

**FOR  
AGENDA**

SM/14/277  
Correction 1

CONFIDENTIAL

September 23, 2014

To: Members of the Executive Board

From: The Acting Secretary

Subject: **October 2014 Global Financial Stability Report—Executive Summary and Chapter 1**

The attached corrections to SM/14/277 (9/12/14) have been provided by the staff:

**Typographical Errors**

**Page 16, Figure 1.6, Panel 1:** New Panel 1 replaces old Panel 1 which was incorrectly duplicated from Panel 2.

**Page 60, Figure 1.25, Panel 3:** Chart replaced. Earlier version was missing data.

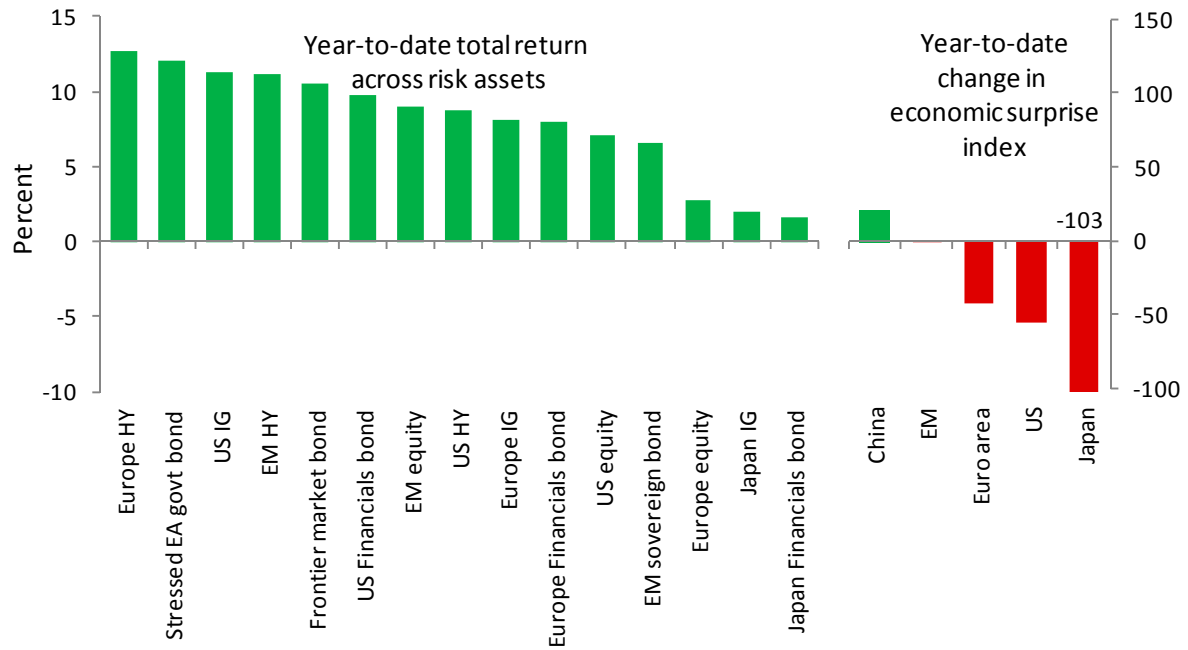
Questions may be referred to Mr. Dattels (ext. 37938) and Mr. Jones (ext. 35633) in MCM.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (2)

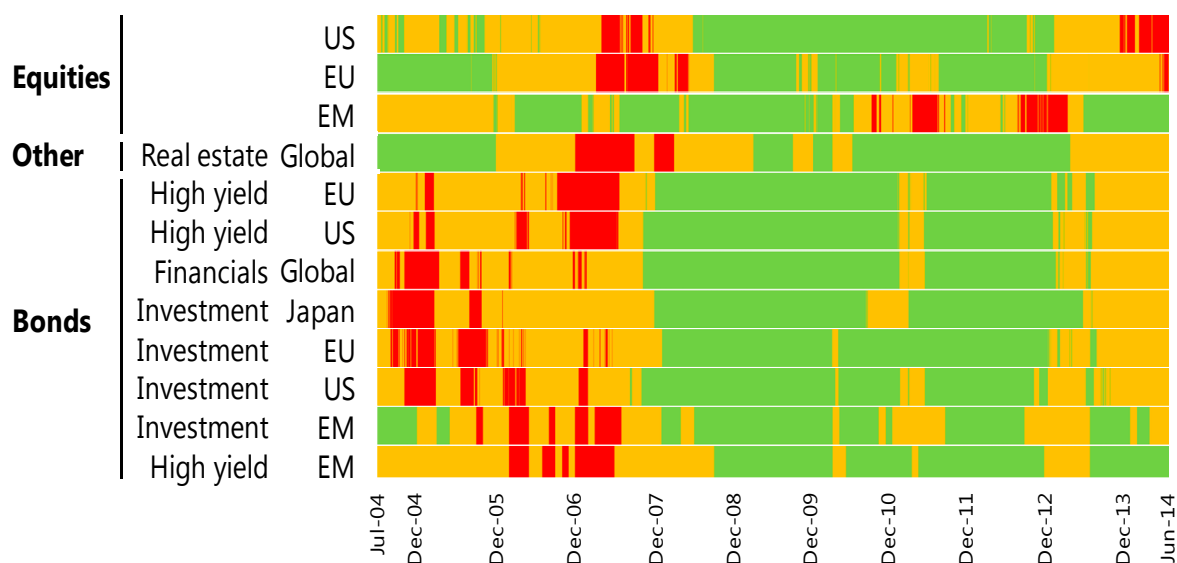
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**Figure 1.5. Financial Markets Are Buoyant, Despite Economic Disappointments**

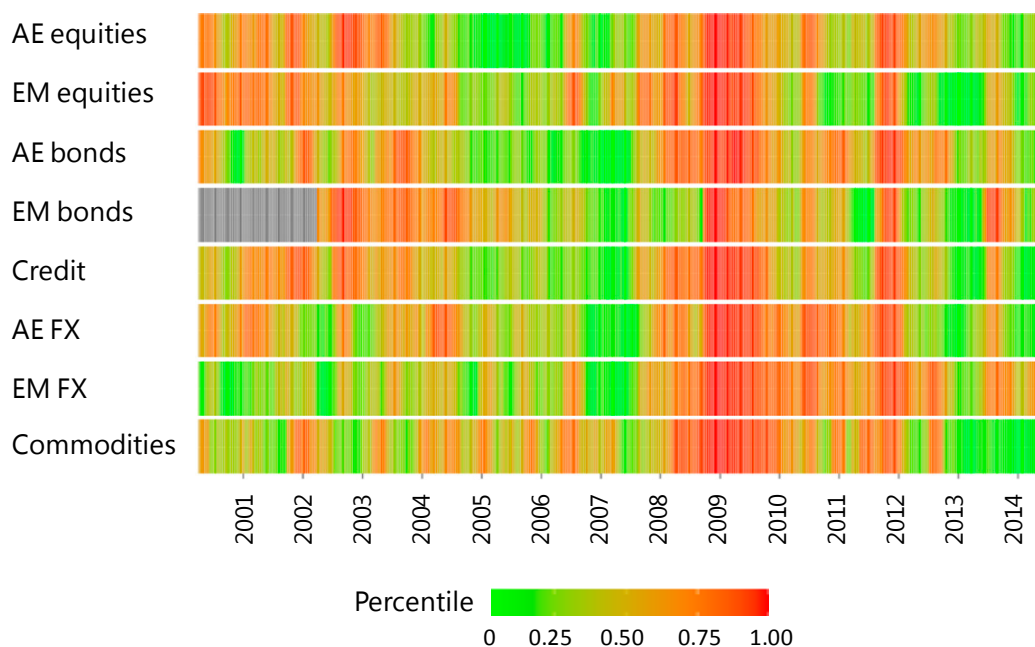
Source: IMF staff calculations.

Note: emerging market = emerging markets, EA = euro area; HY = high yield; IG = investment grade; YTD = year to date.

**Figure 1.6. Global Heat Maps****1. Asset Price Heat Map**

Source: IMF staff calculations.

Note: red = top (bottom) 10 percent of equity prices (bond spreads); green = bottom (top) 50 percent of equity prices (bond spreads); yellow = remainder of the price (spread) distribution over July 2004 – June 2014. EM = emerging market; EU = European Union; US = United States.

**2. Volatility Heat Map**

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

Note: Percentiles of three-month realized volatility. AE = advanced economy; emerging market = emerging markets; FX = foreign exchange. Percentile value of 1 corresponds to the maximum level of asset volatility for the entire period, 0 corresponds to the minimum.

**72.** Furthermore, the concentration among the advanced economies as the source of portfolio investment is even more striking. As of 2012, four of the world's most financially integrated countries, Hong Kong SAR, Singapore, the United States, and the United Kingdom, sourced at least half of all equity portfolio investment to the major emerging market economies, and at least a third of the total advanced economy fixed-income portfolio investment. Portfolio allocations from U.S. residents alone account for more than a third of equity portfolio investment in most major emerging market economies. Given the degree of concentration for portfolio allocations, the prospects for tighter monetary policies in the United Kingdom and the United States could have a significant impact on portfolio flows to the largest emerging market economies.

**73.** An unintended consequence of these stronger financial links between advanced and emerging market economies in recent years is the increased synchronization of asset price movements and volatilities. Shocks emanating from advanced economies can now more quickly propagate to emerging market economies via the portfolio investment channel and changes in underlying market liquidity. The increasing correlation in recent years between asset prices of emerging and advanced economies (in both equities and bonds) is consistent with this increased synchronization (Figure 1.25, panel 1). This synchronization is also found in volatility; global low volatility, particularly for emerging market fixed-income assets, can be linked to low volatility in U.S. fixed-income markets, a by-product of unconventional monetary policies. Conversely, when volatility in U.S. Treasuries switches to a higher level, the knock-on impact on the volatility of other asset classes is also very rapid, as shown in the May 2013 risk-off episode (see Annex 1.4).

### ***Normalization of monetary policy could trigger a significant disruption to global markets***

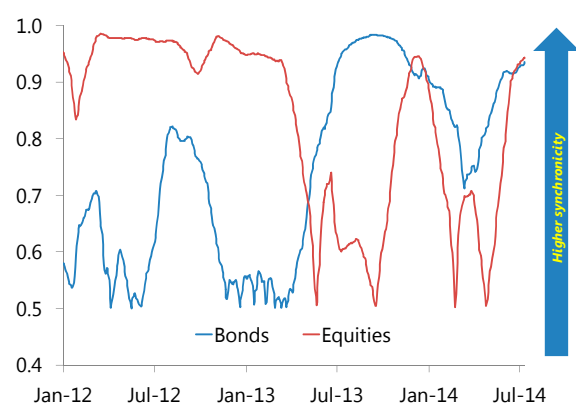
**74.** There are a wide variety of possible events that could trigger a sharp reversal of risk appetite and increase volatility in credit markets. Such events include major geopolitical flare-ups, or sudden shocks to large, systemically important, emerging market economies. Perhaps the most plausible trigger for a broad-based market repricing is the expected reduction in monetary accommodation in the United States.

**75.** If monetary normalization and interest rate adjustment proceeds smoothly, the impact on asset market volatility may be well-contained, leading to a smooth adjustment of asset allocations over time. However, the change in U.S. policy could have repercussions extending to all major markets, radiating out from global bond and credit markets. As shown in Annex 1.4, shifts in volatility in U.S. Treasury markets to a high level tend to drive up volatility in other asset classes rapidly to a correspondingly high level. Given the increased role of redemption-prone investors in rate sensitive credit markets, and the numerous amplifying factors described in this report that could reduce liquidity during times of stress, the monetary policy exit process may be accompanied by significant bouts of increased volatility. Reflecting these developments, the sensitivity of volatility to

## Figure 1.25. Volatility Developments

**Increased synchronization of advanced economy and emerging market asset prices.**

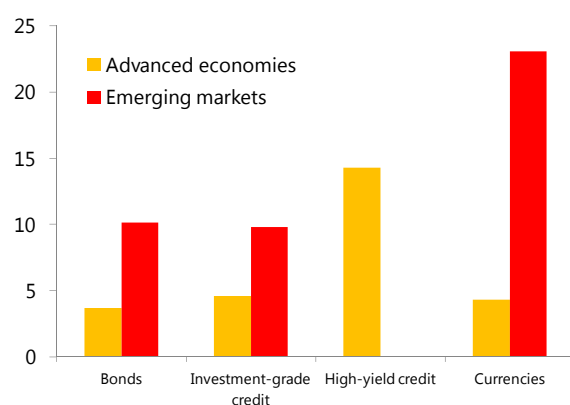
**1. Portion of Total Variation Explained by the First Principal Component of Levels of Emerging Market and Advanced Economy Bonds and Equities (Six-month moving window)**



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

**... and volatility increases a lot more for emerging market than advanced economy assets during periods of high risk aversion.**

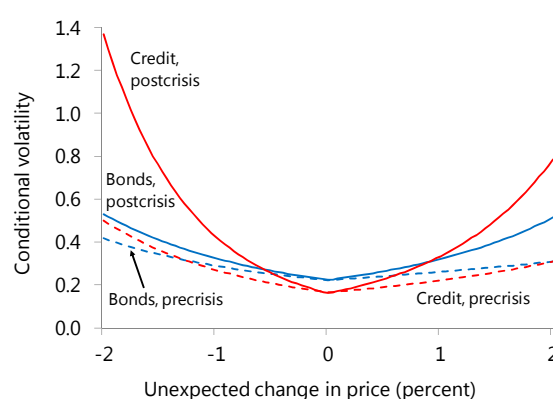
**3. Increase in Volatility from Moving from a Low to a High Volatility Regime (Multiples)**



Source: IMF staff calculations.  
Note: See Annex 1.4 for more information.

**Volatility has become more sensitive to price declines for sovereign bond and credit markets . . .**

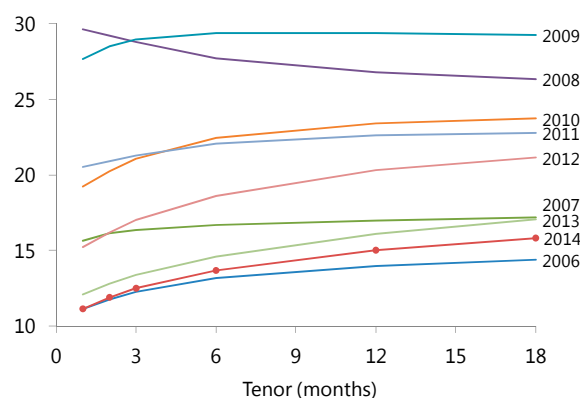
**2. News Impact on Asset Volatility**



Source: IMF staff calculations.  
Note: See Annex 1.4 for more information.

**Longer-term implied volatility remains very low.**

**4. S&P 500 Implied Volatility Term Structure (Daily average)**



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