II. Potential macro environmental risk factors

2.1 International economic and financial conditions

2.1.1 International economic conditions

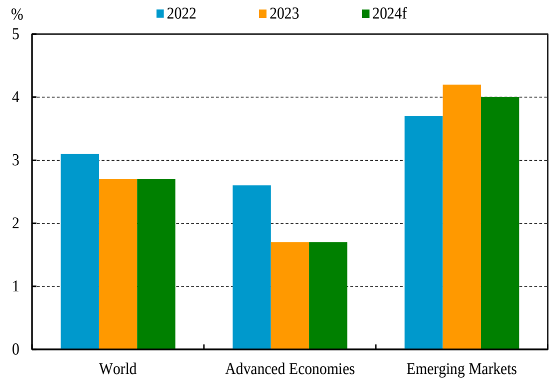
The economic growth rate saw only a slight decline throughout the year amid the global disinflation of 2023, reflecting resilient economic conditions. However, economic growth showed divergent paths across countries. Among them, the US and Japanese economies grew steadily, while the euro area experienced a sharp decline. China's economic growth somewhat exceeded the target, set at the beginning of the year, as a result of a lower base period in the previous year.

Looking ahead to 2024, in spite of the fact that global manufacturing and services sectors are expected to recover gradually, economic growth will stay at the same level owing to geopolitical tensions and still-high funding costs. Moreover, several adverse factors such as geopolitical issues are likely to limit the decline in global inflation, and the future trajectories of monetary policies in major economies are also highly uncertain.

Global economic growth showed resilience, but uncertainty remained elevated

During the global disinflation of 2023, sharp interest rate hikes by major central banks limited the momentum for economic growth. Nevertheless, thanks to greater-than-expected government spending and household consumption, employment and incomes saw steady growth. A higher-than-expected labor force participation rate also benefited a supply-side expansion. Moreover, the accumulation of substantial savings by the households in major advanced economies during the pandemic helped support global economic performance.

Chart 2.1 Global economic growth rates



Note: Figures for 2024 are S&P Global Market Intelligence estimates.
Source: S&P Global Market Intelligence (2024/5/15).

Consequently, the economic growth rate only experienced a mild deceleration, dropping to 2.7% in 2023 (Chart 2.1), showing that economic activities were still resilient.

Looking forward to 2024, the gradual recovery in global manufacturing and services sectors are anticipated to fuel momentum for economic growth. Nonetheless, geopolitical tensions and elevated funding costs owing to the high interest rate environment, as well as uncertain monetary policy stances of central banks in the US and Europe, may impede global economic growth. Additionally, upcoming elections in the most populous economies, including the European Union, the US, and India, will further complicate international political and economic conditions. S&P Global estimates[12] that the global economic growth rate will remain at 2.7% in 2024. For advanced economies, growth is projected to remain at 1.7%, while the rate in emerging economies is expected to drop to 4.0% (Chart 2.1).

China's economic growth may slow down

In 2023, the post-pandemic economic recovery in China fell short of expectations. Defaults by major real estate developers, such as Evergrande Group and Country Garden Holdings Company Limited, triggered a domino effect that led to a significant downturn in the real estate sector and severely undermined market confidence. This greatly reduced the effectiveness of the government's economic stabilization policies. Nonetheless, owing to the lower base effect, the annual economic growth rate still rose substantially to 5.2% in 2023, surpassing the initial target of 5.0%.

Looking ahead to 2024, a resurgence in the real estate sector in China appears unlikely in the short term. Rising local government debt risks, coupled with sluggish investment, weak domestic demand, and a rapidly deteriorating demographic structure, are expected to decelerate economic growth. S&P Global forecasts that the annual economic growth rate will decline to 4.8%. In terms of fiscal conditions, China is anticipated to maintain its expansionary fiscal policy and intensify regulatory efforts to stabilize the economy. According to the IMF, China's government debt-to-GDP ratio is projected to continue trending up to reach 88.6% in 2024.

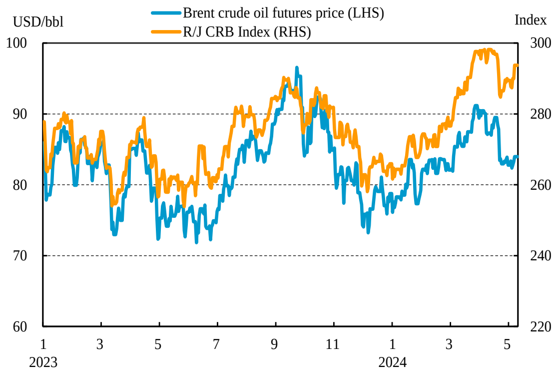
Global inflation moderated, but remained at elevated levels

In 2023, oil prices had been affected by a mix of bullish and bearish factors. Among them, the output cuts announced by the Organization of the Petroleum Exporting Countries and its allies

[12] S&P Global Market Intelligence estimate on May 15, 2024.

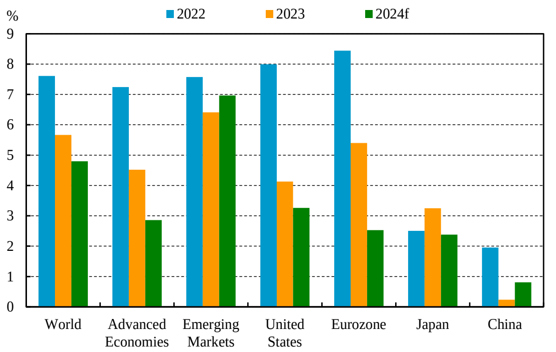
(OPEC+) and the Red Sea shipping crisis led to a rise in oil prices. On the contrary, market expectations of oversupply as a result of the deteriorating economic outlook in China, along with a greater-than-expected increase in output among non-OPEC countries, suppressed the potential rise in prices. In sum, crude oil prices fluctuated within a limited range throughout the year (Chart 2.2). In terms of commodity prices, as central banks in major economies continued to adopt tightening monetary policies to curb inflation, the annual average of the R/J CRB Index, designed to track overall global commodity prices, came down to 272 in 2023 from 285 the previous year. As a result, the global CPI inflation rate declined to 5.7% in 2023 from 7.6% in 2022. Among economies, advanced economies and emerging economies saw decreases to 4.5% and 6.4%, respectively (Chart 2.3), albeit still higher than the pre-Russia-Ukraine war level in 2021.[13]

Chart 2.2 Global commodity prices



Source: Bloomberg.

Chart 2.3 Global headline inflation indices



Note: Figures for 2024 are S&P Global Market Intelligence estimates.
Source: S&P Global Market Intelligence (2024/5/15).

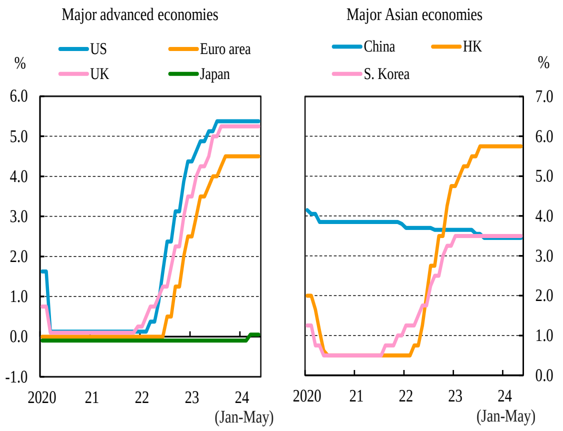
From the beginning of 2024 onwards, a constant softening in labor markets and relatively tight monetary policies helped cool inflation. However, given ongoing geopolitical tensions, commodity prices may be exposed to upside risks again owing to shipping disruptions. Considering this, together with food insecurity arising from extreme climate events and El Niño, as well as rigidity of services sector prices, S&P Global predicts that the global CPI annual growth rate will drop only moderately from 5.7% to 4.8% in 2024. On one hand, the rate in advanced economies is expected to continuously decrease to 2.9%. On the other hand, S&P Global anticipates that the CPI inflation rate of emerging economies will rebound to 7.0% as many economies in Latin America and emerging Europe have already begun easing cycles (Chart 2.3).

[13] The global CPI inflation rate in 2021 was 3.9%. Among economies, advanced economies and emerging economies reported CPI inflation rates of 3.2% and 3.9%, respectively. For more details, please refer to CBC (2023), *Financial Stability Report*, May.

The future monetary policy path of major central banks remains unclear

Since the second half of 2023, considering the progress made on combating inflation, together with subdued global manufacturing, moderate activity in services sectors such as tourism and entertainment, and rising global geopolitical risks that might hinder global trade recovery, most of the major economies' central banks have paused interest rate hikes but kept rates at an elevated level. Among them, the Fed put a hold on interest rate hikes after raising its target band for the federal funds rate to 5.25%-5.50% in July 2023, and continued to reduce the size of its balance sheet. The Fed emphasized it would maintain the target range until inflation was moving sustainably toward 2%.

Chart 2.4 Policy rates in major economies



Notes: 1. Advanced economies: figure for the US is based on the median of the federal funds rate target range; for the euro area, the interest rate on the main refinancing operations; for the UK, Bank Rate; for Japan, interest rate on banks' excess reserves.
2. Asian economies: figure for China is based on one-year loan prime rate; for Hong Kong, Base Rate; for South Korea, Base Rate.
3. Figures are as of May 15, 2024.

Sources: Central banks and monetary authority websites.

The European Central Bank (ECB) suspended reinvestments under the asset purchase program as of July 2023, and raised its main interest rates two times, totaling 0.5 percentage points (pps), in July and September, respectively, before keeping them unchanged. The ECB stated that it would gradually adjust its monetary policy stance based on the incoming economic and financial data, the dynamics of underlying inflation and the transmission effects of monetary policy on the inflation outlook. In view of the ongoing inflationary pressures resulting from wage growth, the Bank of England (BoE) also paused rate hikes after raising its Bank Rate in August 2023 by 0.25 pps to 5.25%. As for Japan, thanks to relatively mild domestic inflationary pressures, the Bank of Japan (BOJ) kept an accommodative monetary policy. Nonetheless, in March 2023, the BOJ raised the policy rate by about 0.10 pps, ending its negative interest rate policy (Chart 2.4).

Among Asian economies, China continued its accommodative monetary policies to underpin the real economy. Since the second half of 2023, the People's Bank of China (PBOC) has successively reduced the loan prime rate and the reserve requirement ratio for financial institutions. Meanwhile, the Bank of Korea decided to maintain its restrictive monetary policy stance over a certain period of time in the future. It will keep its policy rate unchanged at 3.50% with the aim of ensuring price stability. The Hong Kong Monetary Authority, for the purpose of maintaining effective operation of the linked exchange rate system, raised the Base Rate by 0.25 pps in July 2023 following the Fed's rate hikes (Chart 2.4).

Currently, central banks in the US and Europe intend to maintain interest rates at restrictive levels until inflation falls back to the desired range. However, the timeline for rate cuts, to some extent, still remains uncertain. A premature pivot toward monetary easing could lead to an overheated economy triggering asset price bubbles, thus pushing up inflation once again. Instead, if rates were cut too late, it could result in a recession and, in turn, have an impact on the financial system. The future trajectory of monetary policy, therefore, warrants close attention.

2.1.2 Global financial conditions

From the beginning of 2023 onwards, despite the fact that global central banks maintained high interest rates to curb inflation, the pace of rate hikes has slowed, which has fueled optimism about future rate cuts. As a result, international stock and bond markets have rebounded noticeably and global financial conditions have turned to ease. However, despite a slight easing in China, the poor economic outlook, coupled with significant declines in property prices and corporate valuations, means that China's financial conditions have been kept somewhat tight by historical standards.

Looking ahead to 2024, several factors warrant close attention as they could heighten global financial instability risks, including the future trajectories of monetary policies among major central banks in advanced economies (e.g., the Fed), the deterioration of credit quality in the US CRE markets, the ongoing developments in China's financial and real estate markets, together with its substantial levels of local government debt, and the elevating geopolitical and cyber risks.

Financial conditions turned to ease

In 2023, although major economies, such as Europe and the US, continued to implement monetary tightening to tame inflation, investors anticipated that inflation would soon ease and central banks were likely to achieve a soft landing relying on their policy tools. Supported by widespread market expectations of interest rate cuts, corporate valuations in advanced economies like Europe and the US improved, resulting in gradually easing financial conditions. On the other hand, in China, financial conditions have eased slightly amid monetary loosening. However, concerns surrounding the lack of economic growth momentum and the pressure on the real estate market have raised financial stability risks. These issues have eroded the prices of risky assets and investor confidence, keeping financial conditions relatively tight.

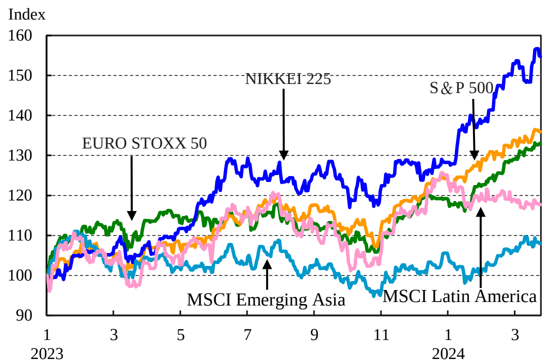
Since the beginning of 2024, market investors have held a cautiously optimistic outlook on achieving a soft landing. This, together with decreasing long-term bond yields and the recovery of stock and corporate bond markets, have further loosened financial conditions, especially in advanced economies. In emerging markets, decreasing volatility in exchange rates has led to a lower external financing risk, thus modestly easing financial conditions. In China, notwithstanding further easing of financial conditions compared to a year earlier, the overall condition remained tight by historical standards owing to persistent weakness in the real estate market.

The future trajectories of monetary policies in advanced economies will have decisive impacts on financial markets

From the beginning of 2023 onwards, amid abating inflation, global stock markets have been mildly recovering. Nonetheless, in October, the surge in US government bond yields reduced the attractiveness of stocks, bringing about capital outflows from stock markets and a reversal in prices. Since November, with market expectations that the Fed's rate hike cycle would conclude soon, along with optimistic prospects in industries like semiconductors fueled by robust demand for AI-related products, stock markets in Europe, the US, and Japan saw substantial gains, with Japan showing the most remarkable increase (Chart 2.5).

With regard to bond markets, in 2023, as a consequence of ongoing tightening monetary policies by central banks in Europe and the US, government bond yields gradually ascended. Among them, the yield on the US 10-year Treasury hit a 16-year high in October but later retreated as the market predicted a shift in the Fed's monetary policy stance. Subsequently, European and US bond yields fluctuated within a narrow range. Japan scrapped its negative interest rate policy, leading to mounting government bond yields. In China, monetary policy remained accommodative owing to a slower-than-expected economic recovery, which triggered a gradual decline in

Chart 2.5 Major international equity indices

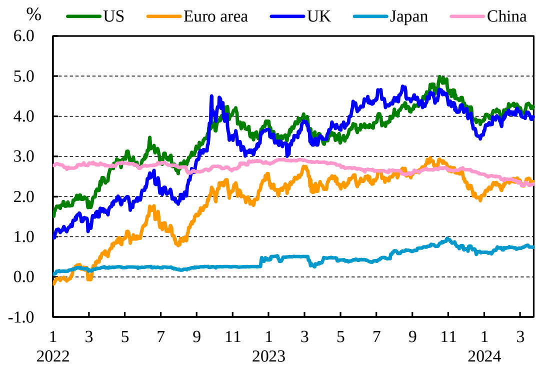


Notes: 1. January 1, 2023 = 100.
2. The EURO STOXX 50 refers to a stock index consisting of the largest 50 stocks in the 12 major economies of the euro area.

Source: Bloomberg.

bond yields (Chart 2.6). The movement of US interest rates has caused fluctuations in both the global financial cycle and financial asset prices. Therefore, the end of the Fed's rate hike cycle will undoubtedly pose a critical impact on global financial markets, warranting close attention.

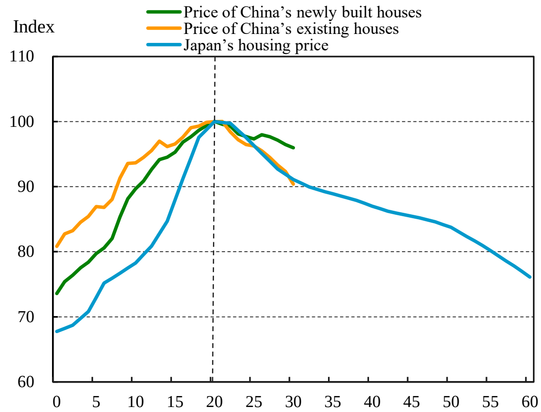
Chart 2.6 10-year government bond yields in major economies



Source: Bloomberg.

The weakening of China's housing and stock markets, coupled with unresolved local government debt issues, could exert a serious adverse effect on financial institutions

Chart 2.7 China versus Japan's 1990s housing market movements



Notes: 1. The vertical axis represents an index with the highest data point set to 100.
2. On the horizontal axis, the starting point of the data is 0, and 60 represents 60 months after the starting point. For China's data of newly built houses, the starting point is September 2021; for data of existing houses, the starting point is December 2021. The starting point for Japan's housing price data is September 1990.

Source: IMF (2024), Global Financial Stability Report, April.

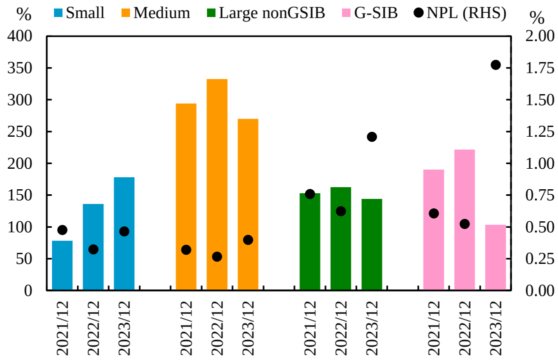
Compared to the housing price trajectories during Japan's real estate bubble in the early 1990s, China's housing market downturn has shown few signs of bottoming out and declines in the prices of newly built houses have been moderate (Chart 2.7). Yet, home prices, sales and investments have dropped off sharply. In spite of the government's supportive policies, the effectiveness in restoring home buyers' confidence was somewhat limited. The abovementioned policies include mortgage rate cuts, easing of home purchase restrictions, and encouraging banks to grant loans for real estate enterprises and the redevelopment of urban villages, which are literally traditional villages within a city.

Apart from the real estate market, the continuing operation of China's local government financing vehicles (LGFVs) has also raised market concerns. By the end of 2022, total LGFV debt reached 45% of GDP, with four-fifths held by banks, mainly in the form of loans. More than 30% of this LGFV debt has had an interest coverage ratio below 1, which can be considered nonperforming without government support. If the banks were to suffer half of the debt restructuring cost of the LGFV debt, they could face impairment charges of about RMB3.4

trillion, equivalent to a reduction of 1.7 pps in their average capital adequacy ratios.

Reflecting property market ailments as well as disinflationary pressures, China's stock market has come under pressure. In comparison to the strong rebound in global stock markets, Chinese and Hong Kong stock prices saw a slump, dragging down the net asset value of equity and hybrid mutual funds by over 20%. Since wealth management products such as funds are held almost exclusively by retail investors who lack experience in handling market volatility, an increase in bond yields could prompt large-scale redemptions by investors. This, in turn, would induce further spikes in yields and trigger tightening in other funding markets.

Chart 2.8 CRE coverage and NPL ratios in the US



Notes: 1. The left scale represents the coverage ratio, while the right scale represents the nonperforming loan rate.
2. Small banks correspond to banks with less than $10 billion in total assets, Medium banks correspond to banks with assets between $10 billion and $100 billion, Large nonGSIB corresponds to large banks with assets above $100 billion not classified as G-SIBs, and G-SIB corresponds to banks classified as G-SIBs.

Source: IMF (2024), *Global Financial Stability Report*, April.

The CRE sector in the US faced big challenges

Since the outbreak of the pandemic in 2020, the real estate market has undergone structural changes. Under the impacts of supply chain disruptions, labor shortages, and a shifting preference to work from home, the CRE market in the US and Europe witnessed a notable downturn. In 2023, global real CRE prices fell, with the US office sector dropping sharply by 23%. In a high interest rate environment, it was estimated that of the $1 trillion of debt maturing in the US CRE market in 2024 and 2025, the refinancing gap would exceed $300 billion. In addition, the quality of CRE loans also deteriorated markedly. The nonperforming CRE loan rate for US banks by the end of 2023 doubled from a year earlier, reaching 0.81%, and the coverage ratio slid to 154%, with a more pronounced decrease for global systemically important banks (G-SIBs) than for other banks (Chart 2.8).

In 2024, global CRE prices could decline by more than 10% in several segments. This may have a significant effect on small and regional banks, which are generally lower capitalized and have a larger exposure to the CRE sector than large banks, thus constraining their funding ability when CRE prices fall. Under severe scenarios, this could bring about more restrictive funding conditions, and ultimately form a vicious cycle of plummeting CRE prices and bank losses, which might pose an adverse shock to the macro-financial environment.

Geopolitical and cyber risks may threaten financial stability

With the outbreak of the Russia-Ukraine war, and conflicts between Israel and Palestine, as well as Israel and Iran, prolonged hostilities will continuously impose high uncertainty on the global economic outlook. If these conflicts escalate and severely impact economic activities, there would be a sudden pullback from risky assets, resulting in negative effects such as large declines in asset prices.[14] Furthermore, geopolitical tensions will induce a reallocation of cross-border credit lines and investment portfolios. A worsened situation could cause a reversal of capital flows from rival countries and a reduction in foreign direct investment. This, in turn, may affect asset prices and allocations, and disrupt the international payment system, thereby undermining macro-financial stability.

Since the outbreak of the COVID-19 pandemic in 2020, owing to increasing dependency on technology, together with financial innovation and Russia's invasion of Ukraine, the number of cyberattacks has almost doubled. Additionally, almost one-fifth of the cyberattacks in the past two decades have influenced the financial sector, with banks being the most frequent targets. Cyberattacks can dampen market and public confidence in financial institutions, potentially leading to bank runs and posing liquidity risks. Eventually it could adversely affect macroeconomic and financial outcomes by undermining the ability of banks to grant loans and disrupting the functioning of payment systems.

[14] OECD (2023), *OECD Economic Outlook, Volume 2023 Issue 2*, November.