A ‘New Age’ of uncertainty

Central bankers and policy makers have a much more complicated and difficult job nowadays, Daniel Dăianu writes.
The Great Recession has turned paradigms, policies, and the overall mood in industrialized societies upside down. But there is a heavy fallout in emerging economies too. Not least because of the huge externalities reserve money centres’ policies entail around the world and their weight in the global economy. A gripping new ‘age of uncertainty’, of disruptions, seems to be a proper term to capture people’s sentiments and changes of all sorts. Below is an attempt to sum up the dramatically altering environment in which policy-makers, central bankers included, operate nowadays.

The overall environment: cognition and policies
Cognitive models in economics and business are questioned seriously; how to model non-linearities (tail events) is a big challenge, as is the integration of finance in macroeconomic models (Borio, 2012). There is a paradigm shift which says that price stability is not sufficient for economic stability. Thence the need to use macroprudential tools. Conventional and non-conventional shocks (including cyber attacks) proliferate and this harms systems’ robustness and resilience. Rising complexity and inability, frequently, to understand it is a further proof that there is need for more simple, more transparent financial sectors.

The financial sector has powerful destabilizing features (Stiglitz, 2010; Blanchard and Ostry) and reveals a derailed institutional culture, in spite of efforts undertaken to reform its regulation and supervision in recent years. Oversize is also an issue for this industry (Pagano et al, IMF), that is extracting undue rents from the rest of economy and contributes to resource misallocation (Caruana).

Central banks are over-burdened in many countries; they can no longer rely on simple rules (like the Taylor’s rule). This makes central bankers’ life much more complicated and obfuscates the delimitations between monetary policy and other policies, especially when financial stability gets to the centre stage. The development of capital markets, however welcome this may be for diversifying funding sources in a period of bank deleveraging, brings about new systemic risks. Regulators and supervisors of these markets will, arguably, have to think increasingly like central
bankers to the extent shadow banking creates 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).

There is a spectre of much lower growth in the industrialized world due to debt overhang (a balance-sheet recession/Koo), demographics, income inequality (Piketty and Saez, IMF and OECD), technical change, and zero-sum games in the world economy, etc. Summers talks about a new ‘secular stagnation’ (see also (Eichengreen; Jimeno, Smets and Yiangou); Rogoff refers to a ‘supercycle’ by highlighting over-indebtedness. There are massive social and political implications of economic slowdown/recession. As the IMF notices, international policy coordination is often ineffective, although G20 and the FSB do play a role in the reform of finance.

The eurozone is, arguably, no longer menaced by a collapse owing to the ECB’s extraordinary operations and large macro-imbalance corrections in its periphery. The stress tests and asset quality reviews have revealed better capitalization of banks. But other threats are looming: debt deflation could rekindle the menace of a eurozone break up unless the QE program is effective in averting deflation; the link between sovereign debt and bank balance-sheets has not been severed; and it may be quite unrealistic to think that a total delinking is feasible (at the end of the day the only entity which has taxation power, irrespective of how financial markets deem its reputation, are governments); market fragmentation has continued, although the periphery pays much less currently for issuing its debt

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due to ECB's special operations; internal demand in most of the eurozone is quite weak and suffering from the negative loops between weak activity, fragile banks, weak firms, diminished incomes, and the need for fiscal consolidation; the fragility of the growth model that relies on debt; the fallout from the Ukraine crisis on economic recovery in Europe, the return of major geopolitical risks.

Capital flows reversals are a significant threat in view of the disconnect between booming asset markets worldwide and the very slow economic growth rates in most of Europe. The search for yield would quickly be arrested were the Fed to taper its stimulus in a significant way.

**Dilemmas of recent vintage**
Against the background sketched above policy makers in emerging economies (EMs) confront a series of major challenges

**The policy space issue**
For economies to adjust smoothly to shocks they need to rely on highly flexible markets and be able to resort to an array of adjustment tools. In Europe, in the single currency area, where the monetary policy and exchange rate policy are gone, the tasks for policy makers is enormously complicated unless local markets are sufficiently flexible and productivity gains in the local economy match those of neighbouring economies. In emerging economies, policy makers have to deal with the working of a 'global financial cycle' that can overwhelm their policies. This is the gist of Helen Rey's assertion that the 'trilemma' turns into a dilemma when financial markets are highly integrated. At the last Spring IMF meetings Raghuram Rajan, the governor of the Bank of India, was quite incisive about major countries’ responsibility in framing policies that should consider the externalities these produce.

**Financial stability and macro-prudential policy**
Financial stability is a concern not quite of recent vintage. For high dollarization/euroization has always suffused central banks’ monetary policies with a concern for balance-sheet and wealth effects and their relation with finan-
cial stability. There is need to revisit the pluses and minuses of deep financial markets in relation to the size of economy. In addition, one wonders whether the use of highly sophisticated financial products is warranted when markets can be so erratic, volatile. The experience of emerging markets in dealing with massive capital flows permits a range of inferences.

Thus, with regard to the macro picture, 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. This is, not least, because of: a/ the size of liquidity that has been pouring into emerging markets (EMs) during the past decade (EMs have attracted about $7 trillion since 2005 through a mix of FDI, mergers and acquisitions, and investment in stocks and bonds – according to the International Institute of Finance data; b/ much borrowing has taken place primarily via bond markets (capital markets); c/ the emergence of index-tracking Exchange Traded Funds (ETFs), which has increased the indiscriminate nature of emerging market flows, and 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.

Concerning capital markets and fragility to external shocks, the size of domestic saving and domestic investors’ base help in making an economy less fragile (more robust). Deep financial markets entail pluses and minuses (non-resident investors’ share of local currency denominated bond issues). In spite of much improved economic policies in many EMs, investors tend to lump them together in times of sell off. In addition, there are capital markets instruments which entail an indiscriminate impact on emerging economies (ETFs). Capital controls are not of much help when massive outflows take place and political instability does amplify economic instability and risk aversion. Policy responses (policy rate rises) do not, frequently, have a decisive impact, while there can be a severe impact on economic activity. European EMs are, arguably, better prepared now than during 2008-2009 (some of them had awful macroeconomic imbalances before the crisis hit), but high external indebtedness and substantial GEFR continue to make some of them vulnerable.
Capital markets dynamics are linked with financial cycles. What drives a financial cycle is of utmost importance for the EMs, whose macroeconomic policies are heavily influenced by what happens in the big economies. There is currently, a clash of visions with regard to adequate policies under the current circumstances. A Basel (Bank of International Settlements/BIS) view takes a long term perspective and stresses factors and policies which have made economies drift from sustainable trajectories (have amplified boom and bust dynamics) and resources be misallocated. Not delaying rises in policy rates would be a means to combat future boom and bust cycles, new big crises. Another view (linked with the secular stagnation thesis) highlights the threat of being stuck in a very bad equilibrium with intense hysteresis phenomena that may invite social and political troubles. Income inequality and highly skewed wealth distribution, which would impair economic growth, is a factor that should be factored in in both visions; it can bring them closer and reconcile policies that can bolster aggregate demand (for the sake of avoiding debt deflation) with measures that take into account resource misallocation.

We seem to be at the beginning of a new bumpy ride in world financial markets, at a time when the crisis is not yet over (in Europe, the impact of the financial crisis blends with the crisis of the eurozone). 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.

**Economic recovery in the eurozone**

Economic recovery in the eurozone conditions the very sustainability of economic growth in European emerging economies via many channels, including finance. Economic recovery in the eurozone depends not only on national economic policies, but on euroarea level policies: on whether there is a significant bolstering of aggregate demand at the euroarea. More debt restructuring may be needed to help the private sector be reignited (Borio, 2012).

**A trade-off between economic growth and financial stability?**

The possible trade-off alluded to above is, probably, the most profound ‘Grosse Frage’ for academic economists and policy-makers nowadays. One could say that this question sets a Basel view against a view that is more concerned
with the level of resources used in the economy, with the need to combat high unemployment and avoid poor equilibria. One view takes a longer term perspective; the other pays attention to what may push an economy toward a bad equilibrium and keep it stuck there because of hysteresis phenomena. A related question is the growth potential of mature economies. Gordon would say that it is lower than in the past owing to a range of structural factors including demographics, education, the nature of technical change etc. Other voices would argue that this growth potential may be eroded by not adopting the right policies now, in the wake of the current crisis. Others fear that attempts to foster short term growth may sow the seeds of future crises by enhancing the search for yield and risky behaviour (Borio, 2014; Rajan).

Is a way out of this conundrum? Summers (2014) seems to be quite pessimistic in this regard and is quite sceptical of QE programs (owing to their perverse effects); in this respect he meets the Basel view. One would have to consider also the relationship between economic growth and income distribution. It is quite an amazing change to hear top officials of major central banks voicing concerns in this regard, their worries that income distribution may hurt economic growth (Yellen, Mersch, Haldane); IMF and OECD experts voice similar concerns. The debate encompassing these issues is of enormous importance to central banks, for their mission cannot be divorced from what policymakers do in order to resuscitate their economies.

The reform of finance: size, content, shadow banking
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. For example, dealing with the ‘too big to fail’ syndrome requires the application of anti-trust legislation, as it does happen in various industrial sectors; this would imply splitting big financial entities. A sort of Glass-Steagall legislation should be restored, as after the Great Depression. 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 Modigliani-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.
Final remarks
Policy makers have a much more complicated and difficult job nowadays. Not only that the impact of the financial crisis combines with a persistent eurozone crisis, but cognitive and operational models have been questioned. It is a period of increasing uncertainty, when central banks navigate in uncharted territory, which is well illustrated by the diplomatic euphemism of ‘non-conventional policies’. Furthermore, a threat of ‘secular stagnation’ and the menace of debt deflation in the euroarea are pointing at years of painstaking efforts to keep the boats afloat. Central banks in European emerging economies have their tasks shaped by membership, or not in the euroarea, the size of domestic macroeconomic imbalances and of public and private debts, the degree of euroization, intensity of deleveraging, etc. Preserving financial stability is crucial and this mission hinges a lot on the health of the banking sector, on the effectiveness of macro-prudential tools. This goal will influence monetary policy, inflation targeting regimes too. For European EMs, joining the euroarea would, arguably, be a mistake unless there is substantial real convergence and the single currency area does not get proper fiscal arrangements (fiscal integration). Joining the Banking Union is an option under consideration in view of the heavy presence of international banks on local financial markets. But the deep interest and concern of any lucid policy makers is to see the functioning of a ‘complete’ banking union, which should help achieve a proper design of the euroarea. An adequate design and better policies in the euroarea would help prevent debt deflation become a reality and threaten the very existence of the EU.

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