

Podcast with Pedro Duarte Neves (Banco de Portugal)

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SPEAKERS

Taylor Pearce



You're listening to the OMFIF podcast, the show that explores the latest insights and discussions on global finance, economics, and policy for people who love staying informed about the rapidly evolving landscape of the financial world. Join us as we break down complex topics, interview key thought leaders, and provide essential insights to keep you informed about the evolving world of finance.



Taylor Pearce 00:24

Hello, and welcome to the unfit Podcast. I'm Taylor Pierce, Senior Economist of Office Economic and Monetary Policy Institute. And with me today is Pedro Duarte, nevus, Senior Advisor for the board of directors at the bunker to Portugal and former vice governor. We'll be discussing the outlook for global financial stability in light of the IMS recently published global financial stability Report. Welcome, Petro. It's a pleasure to have you. Yeah. Let



me start by thanking you, Taylor and on Schiff, for having me here. It's really a privilege to be exchanging views with you on the current outlook for financial stability. Let me say that as usual, I mean, the disclaimer applies the views and opinions expressed are mine, and do not necessarily reflect those of bank Portugal or the euro system.



Taylor Pearce 01:12

Great. Thanks. Great to have you. Just to start off with scene setting question. The base case for the IMF is a soft landing scenario. Is this also your view? Oh,



yes. Yeah, the short answer is yes, a soft landing is by far the most likely economic scenario looking forwards. And just to understand better, what is going on, let us come back to where we were, say two years ago, when the cycle of interest rate increases began so much 22 in the US. And at that time, it prevailed an almost unique combination of economic variables, inflation at 14 year ice, and the big Laker, as we know, in unemployment at or very close to all time lows, 4050 year lows, and no financial depth at all time highs. And then the time there was a prevailing concern on stagflation that meaning I inflation and I an employment. So since that monetary policy tightening in a synchronised way around the globe, by the way, no way never experienced before. And the impact of monetary policy, as we know, tends to pick two years later. So whereas today, inflation was reduced as fast as it went up. And it's now very close to price stability definitions, this inflation as a matter of fact, is proceeding faster, I mean, much faster than inflation. And what is remarkable is that the unemployment rates are extremely close to the March 22 figures 1/4 of a percentage point above in the case of US and UK and 1/4 of a percentage point below in the case of euro area, where by the way, they unemployment rate is at record lows. So labour markets remain historical tight in most advanced economies. And the euro area market labour market in particular is behaving extremely well in terms of unemployment, but in many other dimensions as well like support increasing activity rate reduction of underemployment workers, declining long term employment and cross country mobility of workers. What we have been witnessing is what the financial time is just referred as an a macro late disinflation process, and much fear of recession was avoided. And there are no, I mean, current stagflation worries, that explains why in demonstrating to equation soft blending is the prevailing scenario, which has been translating in optimistic moods in financial markets. Moreover, one of the main features of the recent evolution is the resilience. Well, in some sense, the surprising resilience of the global financial system. Of course, there are some downside risks, but I assume that we'll come to that later in the talk.



Taylor Pearce 04:22

Yes, definitely. Well, thank you for laying out that base case. But even though it's off learning is the most likely scenario. The global financial stability report highlights three key risk factors in this version that could upset that base case. Those are stretched valuations in various asset classes, public and private debt levels and growing vulnerability to cyber attacks. I'd like to go through all of these one by one to get your views. So starting with asset valuations, do you think that risk premiums are inherently undervalued compared to historical standards, and which asset classes are at the highest risk of a sudden repricing?



Well, Taylor my markets seem to be convinced that most of the tightening effects and costs associated with monetary policy are already behind us. And market expectations of a soft landing have been driving stock markets and the compression of risk premiums while indicating a stronger risk appetite, just to mention some figures. In most advanced economies, stock markets have resisted gains of some 30 35% Since January 23, and most of them concentrate over the last six months. corporate bond spreads declined by around 1/30 Since the October 23, global financial stability report and that applying for the major advanced economies and for

both investment grade corporates and ideal bolts in terms of a sudden repricing, I will see probably more risks on corporate boring. But IMF global financial stability report provides a very insightful message. The average correlation across say on one side advanced economies and emerging market economies for equities, bonds, credit and commodity prices, so the average correlation is very high by historical standards exceeding the 90th percentile. Therefore, a sudden shift in investor sentiment, call spread through asset classes, increasing risk premiums in a synchronised way across most market segments. So that is my answer to your question.

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Taylor Pearce 06:48

Yep. Thanks for pointing out those points for from the GSR. I'd like to come back to debt sustainability. And as for your views on where you see the large risks to both sovereign and private credit, let's start with sovereign credit. What's your view there? Where are the risks? Well,

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on public that I will say that recent developments are, in general, somewhat worrisome. For instance, the recent recently released fiscal monitor of the IMF, which is, as we know, a sister report of the World Economic Outlook and the global financial stability report. So the fiscal monitor states that fiscal deficits and debts are on one side they are bigger than before the pandemic outbreak, and they are projected to remain like. Fiscal prospects differ across regions. And there are more concerns in the US and China. We have currently a situation of concern in the US where the fiscal trajectory, unfortunately does not seem to be sustainable. As a percentage of GDP public debt is twice as large as it was in 2007. Around 122% of GDP, the general government deficit last year, which almost 9% and is projected by the IMF to say around 7% in this year and next year. And by the way, it's important to remember that the primary balance has been in deficit over the last 20 years. The fiscal monitor also highlights a substantial increase in public debt in China, which is projected which sheave, almost 90% at the end of this year, and this is some 30 percentage points of GDP above pre pandemic levels. And fortunately, prospects for evolution of the fiscal position are not very encouraging. I would like to draw your attention to a recent paper by Barry Eichengreen and the IMF colleague that claimed that those eight levels of public debt are here to stay. I mean, at least for three reasons. First of all, persistent primary budget deficits are not in the cards, as we have sizable primary deficit in many geographies. Second, public debt did not decline in a favourable interest rate growth rate context as one that was prevailing before monetary policy tightening. So it's much more difficult to reduce it now. And finally, the effects of anticipating inflation with somewhat heavy will with public debt, as a percentage of GDP have already materialised and are not repeatable. So from the point of view of sovereign debt, I think that we have very relevant vulnerabilities. Thanks.

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Taylor Pearce 09:48

So it sounds like globally there are a number of factors contributing to fiscal deficits and debts being worrisome as you put it. So what about private credit? Where are the risks there and some of the factors is that you see as important in that space?



Well on private debt, I will see more risks on possibly on corporate credit and on credit to households. Well, let us start by households, households, indebtedness is not excessive by historical standards. The most recent BIS figures show their total credit to households that seven 3% of GDP in the US and 54% of GDP in the euro area, I mean, below bread, global financial crisis figures, the recent World Economic Outlook or famous of time, we have a full chapter dedicated to the effects of monetary policy on housing markets. And there are two important results there. First of all, is that monetary policy effects on economic activity through the housing channel, they have weakened, and this may reflect at least in part, the effects of macro prudential policy. And this is one of the possible explanations for the soft landing. In spite of that the effects of monetary policy are strong in some countries, typically, in countries with small share of fixed rate mortgage, either degree of household indebtedness over relation of housing prices, and restricting restricted housing supply. So there is some eternity in this channel. But I'd say that prospects are more worrisome again, for the corporate credits. current levels of total credit to no Financial Corporation are very close to pre pandemic, which were historically all time aches, and they are above pray global financial crisis levels by some five percentage points of GDP in both the US and the euro area. Erosion of their ratios through inflation, somewhat improve the overall prospects. However, the current levels of interest rates bring a new risks in relation to the previous allow for longer environments. Moreover, in depth is very important and in opposition to what happens for households. There are not effectively used macro prudential tools here. I mean, neither for banking, but even more so for non banking. There is a recent recently released the OECD the global depth report last month that I've liked some of the main vulnerabilities like I have access to the market by lower rates, corporates, expansion of the non investment grade segment of the market. And more prospectively, the OECD comes out with a key figure that says that one thirds of corporate debt in advanced economies will have to be refinanced over the next three years. And obviously, that either or much higher interest rates than they were issued in the past. And this figure actually is even I get for emerging economies so 50% rather than 1/3. The global financial stability report as a specific Sharpe, they're dedicated to corporate private credit. So the one that is outside the activity of banks and public markets. And I mean, I liked some of the vulnerabilities in this segment of the financial sector. In conclusion, credited duration among corporates, particularly in some segments, real estate, is one of them could be aggravate could be intensified by adverse shocks. So here we have some relevant tools and abilities.



Taylor Pearce 13:53

Thanks for that comprehensive explanation of the risks on both the public and private side of debt. One of the other factors that the G F SR highlights as a risk factor that could upset financial stability is cyber attacks. So which institutions do you think are particularly vulnerable? And what are the risks there?



Yeah, thanks. They alert the global financial stability report and bring some very relevant information on cyber risks. First, the number of cyber attacks as level relative to pre pandemic average. So that's the first result. Second, cyber attacks have been addressed mostly I mean, almost exclusively to services rather than manufacturing. And 1/5 of total cyber incidents ever

affected, financial services and their banks first and then insurers and asset management. A very relevant aspect is the following cyber incidents which are a key are operational risks are basically not ensures that the cyber risk protection gap is about 90% which is a huge figure, consequence from a cyber attack are severe potentially severe. at individual level, we will there be loss of confidence resulting from privacy breaches and authorised operations, the eruption of assets, failures of outsourcing by third party service providers and will also affect the very relevant proportion of the industry. If the failure of a financial market Infrastruktur are of a key cloud service provider propagates across the financial system. Supervisors are doing their job and they are following a three pillar approach to mitigate the risk associated with cyber breaches, which basically are having board members accountable for managing this risk, the reporting of cyber incidents and testing response and recovery procedures. And by the way, let me just recall that TCB announced the that cyber stress test will take place this year to assess the capacities of response and recovery of more than 100 banks, which are likely supervised by the ECB. Cyber stress testing as a distinct interventions advantage in synthetic provides relevant insights to address the cyber protection gap. For instance, cyber stress testing could contribute to assessing where insurance protection levels fall below I mean, which basically shouldn't be the case socially optimal levels or not, it will also provide some guidance on our risk sharing could be achieved. And let me just conclude by saying that reducing the cyber risk protection gap is essential to increase the resilience of the economy.

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Taylor Pearce 17:02

Thanks for that interesting to hear how the supervision and regulation of the financial sector is evolving in a digital world. We've spoken about stretched valuations in various asset classes, public and private debt levels and growing vulnerabilities to cyber attacks as some of the key risk factors outlined in the IMF report. Are there any other risks that you see that could upset the soft landing scenario, and that could have negative implications for financial stability? Either in Europe or globally?

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Yeah, unfortunately, there are more risks, I will mention, say two. So first of all, there is the risk that renewed commodity price spikes may induce some persistence of core inflation, preventing a faster easing of monetary policy. And that could be particularly the case in the US. And that could of course contribute to, as I mentioned, I have persistence of inflation on the one side, and weaker economic prospects than the IMF projections. On the other side, with possibly negative effects on the credit cycle. A second, I like to draw your attention to the modest growth of the Chinese economy, and also some possible financial tensions there. The World Economic Outlook presented, I mean, this issue, but the previous October one as well. Downside scenarios for China, featuring lower real growth and deflationary pressures. And total non financial left in China is higher now than for most advanced economies. Well, Japan is an exception, non financial corporate debt in China is very, I mean, it was just a very substantial increase over the last 10 years or so. And as I mentioned before public that reached 90% of GDP later this year. So China is a country that we really have to follow very, very closely, indeed.

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Taylor Pearce 19:13

Well, it sounds like there are a number of factors to watch out for and increasingly uncertain, global environment. Just to come to the last question. Now, you mentioned cyber stress testing and some other measures. But I'm wondering what else you think that policymakers regulators or supervisors can do in the near term or across a longer time horizon to ensure the financial system is resilient to increasingly frequent exogenous shocks?



Yeah, I mean, that's, that's not that easy. Let me just start by mentioning that the current macroeconomic situation as some relatives call them contradictory features. So on one side, the real economy is growing very much. This league. And even worse looking forward, global growth is projected to be one percentage point below the average of the two decades, I mean the two previous decades. But on the other side, and in spite of slowdown in growth, the global economy is showing to be remarkably resilient. And I mentioned on that unemployment and the financial sector. At this stage, what is really important is to build the resilience. So accumulated buffers to create space for any expected downturn that could occur in the future to face any unexpected shock that could occur. And to build these resilience means accumulating buffers, both at the micro level and at the macro. So at the micro level, and I mean, that's just before addressing explicitly the policy point, but I will expect firms to achieve efficiency gains cost reductions, and manage reductions of that consumers to increase precautionary savings and also to reduce that banks to increase management buffers, the non banking sector to a special care on liquidity and leverage. And of course, micro Prudential level, I'm sure that supervisors will monitor very closely expositions to the real estate and other sectors that may be affected by the current stage of the cycle. at the macro level, and starting by fiscal policy, it's really crucial to ensure public debt sustainability. Moreover, there is the risk in the present situation of overestimating fiscal space in the short run, as inflation raises government revenues, as we know in short one, and contributes to erode public debt over GDP. But there is also the risk of some length or some negative effects on the follow up of high inflation period, through increase in interest rate payments, like the impact of inflation in public expenditure and possible slowdown of economic if that is the case. At the macro prudential level, I yield expect authorities on one side to build a stronger counter cyclical buffers to increase the macro prudential space, then to reinforce the role of macro prudential stress testing, integrating both the banking sector and the non banking sector which includes insurance, reinsurance patient funds, investment funds, having in mind increasing interconnectors within the financial sector. And finally, there is the need to develop and that is really very important to develop the macro prudential framework for non banks because there are many vulnerabilities in the non banking sector. And the Financial Stability Board has just came out with a public consultation on liquidity preparedness for non bank market participants. Finally, I mean after fiscal policy and macro prudential policy, on economic policy in general, the will the economic outlook actually discuss some possible ways to increase I mean, what we call the total factor productivity through the more efficient allocation of capital and labour across firms and sectors, discovering reforms to Promote Market competition to increase where needed labour market flexibility, integration of migrants harness the benefits of the technological progress, financial stability and so, so it's really very important to further assess these aspects, this policy possibilities, as prospects for real growth as it is in the World Economic Outlook are modest and declining over the foreseeable future. And that's it, they will thank you.



Taylor Pearce 24:20

Great. Thank you, Pedro. I know that you said about those weren't easy questions, but it's been great to have your very detailed and comprehensive views on global financial stability. It sounds like, Well, you mentioned a lot of points. But I think for me, the key takeaway was that on the public and private side at the micro and macro level, some of the key measures that need to be taken are building resilience by accumulating buffers and managing debt to ensure sustainable debt levels. I think that would conclude our podcast unless you have any final final thoughts or final comments.



No, no, no, thank you very much. To be exchanging views review. Thanks for this talk.



Taylor Pearce 25:03

Well, thank you so much, Pedro. It's been a pleasure. And thank you as well to our listeners, be sure to subscribe to our podcasts wherever podcasts are available. Thank you.



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