Revisiting roots of fragility

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The very broad picture

- Erosion of multilateralism and rising protectionism; a new paradigm?
- Ongoing economic recovery, but supported by unconventional policies
- Policy rate divergence among key CBs and capital outflows from EMs
- A safer global financial system?
- Governance structures challenged: many governments can hardly deliver…
- Economic and social cohesion under increasing strain…fragmentation
- New technologies can bring about havoc…climate change also a huge issue

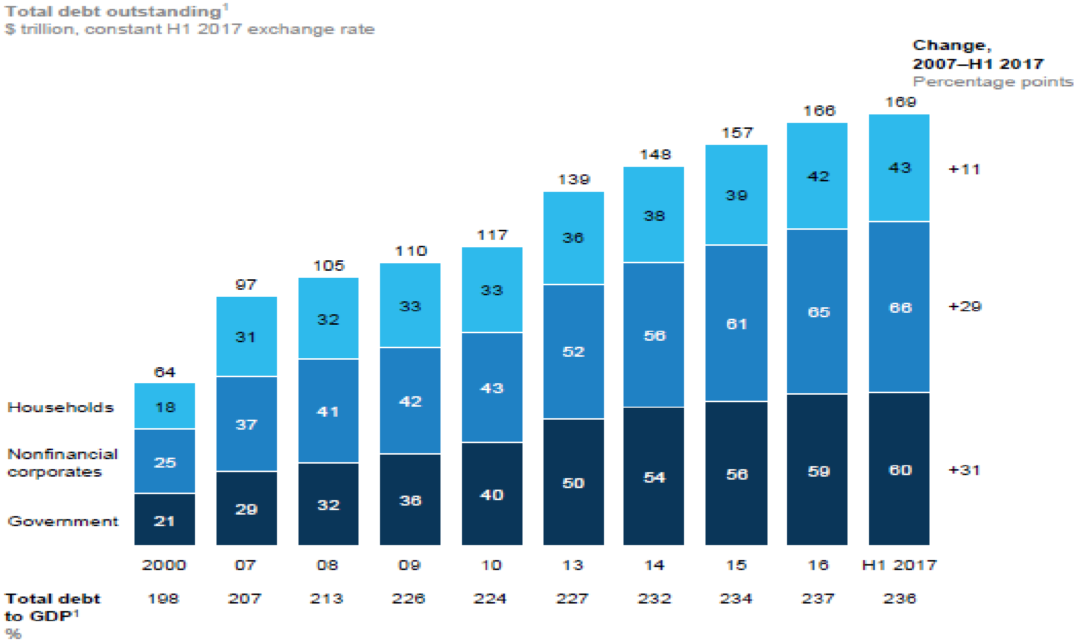
1. A new global financial cycle – when and how will it come to an end?

- Extraordinarily accommodative monetary policies have ushered in a new global financial cycle
- Bigger debts and overvalued assets across the world
- New tremors in emerging economies, which gives salience to debts
- Tightening of financial conditions in the global economy
- Structural conditions matter: the balance between investment and saving); policy rates will stay relatively low

Global debt has increased substantially after the financial crisis at aggregate level…

- Increase in indebtedness has been widely spread across institutional sectors on the backdrop of favorable financing conditions
- This can materialize in important difficulties for debtors as policy normalization has already started in many countries
- Total debt has soared by 74 percent from 2007, reaching 169 trillion dollars in 2017
- Non-financial firms' outstanding debt expanded by 78 percent from 2007, representing 40 percent of total debt

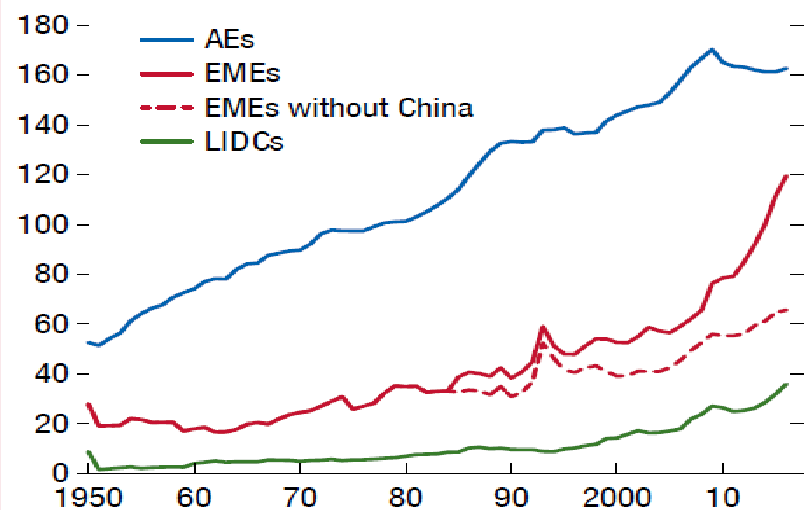
Total debt outstanding (USD trillion, percent of GDP)



Source: McKinsey Global Institute, June 2018

…and across regions

Non-financial private debt
(weighted average percent of GDP)



AEs = advanced economies; EMEs = emerging market economies;
LIDCs = low-income developing countries

Source: IMF Fiscal Monitor, April 2018

- The debt of the non-financial private sector reached a peak of 170 percent of GDP in 2009
- Non-financial debt in emerging markets economies started to accelerate in 2005 and has surged in the last decade
- China alone stands for three-quarters of the increase in global private debt

Global financial are tightening

Global financial conditions have tightened

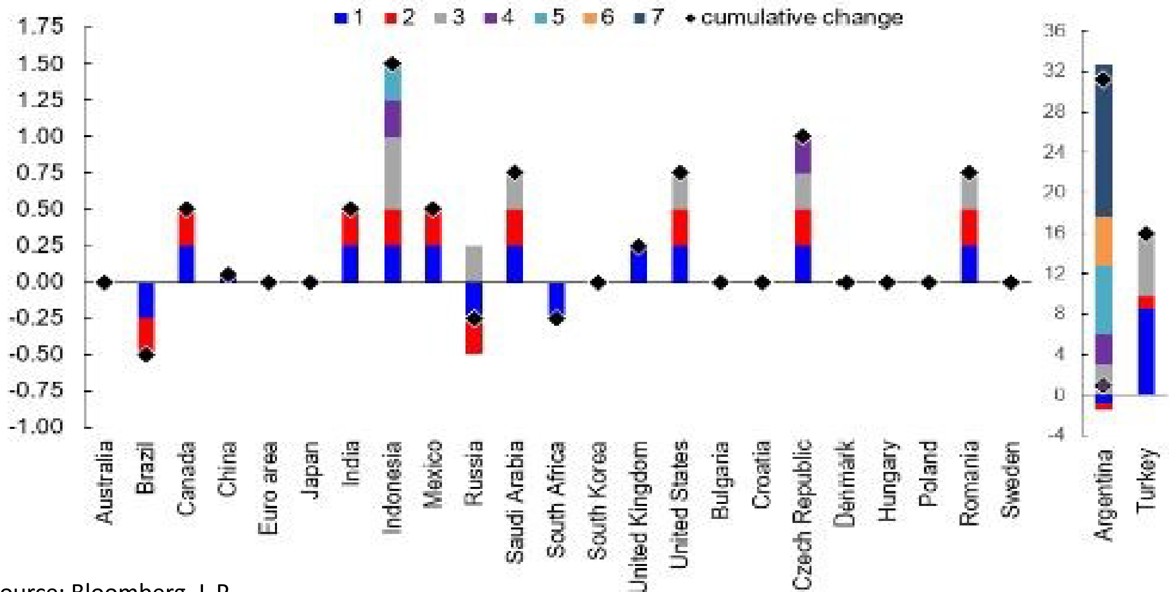
Bond Yields (%)

Source: Bloomberg, Meeting of the Central Banks Governors' Club, Bucharest, 20 September 2018

On the rise

Many central banks represented in the G-20 have raised policy interest rates this year–usually more than once.

(policy rates, changes in 2018; percentage points)



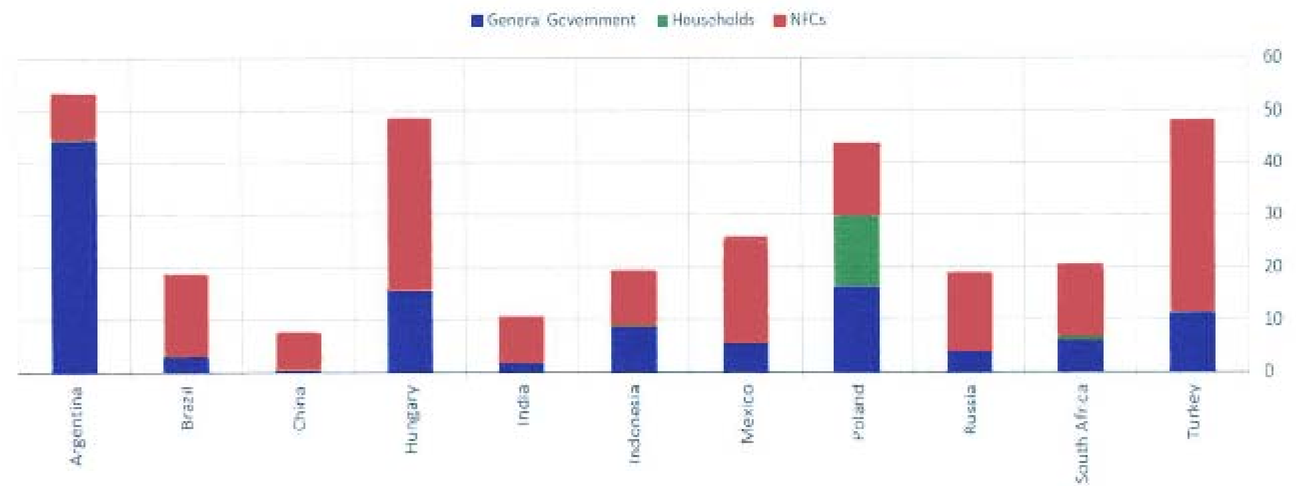
Source: Bloomberg, L.P.

Note: As of October 5, 2018.

Hard currency denominated debt

Countries with high foreign currency denominated debt are the most affected

Foreign currency denominated debt (% of GDP)



Source: IIF, Meeting of the Central Banks Governors' Club, Bucharest, 20 September 2018

Depreciation and inflationary pressures

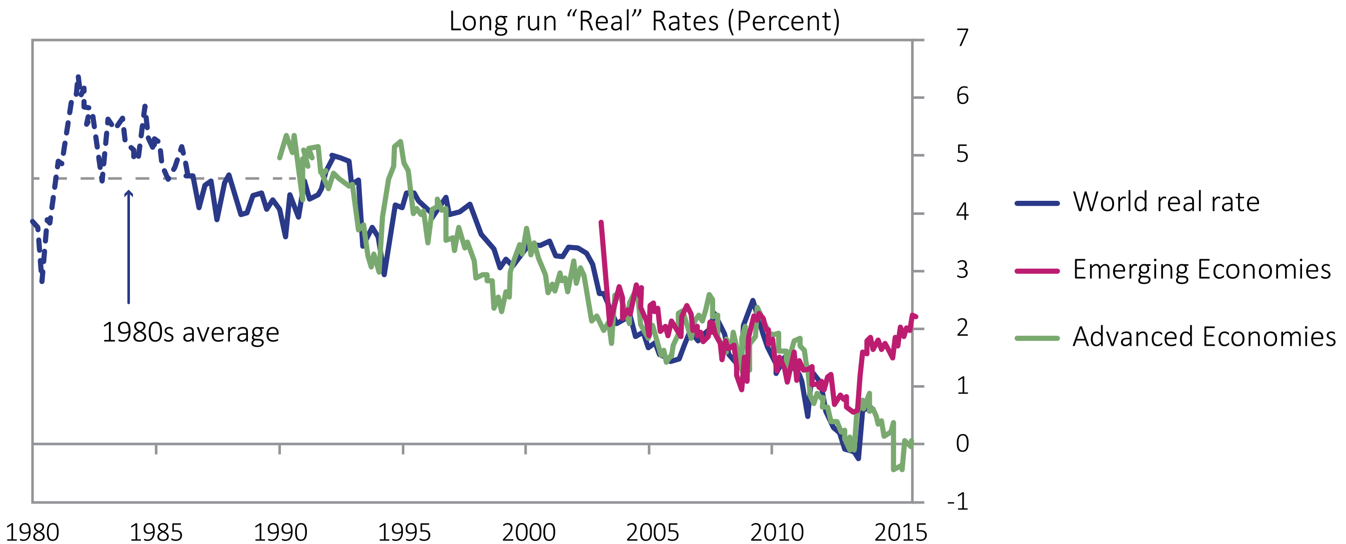
Depreciation have increased inflationary pressures in emerging economies

CPI in EMEs (YoY%)

Source: OECD, Meeting of the Central Banks Governors' Club, Bucharest, 20 September 2018

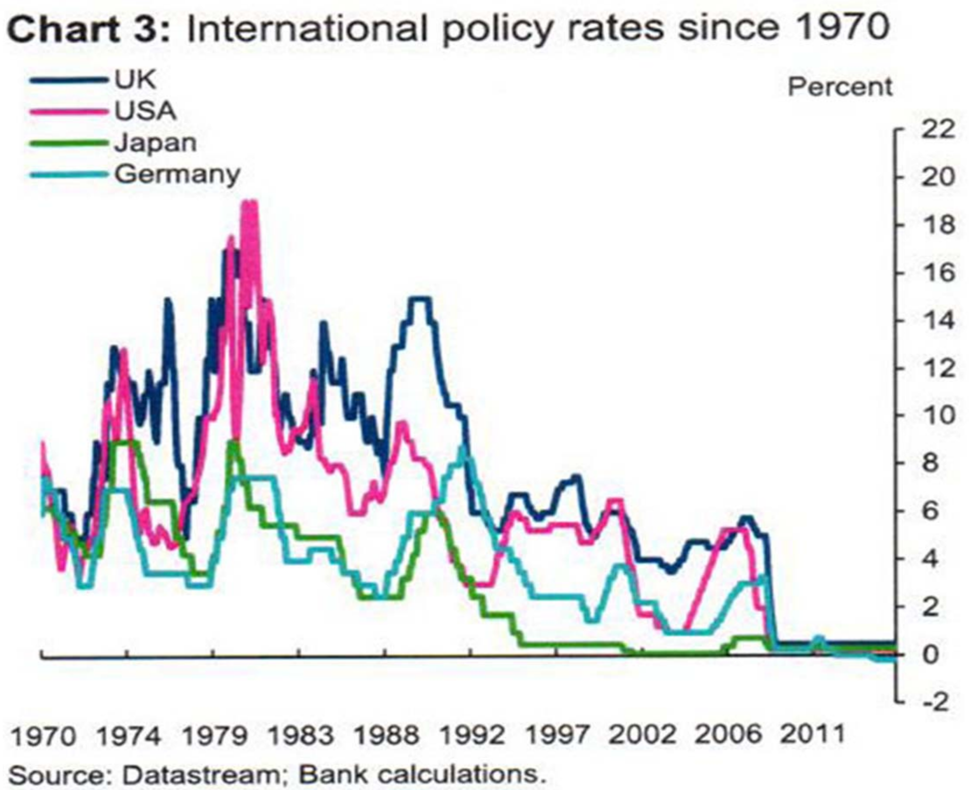
Policy normalization?

Long run real interest rates: years of high borrowing fueled growth hid structural trends (-450bps)



The real rates show the average 10-year yield of inflation-linked bonds in the G7 during 1980-2013 (King and Low, 2014). Other sources: Rachel and Smith, Haldane, Laubach and Williams, IMF....

Policy rates since 1970 (Haldane)



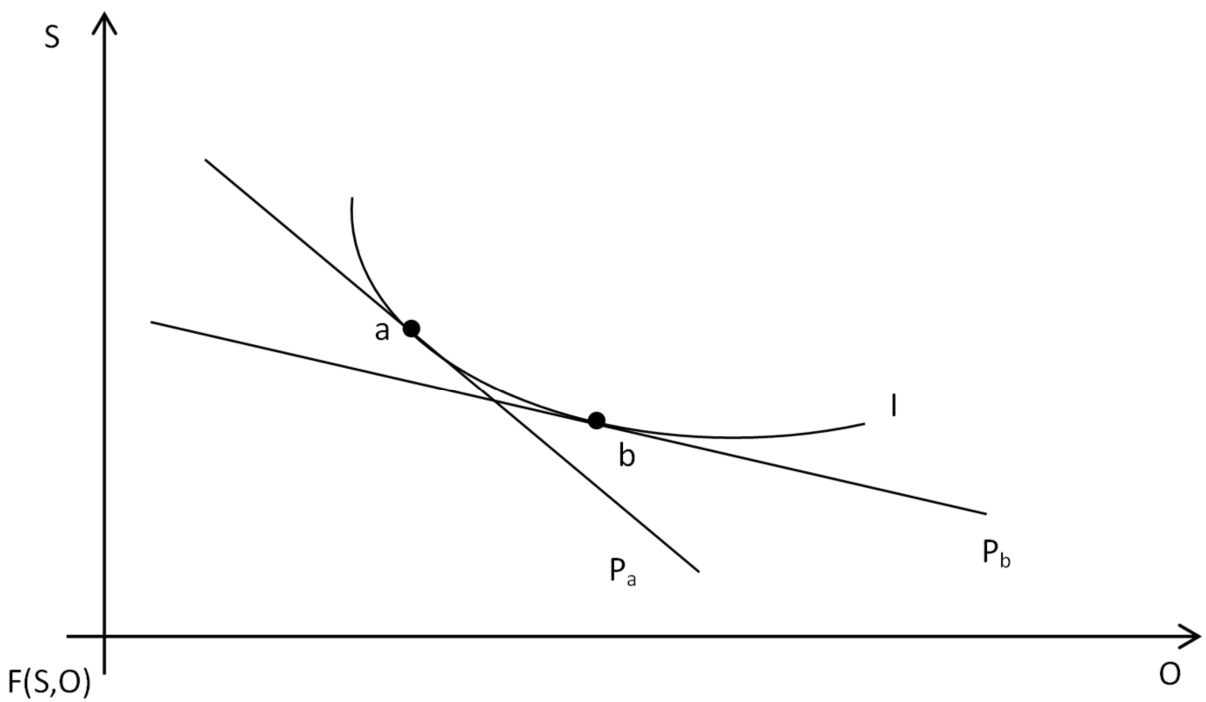
2. An "inward-looking syndrome"

- Rising protectionism (New Protectionism/NP)
- *Free vs. fair trade*; this syndrome is linked with national security concerns (military, terrorism, immigration pressures, etc). (my figure)
- An irony: it is AEs that clamor for *fair trade*
- In spite of GSCs and strong interdependencies, there seems to be a shift toward regional interdependencies…
- Separate payments systems (an EU project…)?

Analytics of a big trade-off

- A social utility function which includes protection/security **(S)** and economic freedom **(O)** as an expression of economic openness, as public goods
- F = F (S, O) would indicate levels of citizens' comfort in terms of the these public goods; **F = ((1- a) xS + a xO)**, where **(a)** would be a variable in consonance with people's attitude toward the two public goods
- **Substitution between protection measures and economic openness has limits**. These two public goods are not independent of each other
- From a certain level, protection measures, or restrictions distort an *open society* exceedingly. And a total openness of the economy/society, with no rules and protection measures, may cause enormous costs, social anomia

Graph: The relation between protection (S) and economic openness (O)



NP whither?

- NP can be interpreted in a narrow sense, along the lines of trade/economic relations, and in a broader sense, with measures targeting national security
- In both cases, the liberal order, as it was set following the WWII, is questioned
- A liberal order is not synonymous with *market fundamentalism*
- The world shows signs of fragmentation, with societies more polarized
- A corrosion of international, global institutional arrangements...
- **The New protectionism may be tied to tides of economic openness in the inter-state system, with secular cycles (Kondratieff and Schumpeter)**

3. Is the financial system safer?

- **Though banks are better capitalized and less leveraged, it a tough call to say that the global financial** system is safer
- ***Shadow banking*** on the rise (in EU more than 50% of financial assets)
- A high degree of interconnectedness, still high leverage in many of its parts, highly risky financial instruments
- Systemic risks evolve in capital markets
- A LoLR could be called upon in capital markets (just think about CCPs)
- 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
- A new wave of finance deregulation is underway in the US
- Cyber-attacks can take a heavy toll on financial stability

4. Re-examining a few concepts

- Low inflation can be misleading, for rising external imbalances can bring an economy into big trouble.
- Defining a menacing current account deficit… 3% of GDP? (India, Indonesia…)
- **Trust (lack of (trust):** What can trigger a loss of trust when the macro picture looks nice?
- Hidden vulnerabilities that come brutally into the open;
- The state of the banking sector, where much rot (NPLs) can be hidden
- The erosion of a central bank credibility; when its independence is questioned; political tensions that may impair the soundness of economic policy
- Insufficient buffers
- A small size of economy and lack of diversity and of export strength; one should recall the Asian experience, with South Korea a telling example of the capacity to bounce back rapidly
- Perceptions do matter, and if they turn against a country…; contagion can be at work too

5. Financial stability

- Financial stability is at the center of CBs concerns
- It is not a concern of recent vintage in EMs. High dollarization has always ingrained policies with a concern for balance-sheet and wealth effects
- Macroeconomic fundamentals (external imbalances, gross external debt and short term debt, budget deficits, etc.) matter much, but they do not provide insulation against a wave of great scale unless macro-prudential 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
- **Private indebtedness matters as much as public debt (a key lesson of the Asian crisis of 1997-98); external indebtedness is critical!**

6. Macro-prudential policies (MPP)

- 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 --area for policy creativity?
- What drives the GFC 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 help 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
- To address firms' debt bias: limit interest deductibility, or apply a neutral stance between equity and debt

Final remarks

- **Protectionism and the erosion of multilateral arrangements can have a huge impact; a new global order? Brexit is also an issue**
- 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
- **Over-indebtedness is a heavy burden**; it may be softer in the US where capital markets are pretty deep, whereas the EU relies heavily on banks, with their overloaded balance-sheets. For some EMs the expansion of external corporate debt is a threat
- The financial system is hardly safer after a decade since Lehman Brothes
- **Income inequalities** create tensions in society, which fuels populism and protectionism; globalization limits come to the fore
- New technologies may destroy more than create jobs, at least in the short and medium run
- Limits of cognitive models and policies that are navigating unchartered waters; but we can take comfort in the fact that a generalized Great Depression was avoided, at least until now