CHAPTER 3

# FINANCIAL CONDITIONS AND GROWTH AT RISK

## Summary

Changes in the state of the financial system can provide powerful signals about risks to future economic activity. As in the run-up to the global financial crisis, financial vulnerabilities, understood as the extent to which the adverse impact of shocks on economic activity may be amplified by financial frictions, often increase in buoyant economic conditions when funding is widely available and risks appear subdued. Once these vulnerabilities are sufficiently elevated, they entail significant downside risks for the economy. Thus, tracking the evolution of financial conditions can provide valuable information for policymakers regarding risks to future growth and, hence, a basis for targeted preemptive action.

This chapter develops a new, macroeconomic measure of financial stability by linking financial conditions to the probability distribution of future GDP growth and applying it to a set of major advanced and emerging market economies.

The analytical approach developed in the chapter can be a significant addition to policymakers' toolkit for macro-financial surveillance. The chapter shows that changes in financial conditions shift the distribution of future GDP growth. While a widening of risk spreads, rising asset price volatility, and waning global risk appetite are significant predictors of large macroeconomic downturns in the near term, higher leverage and credit growth provide a more significant signal of increased downside risks to GDP growth over the medium term.

Thus, at the present juncture, low funding costs and financial market volatility support a sanguine view of risks to the global economy in the near term. But the increasing leverage signals potential risks down the road. A scenario of rapid decompression in spreads and an increase in financial market volatility could significantly worsen the risk outlook for global growth. These findings underscore the importance of policymakers maintaining heightened vigilance regarding risks to growth during periods of benign financial conditions that may provide a fertile breeding ground for the accumulation of financial vulnerabilities.

A retrospective, real-time analysis of the global financial crisis shows that forecasting models augmented with financial conditions would have assigned a considerably higher likelihood to the economic contraction that followed than those based on recent growth performance alone.

Improvements in predictive ability of severe economic contractions, even over short horizons, can be important for timely monetary and crisis-management policies. The ability to harness longer-horizon information from asset prices and credit aggregates can also help in the design of policy rules to address financial vulnerabilities as they develop. The richness of the results obtained across countries suggests that there is significant scope for policymakers to further adapt the approach used in this chapter to specific country conditions including, importantly, to reflect structural changes in financial markets and the real economy.