Revisiting roots of fragility in emerging economies*

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Extraordinarily accomodative monetary policies, which were implemented by major central banks in order to avert a financial meltdown have, arguably, ushered in a new financial cycle, which is illustrated by bigger debts and overvalued assets across the world. But structural conditions, too, lie behind very low interest rates[1]. Basically, these conditions refer to the balance between investment and saving . What this new financial cycle will lead to should be a source of concern against the background of trends such as :

- An erosion of multilateralism as the guiding principle of the international policy arrangements;
- An "inward-looking syndrome" that is spreading around; this hooks up with proliferating protectionism and the distinction between *free vs. fair trade*; this syndrome is linked with national security concerns (military, terorism, immigration pressures, etc).
- In spite of global supply chains and strong interdependencies in the world economy, there is a shift toward emphasizing regional arrangements as well (nota bene: EU's call for strengthening its "economic sovereignty")
- Though banks are better capitalized and less leveraged, it a tough call to say that the global financial system is safer nowadays. Shadow banking has been growing, questionable financial products are in demand anew, risky investments have been surging again and, not least, a new wave of finance deregulation is underway in the US;
- New tremors in emerging economies, which gives salience to a big rise in debts –according to Mc Kinsey Global Institute, global nonfinancial corporate debt (including bonds and loans) has more than doubled over the past decade to reach USD 66 trillion in mid-2017, while 2/3 of the rise in corporate debt is assigned to developing countries;
- Cyber-attacks can take a heavy toll on financial stability
- Brexit is not clear in terms of its *denoument* and can be pretty disruptive

The analysis below reexamines briefly a few issues and concepts; the silverline is financial stability.

1. Re-examining a few concepts

What is an overheating economy, and is inflation a thing of the past?

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[1] Mario Draghi, speech at the ADB annual meeting in Frankfurt, the ECB website (2016).

Low inflation has been a feature of the past decade in much of the global economy. Explanations abound, whether these refer to globalization, technological change, the diminishing bargaining power of labor. But low inflation can be misleading when judging economic overheating, for large, rising external imbalances cand bring an economy into big trouble. And dealing with a balance of payments crisis would entail higher inflation were massive exchange rate depreciation used for macroeconomic correction.

How should we define a menacing current account deficit? We see that the Indian rupiah and the Indonesian currency are both under pressure at current account deficits of around 3% of GDP (sure, one has to factor in the structure of funding).

By the way, hyperinflation can still be met (as in Venezuela cuurently, or Zimbabwe not a long time ago) and inflation is in the double digit in some economies. In several European emerging economies inflation is above target on account of both supply and demand factors.

Trust (lack of (trust)

Trust is as important as ever, but it is more important for fragile economies. What can determine a loss of trust even when the macro picture looks benign?

- Hidden vulnerabilities that come brutally into the open;
- The state of the banking sector, where much rot (NPLs) can be hidden; banks still use tricks to make their balance-sheets look better ("balancesheet capital ratios have risen to 12% from 8% before the crisis, but investors do not believe them; "Apply market values to banks' unweighted total assets –the so called leverage ratio –and you get a different picture: this stands at a lower level than in 2006…Jonathan Ford, FT 17 Sept..FT, "Fragility lurks behinf a confidant façade)
- The erosion of a central bank credibility; when its independence is questioned this harms its credibility (central banks are under siege in not a few countries, around the world)
- Political tensions that may impair the soundeness of economic policy
- The lack of sufficient buffers
- The small size of the economy and its lack of diversity and of export strength; one should recall the Asian experience with South Korea providing a a telling example of its capacity to bounce back rapidly
- Perceptions do matter in financial markets, and if they turn against a country bads can be expected; and contagion can be at work…

Integration vs fragmentation of markets

The developments of the past decade further questions the wisdom of promoting deep and sophisticated financial markets in emerging economies. Ironically, in the euro area , where the logic of the single market operates, there has been a fragmentation of markets after 2009 and a retrenchment of major banks' operations. It is like common sense dictated the behavior of financial institutions. An inference comes up: to believe that only regulatory changes can foster a capital markets union and deeper integration of markets seems to be very bold proposition; more credible is the thought that a proper combination betwwen risk-reduction and risk-sharing, and a change of the institutional and policy arrangements are needed to this end.

On a wider scale, one gets to the issue of putting finance (global finance) in the service of economies, which implies mitigating its destabilizing features; this would ask for continuing refoms of global finance.

The *policy space* issue

For economies to adjust less painfully to shocks they need to rely on flexible markets and be able to resort to an array of correction tools. In Europe, for instance. in the single currency area, where own monetary policy and exchange rate policy are gone, the tasks for policy makers can easily turn overambitious unless local markets are sufficiently flexible and local productivity gains do not match those of neighboring economies. And in many economies, policy makers have to deal with the working of 'global financial cycles", that can overwhelm their policies.

Financial stability

Financial stability has been brought back at the very center of central banks'concerns. Though, one needs to mention that financial stability is a concern not quite of recent vintage in emerging economies. There, high dollarization/euroization has always ingrained policies with a concern for balance-sheet and wealth effects and their relation with financial stability.

There is a clash of visions with regard to optimal policies when considering financial stability.. A Basel (BIS) view stresses factors and policies which have made economies drift from sustainable trajectories (have amplified boom and bust dynamics); not delaying rises in the policy rates would be a means to combat future boom and bust dynamics. Another view highlights the threat of being stuck in a very bad equilibrium with intense *hysteresis* phenomena, that may invite social and political troubles .

Macroeconomic fundamentals (external imbalances, gross external debt and short term debt, budget deficits, etc) matter much, but they do not provide insulation against a tidal wave of great scale unless macroprudential policies are of help. This is, not least, because of: a/ the size of liquidity that is circulating through global markets; b/ much borrowing has taken place primarily via bond markets (capital markets)n ; c/ the emergence of index-tracking Exchange Traded Funds (ETFs) which leaves them vulnerable to across the board withdrawals.

Sound macroeconomic fundamentals can make the difference between a recession and a balance of payments crisis (a "sudden stop").

Private indebtedness matters as much as public debt, and external indebtedness, gross external financing requirements (GEFR) lie behind fragility to external shocks. This was a key lesson of the Asian crisis of 1997-98.

2. A persistence of low equilibrium rates?

If one accepts that QEs have favored a new financial cycle after 2009, with much of the injected base money fueling debt expansion in emerging economies, then, what are the prospects for interest rates in the global economy.

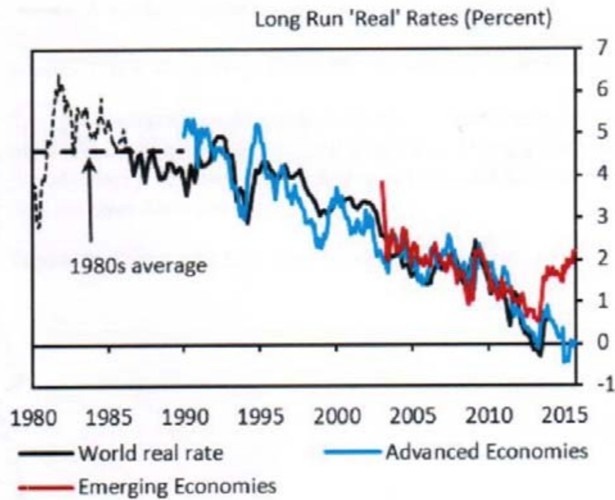
"Policy normalization" will take place at different paces. The Fed will continue to raise the policy rates, but it is hard to believe the precrisis level will be reached –a new normal is in front of us. The ECB will be quite slow with its moves when it comes to policy rates. Japan is a very special case and will continue to be.

But low policy rates will persist, although the policy-reversal in the US has a significant impact on the economies that have large USD exposure. For low policy rates are linked with demographic and productivity trends, globalization, the

financial crisis, overburdening debts, income distribution, new technologies, growing uncertainties, all these have impacted strongly on investment and saving. The equilibrium interest rate, at which there is full resource utilization, has arguably fallen significantly in industrial economies. This is also seen in the trends of long-term real interest rates and yields on 10-year bonds (BIS data, King and Low, 2014; Rachel and Smith, 2015; figure 1 and figure 2)..

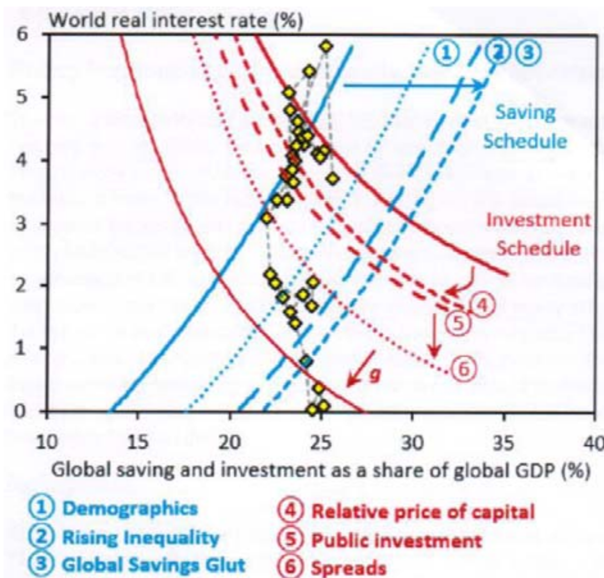
Massive capital movements complicate the picture. This is what Mario Draghi pointed out at an ADB's annual meeting in Frankfurt by referring to the balance between investment demand and the supply of saving in the global economy.

Figure 1: the fall of real rates in the world (1980-2015)



Source:Rachel and Smith, who quote King and Low (2014), Consensus Economics, IMF, Datastream

Figure. 2: shifts in saving and investment schedules in the world ecnomy (1989-2015)



Source: Rachel si Smith, 2015

3. Emerging economies and capital flows as a source of fragility

Countries with large budget and external deficits, high external debt, are more vulnerable and prone to balance of payment crises; here one meets domestic vulnerabilities.It should be stressed however, that the Asian crisis and other episodes of crises have taught painful lessons and not a few emerging economies are better prepared currently to withstand shocks: average public debt, in general, is significantly smaller than in advanced economies, budget deficits are under control, foreign exchange reserves are up. But where private external debt has been rising rapidly a major weakness operates.

European emerging economies have undergone remarkable macroeconomic adjustments in recent years. They have an apparent advantage in the EU since, on average, their overall public and private debt is almost half as a share of GDP compared to developed EU countries. Likewise, their USD exposure is relatively low, which protects them somehow from the impact of Fed policy changes. But they are facing significant dilemmas:

- is it reasonable to foster a reduction of currency substitution by all means when euro adoption is mandatory at one point in time? One may be tempted to say yes due to the rise in the room for maneuver of monetary policy;

- If the Impossible Trinity (autonomous monetary policy, stable exchange rate, and free capital movements) is actually a dilemma (Helene Rey), capital controls may be useful – be they under the guise of macro-prudential measures.. These measures require, however, a good coordination among central banks and regulators in general[2] ;

High liquidity and, yet, *sudden stop* threats

In spite of the claim that it is safer now, the global financial system is rife with vulnerabilities, not least because of a high degree of interconnectedness, still high leverage in many of its parts, highly risky financial instruments. In spite of more severe capital and liquidity requirements, of a new regulatory and supervision regime, sudden stops may yet emerge and induce contagion.

The fragility of the financial system is mirrored by developments across shadow banking, by systemic risks which evolve in capital markets. <u>One should not rule out that the lender-of-last-resort function would be called upon for such markets too (just think about CCPs)</u>. The bottom line is that there is need for continuing reforms of finance in view of the risks posed by interconnectedness, the too-big-to-fail syndrome, bad practices of this industry.

4. THE *FINANCIAL CYCLE* AND MACRO-PRUDENTIAL POLICIES

The effectiveness of MPPs hinges on the degree of financial markets integration; when external funding of local companies is widely available this effectiveness is seriously impaired. This is an area for policy creativity!

- MPMs need to consider drivers of financial cycles, whether there are policy drifts that derail these cycles;

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[2] The 2006-2008 experience indicates that the strong rise in real credit growth was also stimulated by loan externalization which was practiced by foreign banks' subsidiaries.

- what drives the global financial cycle is critically important and, in this context, the role played by market-makers' policies; what could appear a justified MPP to a major central bank, may cause tremors in other markets;

- targeted capital controls can helpe in underpinning financial stability in economies that can be ravaged by massive flow reversals.

- regional monetary arrangements (like those tried after the Asian crisis) can help;

- there is need to think about and try to shape inter-connectedness (Haldane and May, 2011);

- in the EU the cooperation between host and home country authorities is critical for the effectiveness of MPP;

- tight regulation and supervision of financial markets and the change of business models in the financial industry could bring about more robust and resilient organizations and economic systems;

- rediscovering the logic of the Bretton Woods arrangements would bolster the resilience of the international financial policy regime;

- joining the euroarea can be seen in the MMP logic; but lack of economic robustness can turn currency risk into re-denomination risk.

Designing proper regulatory and supervision frameworks of finance in the 'market-maker' (big) economies is essential for dealing with negative spillover effects of their policies. How can the ECB coordinate its policies better with the FED and other major central banks, for the sake of mitigating boom and bust dynamics in the global economy, has to be given more clear answers. The Financial Stability Board, , G-20, and, not least, the IMF can play a significant role in this respect.

5. A policy agenda for bolstering financial stability

Policies have prevented a new *Great Depression* in most of the industrial world, but their limits are obvious while prevailing theories are not of much help. Financial risks are ubiquitous in highly intregrated markets and non-standard measures have significant side effects..

Monetary policy

QEs have become "standard" practice in recent years. A few questions arise in this regard:

- Is it temporary business, or is it a harbinger of a longer term shift in monetary policy conduct?
- Will the enourmous injection of base money in the global economy stay "silent" for years to come?
- Will a "liquidity" premium operate and impede surges of money velocity, and, therefore, of inflation?
- Are negative equilibrium rates to be seen as normal? If resource allocation were adequate, natural rates should, presumably, not be below zero.
- Should we target a higher inflation rate (as Olivier Blanchard, John Williams, and others recommend) to reinforce the monetary policy instrument? Should we target a price level, or a nominal GDP?

Monetary policy conduct may have to change considerably if one sets price levels and nominal GDP as targets (John Williams). John Williams, William White, and other scholars argue that there is need to rethink the monetary policy analytical framework, that we need to dismiss a paradigm that focused narrowly on price stability and neglected

complexity, systemic risks, financial stability. White goes so far to invite a closer look at narrow banking (2013), at a reform of finance. This is a line of reasoning one finds in more radical ideas (Mervyn King; Martin Wolf; John Kay; Benes and Kumhof, etc).

It is increasingly clear that price stability cannot be divorced from financial stability concerns and that monetary aggregates have to be monitored closely (Axel Weber); that macroprudential policies need to be used.

Finance reform

Measures have been taken in order to bolster capital and liquidity requirements, reduce leverage, limit pay, enhance transparency and discourage excessive risk-taking, etc. But, arguably, more has to be done (Admati and Helwig). For example, dealing with the "too big to fail" syndrome requires the application of anti-trust legislation; this would imply splitting big financial entities.

Ring-fencing retail from trading activities is, arguably, not sufficient for protecting tax-payers. More own capital and less reliance on debt (as against the Modiglian-Miller theorem which implies that where capital comes from does not matter) , rules that prohibit the use of depositors' money for the own trading of banks would also contribute to making systems more robust. And inter-connectedness should be reduced by reshaping finance (Haldane and May, 2011).

The current wave of de-reregulation in the US is a big step backward and should not be replicated in Europe. Shadow-banking should be regulated not less than banking.

Regulators and supervisors of capital markets will arguably think like central bankers ever more to the extent shadow banking creates new systemic risks (think just about the role central counterparties are asked to play, the volume of funds moved by hedge funds and money market funds worldwide, and sudden stops that can occur in these markets).

A new Bretton Woods is needed

It is never futile to stress how much important for global markets is *the international policy regime*, what big players in the global economy do. In highly integrated financial markets the "trilemma can frequently be a "dilemma"and the degree of euroization/dollarization matter much in emerging economies, be they less indebted.

Like almost 60 years ago, in order to create adequate policies one has to come to grips with the profound roots of the financial crisis and the Eurozone pains and, arguably, rediscover the Bretton Woods spirit and logic – which were imbued with concern for the fate of the free world, of helping economic recovery in an open international system. Finance must be reined in and downsized.

Final remarks

Let me conclude with a few inferences:

- Protectionism and the erosion of multilateral arrangements can have a huge impact on the global sytsem;

- Brexit is still a big uncertainty, with possible destabilizing effects in Europe

- the slowdown of the global economy (which is due to structural factors) was obvious before the eruption of the financial crisis; the current economic recovery in advanced economies is due, largely, to unconventional policies

- structural factors have changed the propensity for investment and saving . Against this background, natural interest rates have turned much lower since long;

- over-indebtedness is a huge burden; it may be softer in the US where capital markets are well developed, whereas the EU relies heavily on banks, with their overloaded balance-sheets. For some emerging economies the expansion of corporate debt will be paid dearly

- income inequalities create tensions in society; this is fueling populist and protectionist movements in both developed and emerging economies; globalization limits come to the fore ;

- can new technologies bring in a new upswing? It is not impossible, but it is time consuming given that debts are high, the financial sector is still fragile, and there are numerous tail events, big uncertainties. Moreover, new technologies may destroy more than create jobs, at least in the short and medium run;

- limits of cognitive models are increasingly clear and policies are navigating unchartered waters; but we can take comfort in the fact that a generalized Great Depression was avoided, at least until now;

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