Transcript of podcast with Fabio Natalucci: "Global Financial Stability Report—Volatility, Protectionism, Raising Risks"

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Hello. I'm Bruce Edwards. And welcome to this podcast produced by the International Monetary Fund. In this program: the IMF's latest *Global Financial Stability Report* says the economic recovery is still on track, with a few caveats.

MR. NATALUCCI [soundbite]: *Investors should remain attuned to the risks associated with rising interest rates. It has been 10 years, or many years, since rates have been very low; volatility has been very low. Also, we suggest that investors should stay attuned to the risk of possible escalating trade protectionism.*

MR. EDWARDS: The *Global Financial Stability Report*, or GFSR as it is commonly known, is published twice a year and looks at the risks facing the global financial system. The objective is to prevent future crises by highlighting policies that might help mitigate some of those risks.

Fabio Natalucci is Deputy Director the IMF's Monetary and Capital Markets Department, and heads the team of economists who write the overview chapter of the report.

So, how does one go about assessing the stability of the global financial system, and what does this report focus on mainly?

MR. NATALUCCI: So, the framework for assessing financial stability that we use here at the Fund comprise of two elements. One element has to do with market intelligence. So, we go out, we talk to market participants, and we try to stay, as much as possible, in touch with what's going on in the financial markets.

The financial markets are very dynamic; the market structure is changing very rapidly, and technology is changing very rapidly, so we want to get a good sense of what the emerging threats in terms of financial stabilities are, and we need to be close to the markets, and speak their language.

Then there's a second component of this approach, of this framework that we use, which is a more systematic structural way. This has been introduced in the GFSR in October 2017, it's called "growth at risk." The growth at risk assessment provides forecasts of GDP growth

outcomes in terms of probability distribution at different horizons—say, one year ahead, two years ahead, three years ahead—as a function of the current state of economic and financial conditions.

Essentially, the exercise consists of: if we have a shock—whether it's a trade shock or a financial condition shock, we are very much agnostic on what the shocks could be—and what the odds of shocks are. Then we assess how that shock impacts financial conditions, how financial conditions get filtered to various vulnerabilities that are built through the financial system, and then come up with what the impact of this distribution of growth is—this is the framework.

MR. EDWARDS: So, what does the report find in today's economy?

MR. NATALUCCI: Through the prism of this framework, our assessment is that short-term risks to financial stability have increased somewhat, while medium-term vulnerabilities, or medium-term risks to financial stability remain high. The assessment reflects that there are still relatively easy financial conditions and that they are supportive of growth in the near term, which is a good thing.

They also, after years of very low interest rates and volatility, are leading to a build-up of medium-term vulnerabilities that put growth at risk.

MR. EDWARDS: How would you compare it to your report six months ago?

MR. NATALUCCI: Six months ago, we've seen an increase in short-term financial stability risk, while financial stability risk in the medium term remains elevated. The driver of this modest increase in financial stability risk in the short term; essentially you can pull it back to the "VIX tantrum"—the spike in volatility the equity markets experienced in early February. This is what we call the VIX tantrum, as well as the recent declines in asset prices that reflect rising concerns about an escalation of trade tensions. So, this decline in risky asset prices have translated into tighter financial conditions, therefore a more elevated financial stability risk in the short term.

MR. EDWARDS: So, every country has its own approach to monetary policy, and to trade. To what extent are low-income countries and emerging market economies affected by policies in advanced economies like Europe or America?

MR. NATALUCCI: Just let me say something about monetary policy first. Since the financial crisis, monetary policies have been very accommodative. This has been true across a number of countries, and that accommodation has been crucial to sustain the global economic recovery, essentially to help the global economy recover from the financial crisis …

MR. EDWARDS: When you say accommodative, what do you mean by that?

MR. NATALUCCI: Accommodative means that the central banks have cut interest rates—the policy rate—to zero, and in some cases, they've gone below zero. They have also used

tools—so called unconventional tools—by expanding their balance sheets, and going out and buying assets.

So, this easing of financial conditions has been necessary to help the global economy recover. Now, with the pace of the economic growth picking up, with the recovery becoming more synchronized, monetary policy authorities in a number of advanced countries have either started or are gearing up to normalize monetary policy, which means raising interest rates, the policy rates, as well as start thinking about shrinking the balance sheet.

So far, financial markets have adjusted in a relatively smooth way to the gradual pace of monetary normalization, and also benefitted from very clear communication on the part of central banks.

Now, that said, central bankers face a balancing act here, which is maintaining the appropriate stance of easing monetary policy to continue to support the global recovery, as well as trying to address this build-up of financial vulnerabilities that I described before, so that they can slow down the build-up of financial instability that could put growth at risk over the medium term.

What are these challenges they are facing? An example could be an inflation surprise. So, you could either have a pickup of inflation at least higher than expected, or an investor could decide to reprise inflation risks.

If that happens, the pace of tightening in the US, for example, could be faster than markets expect. That would imply the tightening of financial conditions, and that would increase the financial stability risk, and put growth at risk over the medium-term, as I said before.

MR. EDWARDS: So, what does that mean for these low-income countries and emerging markets?

MR. NATALUCCI: So, I was going to get there (laughs). Now, if you think about it in terms of seeing through the lens of emerging markets—generally speaking, emerging markets as an asset class have benefitted from easy financial conditions and favorable investor sentiment over the years. This has translated into a lot of inflows into emerging markets, and even weaker emerging market economies have been able to issue debt at very favorable or cheap conditions.

Now, if there is a tightening in financial conditions, for example, as a result of the inflation shock I mentioned, this could be accompanied by an increase in risk aversion on the part of investors, portfolio flows could reverse, and it could come back from emerging markets, and could expose some of the weaknesses that have been, in some sense, colored by the easy financial conditions over the years.

MR. EDWARDS: So, this report is, in fact, all about looking at risks and vulnerabilities. What are the key financial vulnerabilities that you're worried about?

MR. NATALUCCI: All right, so that is one. Let me add a couple of things more in terms of emerging markets. One could be that there's a larger role played by fickle or flighty investors in emerging markets, or non-dedicated emerging market investors who could be there because of the conditions now, but who essentially decide to exit the asset class.

MR. EDWARDS: Short-term investors?

MR. NATALUCCI: Short-term investors are known as not necessarily emerging-markets-dedicated. And so, they see opportunistically that there are higher-yielding assets in emerging markets, but when rates are moving higher, they might decide to invest somewhere else. And, as I mentioned, even weaker emerging markets have been able to access capital markets, and so of course when conditions tighten these weaknesses would be exposed.

Another one is the sharp deterioration in debt sustainability in a number of countries, so that debt has been rising very fast, as well as the terms of lending have become more complex. So, the investor base in emerging markets has broadened to include more private investors, and in the event of restructuring, that restructuring could be more complicated. This is a broader picture of emerging markets.

We also looked at other vulnerabilities. Another one we looked at is valuation of risky asset prices to get a sense of whether this valuation is a stretch or not, and our assessment is that in fact valuations are stretched in many markets.

On credits, we see some late-stage credit cycle dynamics, so we see corporate bond spreads being narrow, we see issue of risky bonds at an increase, and we looked at a case study on the leverage-lending market in the US, which traditionally is a barometer of risk taking. Issuances there, for example, hit a record high in 2017 which, in some of the dynamics, is reminiscent of the pre-crisis period.

Let me step back for a second. Post-financial crisis, a number of steps have been taken in the regulatory world to improve the health of the banking sector. So, capital is higher, liquidity is improved, there's better infrastructure to deal with resolutions, and a number of other steps taken that make the core of the financial system—the banks—safer.

Now, there are still some vulnerabilities in the banking sector. The one specifically we looked at is non-US banks, as they are a main player in dollar assets, and so they provide credit, they provide trade credit, loans, and so on. And then they need to fund on the liability side of the balance sheet these dollars.

We found out that there's a structural dollar liquidity mismatch among non-US banks. What I mean by structural dollar liquidity mismatch, is that they rely on short-term wholesale sources for about 70 percent of their funding. That implies that if there is a tightening in financial conditions straining the markets, they could be exposed to the need to fund their asset side, and the marginal liquidity usually is the FX market, and that market can be very volatile and expensive, or not available at times.

MR. EDWARDS: There is a section in the report on crypto assets. Are crypto assets seen as a potential benefit or a liability?

MR. NATALUCCI: Right. We tried to strike a balanced assessment of crypto assets. Of course, amid the stretched valuations of many risky assets, we have seen crypto assets erupting into the financial landscape.

In terms of the benefits, we believe that some of the potential technical advances that are behind crypto assets have the potential to make payment systems and financial infrastructure more efficient. So, to us that's a benefit. There's something there on the technology that could improve efficiency, financial inclusion, and so on. So, yes, a number of benefits.

There are of course some risks. Crypto assets have been affected by fraud, security breaches, operational failures, and have been associated with illicit activities. And so, our financial stability assessment—because this is what the report does—also keeps an eye on investor protection issues, money laundering, and so on.

In terms of strictly financial stability, we think that at present crypto assets do not pose a significant financial stability risk, but it's driven by the sheer size of crypto assets. Of course, they could pose greater risks in the future if their use became more widespread and there weren't appropriate safeguards.

So, the policy recommendations that we have in mind here is that future policymakers should be nimble, should be normative, should be cooperative, and there is a role that the Fund can play here in advancing the agenda of regulation of crypto assets, by providing advice as well as serving as a forum for international cooperation and dialogue on crypto assets.

MR. EDWARDS: So, is this the first time that the GFSR looks at crypto assets?

MR. NATALUCCI: To my knowledge, yes.

MR. EDWARDS: What kind of guidance does the report offer to policymakers—what should policymakers be focused on now to ensure stability and growth in the longer term?

MR. NATALUCCI: We have a number of recommendations along different dimensions. In terms of monetary policy, our recommendation is that central banks should continue to normalize monetary policy in a gradual way, as they've done so far, and they should communicate their decisions clearly.

MR. EDWARDS: In other words, if they're going to raise interest rates, they need to do it slowly?

MR. NATALUCCI: They need to do it gradually. Of course, this assessment is based on the evolution of the underlying economy. And so, this gradualism is based on an assessment of

what the recovery is—it should be data-dependent. So, based on what the performance of the underlying economy is, then you should start thinking about removing or withdrawing monetary policy accommodation. But, I also want to highlight that the importance here is clear communication.

We also recommend that investors should remain attune to the risks associated with rising interest rates. It has been 10 years, or many years since rates have been very low; volatility has been very low, so investors should be attuned to this risk and avoid complacency.

Also, we suggest that investors should stay attuned to the risk of possible escalating trade protectionism. This has been a big issue in recent weeks, and we have seen risky asset prices declining on this concern, so it's important that investors remain attune to this risk.

Our recommendation on emerging markets, as you asked before—we think that emerging markets and low-income countries should build buffers against external risks so that they can be prepared in the event of a shock.

And then finally, policymakers should ensure that the post-crisis regulatory reform is completed and implemented, and they should resist calling for a roll back of reforms.

MR. EDWARDS: Looking into the future, six months from now, when you publish your next GFSR report, are you confident that there will be fewer risks out there?

MR. NATALUCCI: The recovery has been gradual, but it's picking up pace, it has become more synchronized, so at least in the short term we see the risk being balanced on the downside and the upside. I work in the financial stability world, so we tend to be more preoccupied with risk and the downside, if you want.

So, it's very important that we continue to use these two approaches in some sense, that is, do we want to use this structured systematic approach to think about how shocks affect financial conditions and financial vulnerabilities, or do we want to continue to be in touch with markets to understand what's new, what's emerging, and where financial innovation is, to stay as close as possible to the frontier of financial markets.

MR. EDWARDS: Thank you very much.

MR. NATALUCCI: Thank you.

MR. EDWARDS: Fabio Natalucci is Deputy Director of the IMF's Monetary and Capital Markets Department, and oversees the writing of the overview chapter in the *Global Financial Stability Report*. You can read the full GFSR report at imf.org. And if you like this podcast, you can subscribe on iTunes or on your favorite podcast app; just search for "IMF podcasts." And you can now follow us on Twitter: @IMF_podcast.

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