



Transcript of IMF podcast:

[Fabio Natalucci: Financial Stability through a Rocky Recovery](#)

Bruce Edwards:

So there are lots of things that can compromise the stability of the global financial system, especially during a global pandemic.

Fabio Natalucci:

So I mentioned supply chain disruptions, shortages of material, the risk of unmooring inflation expectations. Another challenge that investors have been focusing on is increasing house prices.

Bruce Edwards:

Welcome to this podcast produced by the International Monetary Fund. I'm Bruce Edwards. And in this episode, we dig into the latest Global Financial Stability Report, which tries to make sense of some pretty unexpected trends.

Fabio Natalucci:

The interesting fact is that usually house prices, historically at least, tend to drop during a recession. But in this case during the pandemic, they actually surged.

Fabio Natalucci:

Hi, my name is Fabio Natalucci. I'm Deputy Director in the Monetary and Capital Markets Department of the International Monetary Fund. I am responsible for the Global Financial Stability Report, one of the flagships of the Fund, as well as the global financial markets monitoring.

Bruce Edwards:

So where are we compared to the last financial stability report that was published back in April?

Fabio Natalucci:

The world is continuing to navigate the pandemic and financial stability risks so far have been contained. That reflects ongoing monetary and fiscal policy support, and obviously the rebound of the global economy. Now in advanced economies, financial conditions have eased in addition further since the April 21 Global Financial Stability Report, supported by expectations that

monetary policy will remain accommodative for the foreseeable future. So we have seen increases in equity prices, we have seen credit spreads tightening even more, we have seen house prices rising rapidly in many countries. Now, despite some of these improvements though, financial vulnerabilities remain elevated in a number of sectors. And the concern is that if there is a sudden repricing of risk in markets, for example, as investors reassess the outlook for the economy or for policy, that repricing of risk could interact with financial vulnerabilities. In emerging markets, financial conditions have changed little.

Fabio Natalucci:

We have seen virus mutation, we have seen uneven access to vaccine posing a threat to the economic recovery. They also face funding pressures, or they face inflationary pressure. In some case Central Banks have actually tightened monetary policy. Credit conditions have improved in the corporate sector, but it's still in an uneven way. We have seen corporate balance sheet strengthening, we have seen profitability improving. Defaults and bankruptcy have declined, but there are still differences across countries firm size and sector. So for example, solvency risks have remained elevated in sectors that have been hit by the pandemic, and smaller firms. And in China, credit conditions have tightened, particularly for firms with weak credit ratings and provinces with weak public finances.

Bruce Edwards:

So last time we talked a lot about the unintended consequences of all the money that governments were using to support the various aspects of their economies. Have any of those unintended consequences actually materialized? And do we still need to worry about that?

Fabio Natalucci:

Yeah. So now we are about a year and a half into the pandemic, and I think policy makers are facing a challenging trade-off here. So there's a need to maintain near term support for the global economy, but at the same time preventing these unintended consequences and medium term financial stability risks that could put growth at risk. So a prolonged period of very easy financial conditions, while may be needed to sustain the economic recovery, especially if the strength of economic recovery turned out to be less than anticipated, may result in overly-stretched asset valuation, could fuel financial vulnerabilities that I just mentioned- some of the examples. There are some warning signs looking at for example, increased financial risk taking rising, pricing fragilities in the non-bank financial institution sector.

Fabio Natalucci:

All this points to a deterioration in the underlying financial stability foundation. And so if this vulnerability evolved into legacy structural problems, they could put growth at risk in the medium term, or even at the extreme, test the resilience of the global financial system. And now the possible deterioration of the outlook could make this trade off even more challenging, or for example, if inflation turned out to be more persistent than anticipated. At that point, Central Banks would face a challenging trade-off between having to raise interest rates if needed to contain inflation, but at the same time slowing down the economic recovery.

Bruce Edwards:

So we're all experiencing supply chain disruptions to a certain degree. We hear a lot about semiconductors and chemicals and glass that are affecting manufacturing, and the things that we're not finding on grocery store shelves. How does all this fit into financial stability on a global scale?

Fabio Natalucci:

So price pressures still continue to be viewed as largely driven by pandemic related circumstances. So supply disruption, surge in commodity prices, look at the energy crisis in Europe and China for example, shortages of components and labor. But despite that, concerns

about inflation risks seems to have intensified in the month, during the last few weeks in financial markets. And the concern is that an abrupt sustained increase in interest rate from currently low levels, particular in the US, could trigger a tightening of global financial conditions, and a pull back of risk-taking that could spill over to emerging markets. Now, what are the channels that investors seem to have in mind? One is the underlying dynamic of inflation, whether some of these pandemic related circumstances may feed into the dynamic of inflation going forward. Second channel is whether wage pressures, so we have seen increase in wages, and whether this increase in wages may be passed on to prices, so translate into higher prices.

Fabio Natalucci:

And then importantly, whether there is what the Central Bank will call an unmooring, or de-anchoring of inflation expectations, essentially investor and household raise their expectation of inflation for the future. And this is where the supply chain disruptions, energy price increases, may feed into some of this dynamic. Now the question is, what are markets telling us about the inflation outlook? Both in terms of market pricing, as well as in terms of inflation survey. In terms of market prices, what we call inflation breakevens, you see a notable increase since the lowest during the pandemic, but that's just something that you would expect. So in part because of liquidity, should those inflation breakevens have declined sharply, we have seen a rebound of those inflation breakevens. Those are like market based measures of inflation expectations.

Fabio Natalucci:

Now what we call the front end, so say at the five-year horizon, that is important to be driven by the rebound in the economy, as well as higher commodity prices. So, that's something you would expect. The question is whether you see also increases in what we call the 5-Year 5-Year Forward. So between year five and year 10 of this market based measure of inflation expectations, because that's much more directly linked to the inflation target of Central Banks. And so we do see some increase in that, but they sort of like plateau in some regions. That's true for the US, it's true for the Euro area. It's an important distinction between the five-year move and the more longer 10 year move. Now, another way to look at this is to look at surveys, and you get a similar information. You see an increase in the one year, two year, three year survey based measure inflation expectations, but expectations beyond that seem to be much more well anchored.

Fabio Natalucci:

Now, we also see in emerging markets, pressure in emerging markets, similarly than in advanced economies. For the median emerging market for example, inflation is raising about 1.5 percentage point above the median Central Bank target. But, if you look beyond that, forward survey estimates show that inflation is still anticipated to come down. And so in fact, if you are at the five year horizon, expectations are still well anchored even for emerging markets. Now why those are concerned are important in terms of policy? I mean, the concern is that this upside risk to inflation outlook that are identified may have implication for policies.

Fabio Natalucci:

I mentioned supply chain disruption, shortages of material, the risk of unmooring inflation expectations. Another challenge that investors have been focusing on is increasing house prices. And so how the recent surge in house prices may put upward pressure on inflation, via rising rent costs. Now from a policy standpoint, if inflation turns out to be more persistent than anticipated by investors and policymakers, the risk again is these inflation expectations may become unmoored, and then this reaction of Central Banks or monetary authorities will take center stage. It will be closely scrutinized, particularly for Central Banks like the Federal Reserve, or the European Central Bank. They have recently introduced new frameworks.

Bruce Edwards:

So as you just mentioned there, we have seen house prices on the rise in many countries. In fact, the World Economic Outlook just out today shows that 2021 had the highest annual growth rate

the World Economic Outlook just out today shows that 2021 had the highest annual growth rate in 15 years. And the recent news about a Chinese real estate giant in trouble has made many people nervous, given what happened in 2008. Are housing markets, something we need to worry about at this point?

Fabio Natalucci:

So the housing market has been particularly strong during the pandemic. It reflects the accommodative monetary policy, strong demand for single and multi-family homes, possibly reflecting a shift in preferences for more space and also limited supply. The interesting part is that usually house prices, historically at least, tend to drop during a recession, but in this case during the pandemic, they actually surged across major advanced and emerging market economies. Some countries, take Luxembourg, New Zealand, Turkey, house prices actually have risen more than 15% since the end of 2019. Now importantly here ...

Fabio Natalucci:

What has been an important boost has been fiscal support and the improving economic outlook. They've pushed up personal incomes and they have contained the increase in home price to disposable income. There's a supply story here, so potential imbalance between demand and supply that could explain some of this trend. Supply has been slow to respond to demand. We have seen pandemic related bottlenecks, shortages, rising costs of material and labor, prolonged construction time or delayed, increasing supply, limited building permits for example, in metropolitan areas.

Fabio Natalucci:

So all this supply effect could be another contributing factor to the rising house prices. Now what we've done in the financial stability report, we looked at what we call downside risks to home prices, extreme, worst case downside scenario. The reason being that usually sustained periods of growth in house prices can create the expectation that such prices will continue to rise in the future, leading to excessive risk-taking and therefore vulnerabilities. And so we're trying to quantify what are the downside risks to house prices. Again, looking at the worst-case scenario in that case, our result shows that the house price decline over the next three year could be, at the extreme again, In a worst-case scenario, 14% in advanced economies and 22% in emerging markets.

Fabio Natalucci:

Now there are also new risks emerging in the housing markets. So if you look back at the financial crisis, for example. In this case, household financial positions are much stronger. There's increased net worth, increased real estate equity, and that's because of lower rates because of income support. Now, by contrast in the run up to the GFC, the global financial crisis, we have seen loose underwriting standards, we have seen household with low credit scores, they were able to have access to finance. In this case, we haven't seen that. So those are positive signs that reassure us. On the other hand, there are also some new risks.

Fabio Natalucci:

For example, non-bank mortgage lenders in the United States have become much more prominent. Those are not banks; they play an important role in the mortgage origination market. They do not retain mortgages on their balance sheets, they sell them to government sponsored enterprises, but they don't have deposits. They fund themselves in wholesale funding markets. And there's a high degree of concentration, so making essentially the market more susceptible to stress should financial conditions tighten.

Bruce Edwards:

So the report includes some analytical chapters, as it always does, this time on two topics of particular interest, given the times. One is crypto assets and the move toward digital currencies, which the pandemic seems to have accelerated to a certain degree. And the other is climate

which the pandemic seems to have accelerated to a certain degree. And the other is climate change. What are the big risks that you see associated with these trends?

Fabio Natalucci:

Well, maybe let me start with the crypto chapter, right? So the chapter follows on the crypto ecosystem and possible financial stability challenges. Obviously crypto assets come in different flavors. They've evolved to meet various needs, both speculative investment, currency conversion payments. Now, we don't believe the financial risks are systemic at this point, but they still need to be closely monitored. Given particularly the global implication, and the inadequate operational and regulatory frameworks in a number of jurisdictions. Challenges are operational and financial integrity risks from crypto asset providers, investor protection issues from crypto assets, and decentralized finance, as well as inadequate preserve and disclosure for some stablecoins. Plus, it's a particular emerging market angle where the advent of crypto assets are accelerated or may accelerate what we called cryptoization, and circumvent exchange rate and capital control restriction. The third chapter focuses on the investment fund sector and the role that the sector can play to foster the transition to a green economy.

Fabio Natalucci:

We believe that it can. We believe that it can be an important driver of the transition to a green economy, but it's still too small in terms of size and scope to have a major impact. And then also challenges related to greenwashing, right? So just to put some numbers, the sustainable finance, the asset under management of sustainable investment funds, it's about 3.6 trillion at the end of 2020, and only 130 billion of that total is for climate. And at the same point in the overall sample of asset managers we look at is 50 trillion, or 49 trillion. Now there are positives, I think that's the good news of this chapter, that funds flows into sustainable finance, support climate stewardship, so investor resolution in favor of climate issues, as well as they encourage the issue of securities by firms with favorable ratings.

Fabio Natalucci:

So those are good things. One of the challenges that we highlight in a survey of asset managers that we did is that the lack of adequate climate data. That's a key obstacle in implementing investment strategies. And so to conclude what should policymakers do here? And I think this is important going into COP 26 in a few weeks. I think, one, they should urgently strengthen the global climate information architecture, so climate data disclosure and climate classification, both for firms or corporates and investment funds. Number two, they should ensure proper regulatory oversight in order to prevent greenwashing. Number three, once all these elements are in place, they should consider tools to channel savings toward transition funds. So for example, financial incentives for investment in climate funds. That should be considered to complement other climate mitigation measures, such as carbon tax.

Fabio Natalucci:

And then finally, to mitigate the financial stability risk during the transition, policymakers should implement a climate policy that is consistent with an orderly transition. And so, conduct scenario analysis and stress testing for the investment fund sector.

Bruce Edwards:

Fabio Natalucci, Deputy Director of the IMF Monetary and Capital Markets Department, and head of the Global Financial Stability Report. The latest of which was published earlier today. Always a pleasure, Fabio. Thanks for your time.

Fabio Natalucci:

Thank you so much.

Bruce Edwards:

If you're interested in learning more about the analytical chapter on crypto assets, there's a podcast on that too. Check it out at imf.org/podcasts, or wherever you listen to your podcasts. You'll find the latest global financial stability report as well as all the other IMF flagship reports, including the World Economic Outlook at imf.org. I'm Bruce Edwards, thanks for listening.

IMF Podcasts home: <http://www.imf.org/en/News/Podcasts>

Apple podcast page: <https://podcasts.apple.com/us/podcast/imf-podcasts/id1029134681?mt=2>