Fabio Natalucci:

So what we do, we take the estimates from the IEA in terms of what is needed in terms of financing flows to get to net-zero by 2050. And their number to get there is... (fade under)

Bruce Edwards:

It would've been strange only a few years ago for the International Energy Agency to be mentioned in a report on financial stability. But the world has changed, as have the risks. The latest Global Financial Stability report examines all the worrying trends, including the risk of underfunding climate mitigation in emerging markets, which the IEA estimates will need two trillion dollars per year.

Fabio Natalucci:

In terms of investment, that means going from a 3% share of climate investment to 12. So those are very large numbers.

Bruce Edwards:

Fabio Natalucci is Deputy Director of the Monetary and Capital Markets department and heads the GFSR, as it's commonly known, the latest one out today.

So it looks like interest rate hikes are finally having the desired effect in terms of slowing inflation as was predicted in April's GFSR. But recovery is not happening everywhere at the same pace. In fact, we're seeing equity prices rise in some countries and slide in others, like the US just recently. How might these different scenarios affect monetary policy and what's the risk there?

Fabio Natalucci:

Okay, so I think compared to April when we last spoke the macro backdrop has changed somewhat. So if you just look at aggregate numbers it looks like there's little change, but under the surface there's been important changes in terms of sorts of growth, global growth. Back in April we were expecting the US to slow down. Markets were pricing in maybe a recession, maybe the Fed will cut interest rates. And then on the other hand, China was coming out of COVID. It was going to be the engine of growth. Somehow these two have flipped now, the US is going really strong. The Fed has continued to hike interest rates. It's Signaling that they might have to stay high for quite a bit of time. At the same time China is having problems in terms of the growth outlook, but also in terms of, specifically, the property development real estate sector.

Parallel to that, the process of synchronization of global monetary policy that we have seen over the last couple of years- it seems to be fading. So, central banks in advanced economies are reaching the peak. I don't know when exactly the peak will be, but they have signaled that they're getting to the end of the cycle. While some emerging markets actually have cut interest rates. Then inflation has continued to come down, not only headline inflation although it may be challenged by some oil price moves lately. But also we see some continuous slow decline of core inflation, although it remains high. Now that macro backdrop has been what has been driving the soft landing narrative in financial markets, has supported risk assets, particularly equity credit spreads in advanced economies but also emerging markets and asset class. And that result in this easing of financial conditions that we have continued to see through the summer.

Lately, things started changing and I'll say a couple of words there... but that easing of financial conditions- it's quite unusual for tightening cycles. Usually the monetary policy works to central banks tighten their policy rate, financial conditions tighten, aggregate demand slows, and that's how the story works. The report highlights this risk of repricing. So the risk that there is an abrupt tightening of financial conditions, maybe there is a reassessment of the inflation outlook, markets push interest rates up and then risk assets reprice. We have seen a little bit of this in the last couple of weeks, two, three weeks, maybe mid-September. But particularly US interest rates have come up quite a bit, the real interest rate part, not necessarily the inflation piece but the actual real one. That's what matters though for borrowers in terms of price, so capital and so on.

Lastly, what has been another surprise if you want, into this cycle has been the resilience of emerging markets as an asset class. Part I think because fundamentals are stronger compared to previous decades, but also because some of these countries actually hike monetary policy well ahead of the Fed. So they got some policy buffer that was able to absorb some of the pressure coming from subsequent tightening of monetary policy. Now, of course, there are differences within emerging markets, like larger investment grade have been very resilient. If you look at the upper range of the high yield, so the riskier if you want than the frontier, those countries have been quite significantly stressed and some of them have lost access to markets.

Bruce Edwards:

But in the report you speak of the danger of the de-synchronizing of monetary policy. What exactly are you talking about?

Fabio Natalucci:

The risk is perhaps what we have seen over the last couple of weeks. We have seen rates in advanced economies, particularly the US interest rates but other rates the correlation with other advanced economies rates has been very high. So the rates complex in advanced economies moving higher at the time when some of these emerging market central banks are actually cutting interest rate signals that they may cut interest rates soon as inflation comes down, that divergence may put some pressure on these countries in terms of exchange rate. That would be a headwind for the dis-inflationary processes, put pressure on capital flows and so on. So at the time when essentially you see these rates moving up quite sharply in advanced economies, some of these emerging markets, central banks have indicated they'll be cutting. That's one of the risks.

Bruce Edwards:

I see. So the stress on the banking system that we talked about last April seems to have subsided somewhat and we can talk more about that a little later. But the report sees problems in other sectors that could weigh on growth, what are those sectors and what are the risks there?

Fabio Natalucci:

So in terms of our assessment of financial stability, I think our assessment is that financial stability risk remains elevated, generally speaking. We have seen the acute stress in the banking sector that's been subsiding, so what we have seen post SVB here in the US. But there are still weak tail of banks, and we can maybe as you mentioned, come back to that. But there are also other cracks evident in the financial system in other sectors that could turn these cracks into fault lines. An example is the credit cycle. We may be seeing that the credit cycle is starting to turn, as some of these buffers that corporates have built post-COVID, they're starting to deflate. So a couple of examples, interest rate coverage, so the ability to essentially pay interest rates with available cash and earnings is starting to decline, in a number of countries it's still high but coming down.

Also, we're seeing the share of firms that don't have enough cash, or less cash than interest or expenses is rising. It's rising across the board, advanced economies, emerging markets, small firms or larger firms, different levels. For example, in EMs, the share of firms with less ability to pay or less cash than interest rate, the level is lower in emerging markets than advanced economies. So they're doing better, but there is the directionality. So the deterioration is true also for those firms in emerging markets.

Bruce Edwards:

So just moving on from there, rate hikes affect real estate, and people are always concerned about real estate, especially since the crisis. How do house prices fit into this global financial stability report? Do we need to worry about the depreciating values in houses that are driven by these high interest rates?

Fabio Natalucci:

So I'll start with what is the intended objective policy. Effectively central banks are starting to make the price of borrowing money more expensive. So in the case of real estate, that means that the interest rates on mortgages is going up. Like in the US, it has crossed 7.5%. Two, three years ago, you could refinance at 3%

Bruce Edwards:

Yeah, or less.

Fabio Natalucci:

So the cost of buying a house or refinancing is much higher. But again, in part it's the intended objective of the policy. They're trying to slow down aggregate demand so that they can slow down inflation. What we're seeing is that the real estate is being impacted though in terms of house prices as you were indicating. There's always the story- like is there a risk that there are also unintended consequences? What we've seen so far is that the channel of monetary policy in some sense, in part it maybe has been blunted so far. We haven't seen much. So if you take for example the share of mortgages in the US that is on fixed-rate, that they were refinanced before, it's something like 75, 80%. So for those groups of people, the increased costs doesn't mean much in terms of additional costs.

So you affect essentially the marginal purchaser of new houses and those who need to refinance. What we have seen, which I think it's interesting, it's intuitive, but there seems to be a correlation between what share of your mortgage outstanding is adjustable-rate mortgages and what real house prices have done. In general, on average, countries that have a much larger share of adjustable-rate mortgages have seen a more significant decline in real house prices. And similarly in terms of debt service, how much more you need to pay, countries that have a larger share of adjustable-rate mortgages have seen the debt service mortgage ratio going up more than others. It's not true for every individual country, but I think as an aggregate it's true. This is a way of saying the monetary policy bites more in those countries where mortgage rates move up quicker

Bruce Edwards:

And in a market where mortgage rates are low, which we had for a very long time, I think the adjustable-rate is probably the mortgage of preference.

Fabio Natalucci:

There are differences between countries. Some countries structure- it's more of the share of adjustable-rate mortgages is larger than others. And in the US some of those riskier, more exotic products that are reminiscent of pre-global financial crisis, they have not come back. So that's good news in terms of resilience of the system.

Bruce Edwards:

So commercial real estate is also a growing concern in the report because it's so tied into the broader financial system. What's happening in the commercial real estate sector that is a risk?

Fabio Natalucci:

The commercial real estate sector, it's a very interesting sector, one we have been spending quite a bit of time... I think for two reasons. One is because it's been suffering both from funding structure, so interest rates moving higher, and so the cost essentially of funding the sector is going up but also because of structural changes, post COVID office is a good example, working from home. So it's the combination of the funding pressure and the structural changes that is putting pressure on the sector. In the US there's also a third dimension, it's a sector that has a confluence both of banks and non-bank financial intermediaries. So for example, the exposure of regional and smaller banks in the US is quite high compared to larger banks. And smaller and regional banks account for about 70% of commercial real estate outstanding. So regional banks play a large role in this sector.

But then there's also a significant share of the market that it's not financed through the banking sector but outside of the banking sector, so those non-bank financial lenders. Private equity is one example where some of the money would be channeled to commercial real estate. Now that segment has completely dried up, so there's no money coming from private equity anymore. Commercial mortgage-backed security, so the securitization related to commercial real estate products. That's another market that is really under pressure in terms of spreads for example. And then there's the structural issues, the offices, there's a lot of press coverage of empty offices in big cities. One way to summarize is there's funding pressure and the underlying quality is deteriorating.

If you look at default rates are starting to pick up in quite a visible way. And if you take the default rate, particularly for the office segment, that's where you see a much more pronounced deterioration in asset quality.

Bruce Edwards:

And the report also takes a very close look at what's going on in China, and where real estate is also a big concern. How might the slowdown in China's economy become a risk not only for China but the broader global financial system?

Fabio Natalucci:

So maybe starting with China. So what has still not improved there is the confidence within the real estate sector. So we have seen different indicators, whether we look at retail sales for example, those have been weaker, not just the private distressed property developer but also the larger state or enterprises as well as non-distressed private firms. You also see house prices have not improved. So restoring confidence, I think that's what is needed to get this sector jumpstarted. We've also seen some contagion playing out in the financial sector, not just anymore the property developers but as we have played out in the October 21 GFSR, we had a box where we are trying to play out some of this possible contagion channel from there to the banks, to the corporates, to the local government. We have seen some of that. For example, in the summer there's been a suspension of redemption of one of the trust funds, so this is the shadow banking and non-bank financial institutions.

We also have seen pressure in the local government finances, the so-called LGF fees, the local government funding vehicles have seen spreads widening. And just to give you a number, those LGF fees, the debt issued by these vehicles is about 45% of Chinese GDP.

Bruce Edwards:

Wow, that's significant.

Fabio Natalucci:

Four-fifths of that is through banks, so those are bank loans. So that takes now the banks into the picture. The other fifth- it's bonds that are owed by a number of investors including non-bank financial intermediaries. And then one way that we have a chart in the chapter that looks essentially the three-dimensionality of this. So if you plot the increasing yield of these LGF fees versus the increasing yields on subordinated debt by banks and by geography, you see there's a straight correlation between stress in the LGF fees, how it plays out for banks in that sector. And how some provinces that are fiscally weaker, they've been impacted even more. And that's what I think that's what we are starting to see in terms of contagion.

Bruce Edwards:

So at the end of the day, banks do have to navigate through all this whether in China or outside of China, in the United States, and continue to do business investing and lending money. How risky is it for banks these days?

Fabio Natalucci:

So what we thought we would do, we actually devoted an entire chapter of the analytical chapter on assessing the health of global banking. And we did in a way that tried to incorporate the lessons that we have learned in March with SVB and other banks. And we have done in two pieces. One, we've done a global stress test, we have done it before, but we updated that stress test... one, by including more banks. So we have more than 900 banks across 29 countries. And we also try to incorporate some of those channels that were evident during the March turmoil. So the feedback between liquidity and solvency as well as to try to see what happens if central banks have liquidity facility or not.

We play two scenarios. One is the World Economic Outlook baseline, and one is an adverse severe stagflation shock- growth goes down, negative actually, and inflation is much higher and persistent. A quick summary is that there are more than 215 banks globally actually, that are weak. Weak are defined either as falling below the regulatory minimum of capital or a five percentage point or more decline in their capital. And that accounts for about 40% of global banking assets. So it's a non-trivial share of global banks. Now, of course, this scenario is very severe, so it's a severe adverse but still. And then we have another tool that we call KRI or key risk indicators. This is more forward-looking and this is meant to be, for us, a tool to monitor going forward conditioning banking sector, where we incorporate both traditional static balance sheet indicators on capital of equity, asset quality, liquidity earnings, but also market-based data both from market pricing as well as from analyst forecast.

There are like 12 indicators and we flagged banks when they fail at least three indicators. For example, Q2, there were about 85 banks that were at least being flagged by three indicators or more for about 26 trillion of global assets. So we're going to use this going forward to keep an eye on the health of the banking sector.

Bruce Edwards:

And finally, the need for investment in climate mitigation has never been higher. And there has never been a time where governments, especially in emerging markets and developing countries where it's needed most, have so little fiscal space to do what they need to be doing. How can these countries attract private sector investment to the degree that they need to? And what happens if they can't do that?

Fabio Natalucci:

Essentially this is our chapter three of the GFSR. So what we do, we take the estimates from the IEA in terms of what is needed in terms of financing flows to get to net-zero by 2050. And to get there that requires by 2030, there's about five trillion dollars globally that goes to climate investment. Of that, 40% or about two trillion will need to go to emerging markets. Keep in mind that currently, it's 400 billion. So we need to go from 400 billion to two trillion per year. In terms of investment, that means going from a 3% share of climate investment to 12. So those are very large numbers. Obviously, the public sector cannot do this by itself. Our estimate is that the share of this climate investment that needs to be covered by the private sector, needs to go from 40% to between 80 and 90, whether it's including China or not.

So clearly the private sector needs to play a crucial role here. There are a number of challenges though that the emerging market and development economies are facing. Some of them are typical emerging market challenges- that whether it's climate or not, affects the weakness of the institutional framework, policy framework, uncertainty, legal, and so on. Some of them are climate specific, whether you have climate policies in place as carbon pricing or not, whether there's enough data, there are disclosure. And then there are the specific climate barriers, both in terms of are there enough projects that you can finance. Ultimately you can bring the money, but you need projects in place. And also how to attract private capital, what is the way to make the risk profile more attractive for private investors? Can you scale the project? They're being financed but they're small.

Can you get to scale it up quickly and so on, so specific climate challenges. We look at a number of topics just to give you a quick sense. One is in terms of the financial institution commitment. So whether financial institutions or banks or insurance companies, their policy commitments at this point they don't seem to be aligned with their net-zero target. They need to do much more. Another one has to do for example with the ESG. So this is the big industry that is booming now. But when you look at E, the environmental piece, whether if you do have higher score on the E, whether that means you really have a significant climate impact. And we find that that correlation, if anything, it seems to be negative at times. So clearly investing in E doesn't mean investing in impact.

There are impact investment funds in the investment fund universe that actually are directly geared towards having an impact, but they're a very, very small share of the ESG universe. There's another challenge that I think, so we can close the loop here of how we started, which is external funding costs in the emerging markets world has gone up a lot. And that makes in addition to what I described so far, even more challenging. So pre COVID, when the US Treasury yield was very low spreads were where they were. You would have to pay a specific yield if you want to invest, or as an investor, you only get up to that. Right now you can get almost 5% on the US Treasury, you get another 500 basis points for high yield in the US. That means you can get close to 10%, just by investing in the US.

And so the external environment in terms of financing cost- it's way higher for emerging markets. That means in this environment it's even more challenging to bring in this capital. But there are also opportunities, so all those are not just risks. So the issue is how to get to these flows going to emerging markets so that we need to fund adaptation and mitigation in these countries.

Bruce Edwards:

And what is the financial risk in all this?

Fabio Natalucci:

The financial risk is that if you hold what we call stranded assets, you hold assets that are either from a physical risk or mitigation risk, will be hit in terms of value as some of these risks materialize. It's enough to look at what we have seen in the summer in terms of heat waves, droughts, in some places you have flooding. These hazards seem to become not only more frequent, but also more severe. So they will represent a risk for financial institutions.

Bruce Edwards:

Fabio Natalucci, Deputy Director in the Monetary and Capital Markets department. Always a pleasure. Thank you so much.

Fabio Natalucci:

Thank you for having me.

Bruce Edwards:

Again, Fabio Natalucci is Deputy Director in the Monetary and Capital Markets department and heads the Global Financial Stability report, the latest one of which was published earlier today. Check it out at imf.org/gfsr.

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I'm Bruce Edwards. Thanks for listening.