are beginning to turn as mortgage rates back up dramatically

**US 30y Mortgage rates and Home prices**  
(Percent)

US 30y Mortgage Rate % (lhs)  
US Existing Home Sales Median Price, % m/m (rhs)
House Price at Risk is Substantial, Especially for EMs

**Affordability weighing on house prices**

**House Price at Risk Decomposition**
(Percent, projected contribution, latest)

- Credit boom
- Financial conditions index
- GDP growth
- Past house price growth

**EM downside risks are elevated**

**House-Price-at-Risk, Advanced Economies and Emerging Markets, Three Years Ahead**
(Density; cumulative growth in percent)
In China, Housing Risks May Spread Far Beyond Property Developers

A stalled housing market has put developers into distress, threatening home completions

If pre-sold mortgages end up in default, many banks could face large losses

Residential Real Estate Sales and Property Developer Bonds
(Index, May 2021 = 100)

Banks: Potential Credit Losses Related to Real Estate Exposure
(Percent of total risk-weighted assets)
Globally systemic banks and those in advanced economies seem largely resilient to adverse scenarios…

…but many EM banks face significant recapitalization needs under a stress test.
With high global rates and volatile capital markets, EMs face a risk of large outflows...

...and growth downside risk is nearing peak 2020 levels
The Market for Sustainable Finance in EMDEs is Growing

There has been a strong momentum in sustainable debt issuance in EMDEs…

Sustainable Instruments by Issuance Type
(Billions of US dollars; as of mid-2022)

...while financing for fossil fuel firms in EMDEs is still rising rapidly.

MDBs have to play a key role in crowding in private finance.

MDB Climate Finance from Own Resources & Private Investors (private finance), 2020
(Billions of US dollars, left scale; ratio, right scale)

But Several Challenges Will Need to be Overcome

Note: ADB = Asian Development Bank; AfDB = African Development Bank; AIIB = Asian Infrastructure Development Bank; EBRD = European Bank for Reconstruction and Development; EIB = European Investment Bank; IDBG = Inter-American Development Bank Group; IsDB = Islamic Development Bank; MDB = multilateral development bank; WBG = World Bank Group.
The March 20 market turmoil revealed vulnerabilities of open-end funds.

Corporate bonds held by less liquid funds have higher return volatility.

Swing pricing can mitigate fragilities, albeit often capped at levels that appear too low.

The March 20 market turmoil revealed vulnerabilities of open-end funds.

Corporate bonds held by less liquid funds have higher return volatility.

Swing pricing can mitigate fragilities, albeit often capped at levels that appear too low.

Effective liquidity management tools are key.
Monetary and Macroprudential Policy:

- Central banks should act resolutely to restore price stability and avoid de-anchoring of inflation expectations that would damage credibility. Policymakers need to communicate clearly their policy function, their commitment to achieving their objectives, and the need to further normalize policy to avoid unwarranted market volatility.

- Policymakers should contain further buildup of financial vulnerabilities. While considering country specific circumstances and the near-term economic challenges, Policymakers should adjust selected macroprudential tools as needed to tackle pockets of elevated vulnerabilities.

- Striking a balance between containing the buildup of vulnerabilities and avoiding procyclicality and a disorderly tightening of financial conditions is important given heightened economic uncertainty and the ongoing policy normalization process.
Recommendations for the NBFI sector

• The increasing importance of nonbank financial institutions (NBFIs) calls for counterparties to carefully monitor intraday activity and leverage exposures, strengthen their liquidity risk management practices and enhance transparency and data availability.

• Policy action is warranted to mitigate vulnerabilities and risks associated with open-end investment funds.

• Price-based liquidity management tools such as swing pricing can be effective in lowering asset price fragilities, but policymakers should provide further guidance on their implementation.

• Additional tools could include linking the frequency of redemptions to the liquidity of funds’ portfolios.

• Policymakers should also consider tighter monitoring of funds’ liquidity risk management practices, additional disclosures by open-end funds to better assess vulnerabilities, and measures to bolster the provision of liquidity.