

Comments on:

"Rates Normalization Amid Elevated Global Financial Vulnerability" by Fabio Natalucci

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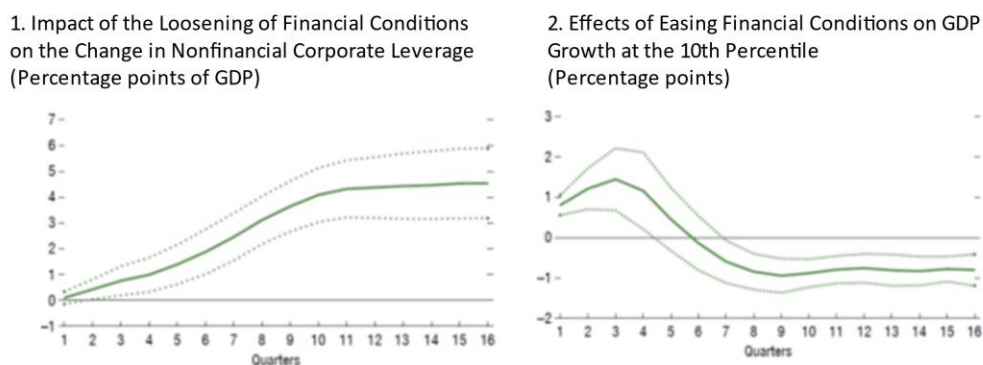
The paper by Fabio Natalucci makes several contributions. It outlines the global experience of previous monetary policy tightening episodes in the past 20 years and points to where likely financial vulnerabilities might be in the world economy today due to an extended period of low interest rates. This topic is important as central banks begin a period of monetary policy tightening. The breadth of the study is wide-ranging across countries and key sectors. The paper then uses a large body of research from the IMF's "Growth and Risk Framework" to explore the drivers of sector-specific vulnerabilities and highlight monetary policy normalisation risks.

The paper draws on a substantial body of research at the International Monetary Fund but does not provide a transparent analytical model that integrates the various sections of the paper. The paper also does not offer any new empirical evidence to test the propositions of the paper. It draws on previous and current research in the IMF on financial vulnerabilities and risks.

While focussing on vulnerabilities from years of ultraloose monetary policy, the paper does not consider current financial vulnerabilities caused by a range of other policies such as the significant global climate and energy transition underway or events in Europe with the war in Ukraine. These vulnerabilities are nonetheless crucial for monetary authorities.

Section 2 outlines "the Growth and Risk Framework" used at the IMF. Some results in this section are surprising and suggest the model used for this project's empirical work may be misspecified. Surprisingly (at least for the 10th percentile of the non-financial corporate sector), a permanent loosening of financial conditions leads to a permanent reduction in **GDP growth** (after 18 months) of between 0.5 and 1.5% forever without any tightening of financial conditions causing this. What is the mechanism? There may be an identification problem in the original model, but it is taken from an earlier IMF report. There is no information in the current paper to understand the mechanism at work. It is likely that a period of financial loosening is frequently followed by a period of monetary tightening, which causes the permanent effect in the empirical model - but this may not be identified in the model. This result implies that it would be a sensible policy to continue implementing repeated financial tightening because that would lead to a permanent expansion of GDP growth at least at the 10th percentile. This policy implication of the model is counterintuitive.

Figure 2a. Association between Easing Financial Conditions, Nonfinancial Sector Leverage, and Downside Risks to Growth



Section 3 of the paper on the evolution of financial vulnerabilities since 2000, primarily since the GFC, produces an interesting heat map of vulnerabilities in Figure 3. This data is presumably for the average vulnerability of the sector (sovereigns, non-financial corporations, households, banks, insurers, asset managers and Other financials). I wonder how important the distribution of vulnerabilities within a sector might be for capturing the actual exposures that may not be reflected in the average across the sector. One could imagine two sectors with the same average measure of vulnerability, but one with a large fat tail of highly vulnerable members offset by some members with low exposure and the other sector with the vulnerability the same across all members in the sector. Would the two sectors be considered equally vulnerable to a shock?

The discussion of figure 5 on the evolution of non-financial sector leverage needs to include some analysis of the asset sides on the balance sheets. There is a short comment about asset-liability mismatch for insurers, but the vulnerabilities from the liabilities in a balance sheet should be assessed simultaneously with the asset side of the balance sheet.

Section 4 of the paper discusses the increasing exposure of banks to sovereign debt. However, as in section 3, the total debt to GDP ratio needs to be considered relative to the assets that the debt may have financed. This discussion is missing from the section. Does it matter what the liabilities in the balance sheet have been doing over the same period? Does it matter if the private banking system holds the government debt versus the central bank? It is not the scale of debt alone that matters – indeed, it is the nature of the balance sheet that matters for assessing vulnerability.

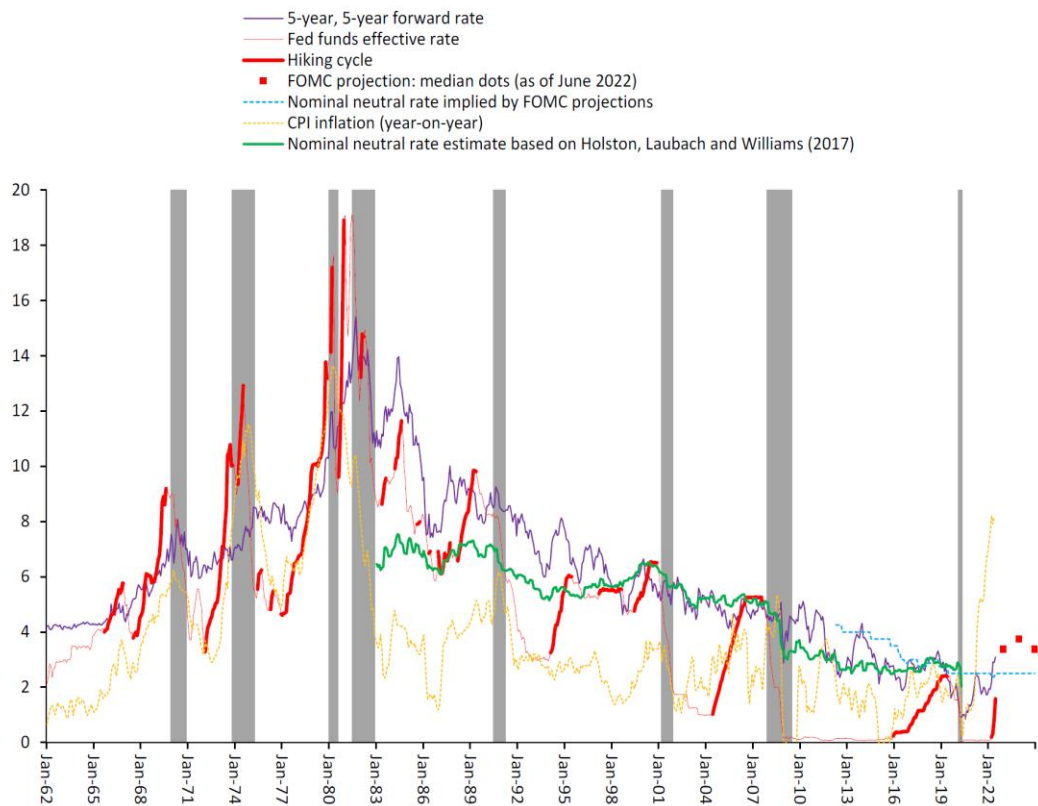
Section 5 outlines vulnerabilities in the housing sector. It would be helpful to assess whether fundamentals are driving housing valuations in different countries. I doubt that all countries have the same experience and that changes in house valuation can be considered in isolation from the fundamental versus speculative drivers of house prices. There is some discussion of house prices relative to income, but an alternative indicator might be house prices relative to wealth. This measure includes housing asset values as well as debt. Indeed high house prices are only a vulnerability if the asset's return does not reflect fundamentals.

Section 9 on Asset valuation uses data from September 2019, which is outdated given the changes in the global economy over the past few years. It would be helpful to have more current data to assess present risks to asset valuations.

Section 10 summarises conclusions for monetary policies across countries. There is an obvious identification problem in figure 25 in trying to relate the causation of recessions through changes in monetary policy. There is a danger when historical episodes are compared without an analytical model that can control for different factors that might be relevant at various times. An analytical basis where shocks are correctly identified may imply that a policy response might be different this time. It is always a risk that policymakers are fighting the last war.

Figure 25. US Monetary Policy Tightening Cycles

1962 onwards
(Percent)



Section 11 on the recommendations for MacroPrudential policy needs more clarity. The main statement of policy relevance is:

"It is crucial to strike a balance between addressing the buildup of vulnerabilities, depending on country specific circumstances, and avoiding unwarranted procyclicality given the acceleration in the pace of monetary policy normalisation in advanced economies"

What is the balance? It is unclear whether the author suggests a tightening or loosening of macro-prudential tools?

Conclusion

The paper's introduction focuses on the period of loose global monetary policy from 2020 to the present in response to the Covid pandemic. However, the outcomes in the world economy over the past three years have been caused by a range of policies that were implemented and a lack of other policies that should have been implemented. It is not just monetary policy that should be considered as the main focus of response.

Vulnerabilities across economies today are financial and fiscally related but are also significantly climate and energy-related. There is little discussion of the implications of the vulnerabilities shown by the energy price shocks from the Ukraine war.

Overall the paper is a rich overview of issues around global monetary rebalancing and the vulnerabilities that may be affected by the tightening of monetary policy. However, the reader is left wanting to dig deeper and better understand the analytical work not presented in the paper.

References

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