Macro Insights Weekly

IMF Notes: Economic resiliency and financial risks

Group Research

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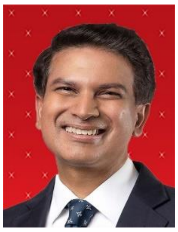

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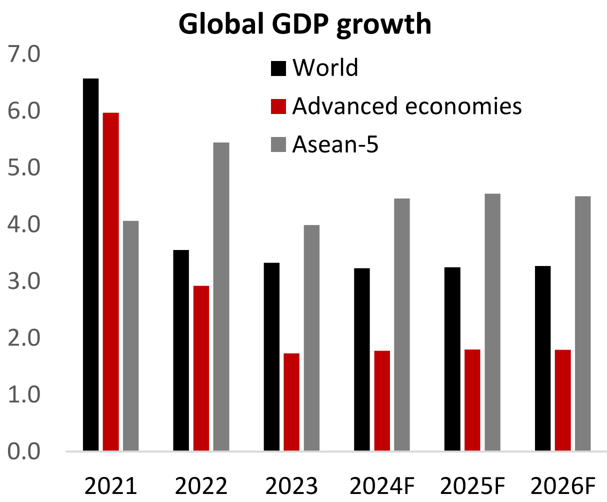
- *The IMF annual meetings, held at Washington DC last week, were characterised by relief over global economic resiliency, juxtaposed by heightened concerns about a variety of risks.*
- *Global growth is expected to remain stable between 2024 and 2025.*
- *Concerns about inflation have receded, but we caution against a victory lap.*
- *USD weaponisation and trade wars are causing investor strategies to shift.*
- *EM resilience would be tested by the outcome of the US elections.*
- *Intersection of AI and capital markets is generating interest from regulators.*

Chart of the Week: IMF sees stable growth

A variety of omnipresent risks notwithstanding, global and Asean-5 growth is expected to remain stable between 2024 and 2025. In the World Economic Outlook forecasts released during the recently concluded IMF annual meetings in Washington DC, global real GDP is expected to rise by 3.2% in both 2024 and 2025, while Asean-5 is slated to rise by 4.5% in both years. Some slowing of China and India's economies could be in store, but overall, global consumption and investment would chug along, as per the IMF.



Source: IMF, DBS. Asean-5: Indonesia, Malaysia, Philippines, Singapore, Thailand.

Notes from IMF meetings: Economic resiliency and financial risks

The annual meetings of the IMF and World Bank, held at Washington DC last week, were characterised by relief over global economic resiliency, juxtaposed by heightened concerns about a variety of risks.

There was an element of satisfaction among DM and EM government officials that the post-pandemic rebound-led inflation has largely abated, and the sharp interest rate increase phase has come and gone without causing economic growth to stumble. This is a sharp departure from the case just two years ago, when there was near-panic about the stickiness of inflation, and the likely spike in unemployment that would be caused by necessary monetary policy tightening.

It has turned out to be quite different; labour markets have barely loosened and asset markets are buoyant, while goods inflation has dissipated considerably. China, a major source of commodity demand, has been on a slowing path, a contrast from the US economy, which has been going strength to strength. This opposing dynamic has offered a degree of balance to the global supply-demand picture. A stable commodity price environment, despite escalating warfare in the Middle-East, has also been a source of support.

Global and Asean-5 growth is expected to remain stable between 2024 and 2025. In the IMF's World Economic Outlook forecasts released during meetings, global real GDP is expected to rise by 3.2% in both 2024 and 2025, while Asean-5 is slated to rise by 4.5% in both years. Some slowing of China and India's economies could be in store (about 50bps each from 4.8% and 7%, respectively), but overall, global consumption and investment would chug along, as per the IMF.

We think it may be too early to declare victory over inflation or take comfort in the apparent resiliency from higher rates. Services inflation remains on the sticky side, strong growth may spill over into higher prices, and the tensions in the Middle-East could reach a tipping point. Already, in recent weeks, the overwhelming expectations of sustained rate cuts have begun to recede, with a great deal of uncertainty building up over how many rate cuts are possible next year. One or two more strong jobs numbers and higher-than-expected CPI prints could cause a sharp change in rates pricing for next year. The recent rise in long-term US interest rates, which has resulted in mortgage rates rising as well, could be a harbinger for things to come.

Higher rates could also materialise under a Trump election victory, which could lead to expectations of higher US fiscal deficit and erosion of Fed independence. That, plus Trump's tariff plans, could lead to firming of the USD, hurting some USD-borrowing sovereigns, firms, and households. These risks will need to be assessed in light of the result of the November US presidential elections.

There was no shortage of concerns over the US, ranging from an increasingly untenable fiscal position, impact of higher tariffs on the rest of the world, and a possible re-acceleration in inflation under a no-landing scenario. We even heard ideas akin to an EU-style carbon border adjustment tax on imports being floated by some Trump loyalists. While such things are less likely under a Harris presidency, no one expects a meaningful improvement in the frictions characterising US trade and commerce.

There was however also some degree of comfort with the US outlook, given the strong state of asset markets, a buoyant investment environment, commanding lead on the global AI race, and sound household and corporate balance sheets.

As has been the case lately, the meetings contained a great deal of discussions and presentations on geoeconomic fragmentation, climate finance, and of course, China. From the so-called "excess capacity" charges to the scale and effectiveness of the ongoing stimulus measures, from the security environment, external and internal, to the China plus one dynamic, the arguments were unfortunately largely binary. There is a great deal of groupthink among DM economies about China, and the thinking is largely about the threats and risks, rather than opportunities and gains from cooperation. We expect this polarisation to persist, with more tariffs and other restrictive measures in the pipeline. The key is to do the best given that inevitable and adverse dynamic.

This is where opportunities for EM are being seen. Supply chain relocation should help India, Mexico, South-East Asia, and a few other countries. Investments from western MNCs, as well as from Chinese companies, are being spread more widely around the world. It remains to be seen if this relocation process would take place without a drop in productivity displayed by China's manufacturing stack, but the choices to do so have been made, no doubt.

Weaponisation of the USD was another widely discussed theme. Surveys show that central banks are increasingly inclined to hold more gold and non-USD assets. Fintech solutions make "deferred barter" feasible, under which countries running trade deficits vis-à-vis China can receive RMB for what they sell to China and send those RMB proceeds back through the import channel. This is not a theoretical construct, it is an increasingly deepening phenomenon, especially in the Middle-East.

US-EU efforts to seize or freeze the assets of the central banks of Afghanistan and Russia, along with a multitude of restrictions over western payment systems like SWIFT, are adding impetus for many governments to reduce over-reliance on the USD. There are already cases where central banks are repatriating their gold reserves custody from London/New York to their home jurisdictions.

Reducing the reliance on the USD is akin to the de-risking of supply chain strategy that is touted a great deal. Just like the pandemic pushed companies to reconsider the efficiency-resiliency trade-off over nodes of manufacturing, similar considerations are at play with regard to the risks of holding USD assets. Alternatives like barter, purchase and localisation of gold holdings , and adding EUR or RMB to reserves are second best, with associated frictions, but they are now very much on the table. The extraordinary rise in US debt issuance adds to these considerations in many corners around the world.

GFSR chapter on AI and GenAI

The meetings featured the release of the IMF's Global Financial Stability Report, which contained an interesting chapter on the potential impact of artificial intelligence (AI and GenAI) on capital markets. The premise of the analysis was that AI and related breakthroughs have the potential to increase the efficiency of capital markets—trading, investment, and asset allocation—through assisted process automation and analysis of complex unstructured data.

The report cited early evidence that these effects are already being felt in the financial sector. Financial firms are hiring large number of AI talent, developers' filing for patents are up sharply, while pricing patterns and trading dynamics already show changes in some markets consistent with the adoption of these new technologies.

Major gains from such a wave would materialise in the medium term; for the time being, the typical use case of AI is extension of existing trends in the use of machine learning and other advanced analytical tools.

IMF researchers argue in the report that AI may reduce financial stability risks by enabling superior risk management, deepening market liquidity, and improving market monitoring.

The risk is however that if trading strategies of AI models all respond to a shock in a similar manner, creating exaggerated price movements or market disruptions. Also, there could be further migration of market-making and investment activities to hedge funds, proprietary trading firms, and other nonbank financial intermediaries, creating a greater degree of opacity in the financial sector.

Firms and governments should also take into cognizance the increase in operational risks as there are only a handful of key third-party AI service providers. There is also the risk that AI-enabled bad actors would carry out cyberattacks and market manipulation with a far greater degree of potency.

Global regulators are working on creating a framework to address these risks. Considerations include calibration of circuit breakers and a review of margining practices in case of rapid AI-driven price moves, as well as enhanced monitoring and data collection of the activity of large traders, including nonbank financial intermediaries.

There will be an increasing need to stay on top of dependency on data, models, and technological infrastructure. Firms should be expecting regulators to demand risk mapping, covering internal and external data interconnections and interdependencies.

Conclusion

The IMF meetings did not bring forth any new, ambitious calls to action. Key cyclical and structural issues remain the same, from sustainable growth to dealing with climate change. Thorny issues like increasing the voice of developing economies in the multilateral system remain on the sideline. The continuous erosion of a rule-based, free trade oriented global system is noted, and those costs are highlighted, but there is little in the power of the well-meaning staff of the World and IMF to push back against the trend. In the coming meetings, more of the same can be expected.

Taimur Baig

FX: Trump Trade risks, JPY's political and policy uncertainties, and GBP's budget watch

We remain cautious of the greenback's recovery after the DXY Index's 3.9% rise in the past four weeks. With the Fed in a pre-FOMC blackout, weaker US nonfarm payrolls this Friday could reinvigorate expectations for two Fed cuts in November and December. US initial jobless claims have risen on a 4-week moving average basis to 239k for the week ending October 18, the highest since early August. Consequently, nonfarm payrolls may fall below 200k, reversing September's unexpected rise to 223k, which triggered the USD's recovery and the rise in US bond yields this month.

The "Trump Trade" that lifted the USD could lose momentum ahead of the US Presidential Election on November 5, mirroring a similar loss 1-2 weeks before the 2016 election. The race between Vice President Kamala Harris and former President Donald Trump remains too close to call. However, according to NBC News, early votes showed Harris leading in Pennsylvania, Michigan, and Wisconsin – the three critical swings states in the 2016 and 2020 elections. Additionally, the DXY's post-election rally in 2016 was also fuelled by the onset of a Fed hiking cycle in December 2016, a stark contrast to today's scenario, where the Fed began a rate-cutting cycle last month.

The JPY started weak on Monday amid post-election uncertainties and doubts over BOJ policy. Prime Minister Shigeru Ishiba, who triggered this month's JPY sell-off with his comment about Japan's unreadiness for rate hikes, will have difficulty hanging on to power. Exit polls indicated that the ruling coalition led by the Liberal Democratic Party (**LDP**) **would lose its parliamentary majority** in the October 27 snap elections. Ishida, who has 30 days to find a third coalition partner, will likely face pressure to resign. JPY bears hope that Sanae Takaichi, a strong advocate of ultra-low interest rates, will succeed him. Meanwhile, the opposition Constitutional Democratic Party will also be looking to form another coalition to form a government.

The Bank of Japan is expected to leave rates unchanged at its meeting on October 31, following the decline in Tokyo's CPI inflation below the 2% target in October. **But it should maintain its monetary policy normalization plan to hike rates through 2025**. The largest labor union group, Rengo, has announced plans to seek wage hikes of at least 5% in 2025, matching this year's increase. Markets will view interventions as opportunities to buy USD/JPY but they should also be wary of the USD's downside risks on a weaker US payrolls report this Friday.

GBP/USD traded below 1.30 last week but found support at a trendline of around 1.29. The UK Autumn Budget 2024 announcement on October 30 has attracted attention. Chancellor of the Exchequer Rachel Reeves has flagged some GBP40 bn of tax hikes and spending cuts to plug a GBP22 billion fiscal "black hole" by the previous government. The IMF has given implicit support to relax the self-imposed fiscal rule to unleash public investment, namely in infrastructure, to achieve long-term growth. Hence, the market does not expect a repeat of the mini-budget crisis, especially now that CPI inflation fell to 1.7% YoY in September, below the 2% target for the first time since April 2021. The OIS market has priced a 25 bps cut in the Bank of England's bank rate to 4.75% at its next meeting on November 7.

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