Current challenges to the world economy

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Are we crazy or are we not?

- „Anyone who believes in indefinite growth in anything physical, on a physically finite planet, is either mad or an economist" (Kenneth Boulding, chairman of the AEA 1968)
- Value and income growth has become increasingly more reliant on **intellectual and immaterial** inputs ever since
- Growth of physical inputs – materials –may evolve to be negligible or come exclusively from recycling in the future
- Global growth may become **slower** as more countries get into middle income position – China's economy is slowing
- But there is **no reason for fearing secular stagnation**

We have a different problem

- Secular stagnation would require at least two major factors: negative global demographics and stagnation or reversal of technological progress; both highly unlikely
- Secular forces have a different impact: **low inflation and excess savings** which keep long-term yields pinned down – almost irrespective of the economic cycle
- Political forces exacerbate the situation: **deglobalization** by sharpened nationalist & populist sentiments lead to **trade and currency wars** - that is the problem of today
- Public policy have to be reevaluated in this new context

The conditions of currency manipulation

- Not fully convertible currency, i.e significant
- Capital controls (especially for exporting capital)
- CB to have a dominant role in the forex markets, occasionally undertaking large-scale interventions
- e/r to be explicit or implicit monetary policy target
- Rapid accumulation of forex reserves in CB assets
- Gov to accept significant losses on forex reserves
- As a price worth paying for keeping or improving export competitiveness and, hence, higher growth

Is China a currency manipulator?

- It was between 2010 and 2014: it tried to slow down the appreciation of the CNY and accumulated 4tr USD forex reserves which at that time was 50% of its GDP!
- It was no longer between 2014 and 2018: capital flight forced the PBoC to defend the e/r from depreciation
- It lost more than 1tr USD in forex reserves (at the same time SAFE tightened capital controls significantly)
- Today China has 3.1tr USD forex reserves; quite stable
- Depreciation may become a policy tool of defending rather than promoting exports in the midst of a devastating trade war with the US

Forex markets have unique characteristics

- In financial markets all bond and stock prices can go up **simultaneously** (especially if i/r is kept artificially low)
- What is impossible: **the simultaneous appreciation of all currencies** – they can move only against each other!
- Moreover, fluctuations can be the result of either market movements or deliberate monetary policy decisions
- And it is very difficult to distinguish between the two
- Hence, currency fluctuations can easily be regarded as manipulation based on secret policy even if it is not
- At the same time weaponisation of currency is tempting

Can the US manipulate the USD?

- The USD does not meet the conditions for currency manipulation
- Full convertibility and no capital controls leave little room for influencing the e/r of the USD by FED forex interventions, but
- **Monetary policy has another tool: i/r policy**
- **i/r movements do have an impact on the e/r**
- Perception is reality: if Trump feels that China manipulates the e/r of the CNY he will be tempted to involve the FED in the trade war
- Hence, pressure on the FED to lower policy i/r will keep increasing
- Irrespective of domestic concerns about price stability and jobs
- Enormous challenge: the independence of the FED is at stake!

Quantitative easing and negative i/r: preventive or mitigating measures?

- Until recently, central banks applied quantitative easing (QE) in recession in order to mitigate the consequences of a downturn
- Now the ECB has announced QE (albeit in a small scale) as a **preventive measure before recession** (exception: Germany)
- But QE and negative (-) i/r are not panacea even in recession
- Moreover, they may create significant distorsions:
- Redistributing income from creditors to debtors (inequality)
- Creating A/L mismatch for contractual savers (pension funds)
- Weakening the banking system by depressing its profitability
- Motivating insurers, banks and savers to hoard physical cash

Phillipp Hildebrand: Central banks need new tools to tackle the next downturn (FT, Sep 3.)

- (-) i/r cannot be depressed much further or held indefinitely
- (-) i/r and QE no longer stimulates credit growth, hence
- financial intermediation has got stuck in a liquidity trap
- More than 1/3 of all government bonds globally have (-) rates
- Monetary policy should „*go direct*”: put CB money directly into the hands of the public and private sector spenders
- Monetary and fiscal policy has to be better *coordinated* and pursue jointly an *explicit inflation target* plus there is a need for a
- Standing *emergency fiscal facility* to be activated when monetary policy has been exhausted and inflation still undershoots its target
- Finally, a *clear and preannouced exit strategy* at all times

Proposal I. Rethinking inflation targeting

- What is inflation? What should inflation measurement include?
- 1 = prices of manufacturing goods and services (core inflation)
- 2 = 1+ food, fuel and medicine (headline inflation)
- 3 = 2 + asset prices (including physical and financial)
- Monetary policy should target the **third** - thus, i/r changes must not aim at keeping asset prices artificially high, no asset bubbles, please
- Today, bond prices no longer reflect genuine credit risk, creating the illusion of cost-free borrowing for many governments and corporates
- **High debt cannot be addressed with even more debt** > a sudden repricing of risk may unleash a new wave of corporate bankruptcies and even sovereign defaults and recessions of unprecedented depth

Proposal II. Reconfiguring fiscal accounts

- Fiscal accounts should be separated into current account and capital account (pretty much the same way as in the balance of payments)
- **Current budget** to include only recurrent items on both sides, e.g.
- standard taxes and normal yearly outlays on current expediture
- **Capital budget** to include extraordinary revenues and one-off items,
- like privatization revenue & investments, plus lending & borrowing
- Current budget should be **in balance** over the business cycle, i.e. **current expenditure must not be financed by one-off revenues**
- Capital budget can borrow exclusively for investments and only if
- L-t cost of borrowing is < yield of investment or long-term value
- In order to maximize NAV of state wealth (MoF to prepare B/S)

Proposal III. Structural reforms

- Monetary policy alone is toothless, needs to be combined with fiscal
- Monetary + fiscal may still be insufficient, income policy to be added
- Macroeconomic policy is no panacea against persistent weak growth
- And no substitute for **structural reforms** enhancing productivity, efficiency and overall competitiveness of both economy & society
- Most important structural reforms in Europe:
- **Education**, strong emphasis on vocational training (e.g.Germany)
- **Health care**, multipillar solutions (e.g. Netherlands, Switzerland)
- **Pension systems**, notional defined contribution scheme (e.g. Sweden)
- **Labor markets**, standard contracts for all, flexicurity (e.g. Denmark)

Multumesc frumos pentru atentie