

**“Cycles and policies: what has
gone wrong?**

**--an age of ultra low interest
rates?--**

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Contents

- Cycles , financial stability, as big concerns
- What has caused the Crisis
- The overall context
- Why ultra-low interest rates matter
- What drives low interest rates
- Central banks' role
- Banks under siege
- What lies ahead?

1. Cycles are back as a big concern!

- The study of cycles is not new: Sismondi, Schumpeter, Kondratieff, Kusnets, RBC (neoclassical view), Keynes, Minsky, Kindleberger,
- The Great Depression
- The Great Recession (GR) debate: Summers (lack of aggregate demand), Rogoff (debt-overhang), Bernanke (savings glut), BIS view

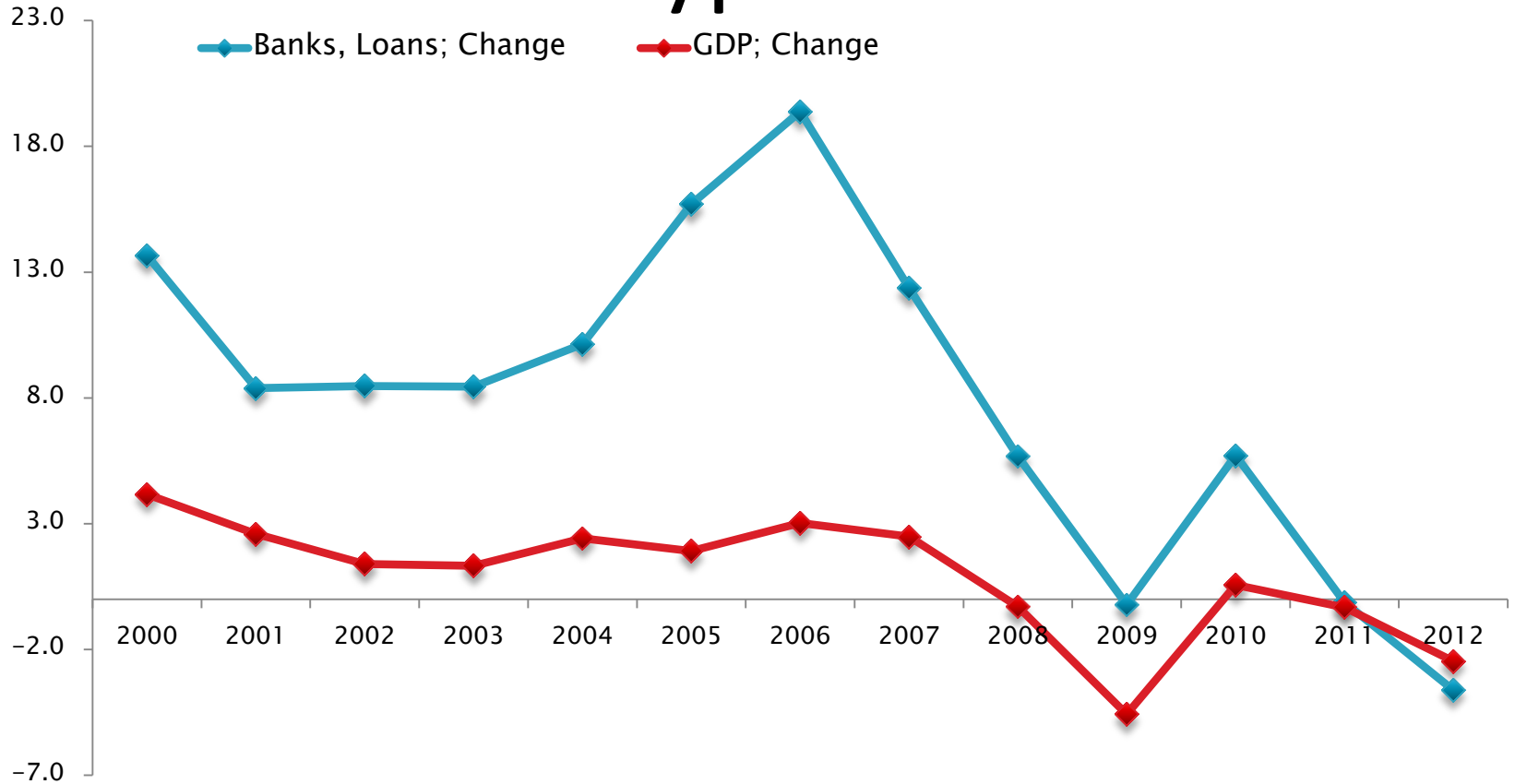
1. Cycles are back (II)

- The Golden era of Macro-management” (post war reconstruction)
- The crisis of macro-management (*Stagflation*)
- Rules vs. Discretion (how to defeat inflation): Central Bank independence and the Taylor’s rule
- *The Great Recession*: change of paradigm/policies/culture of finance?

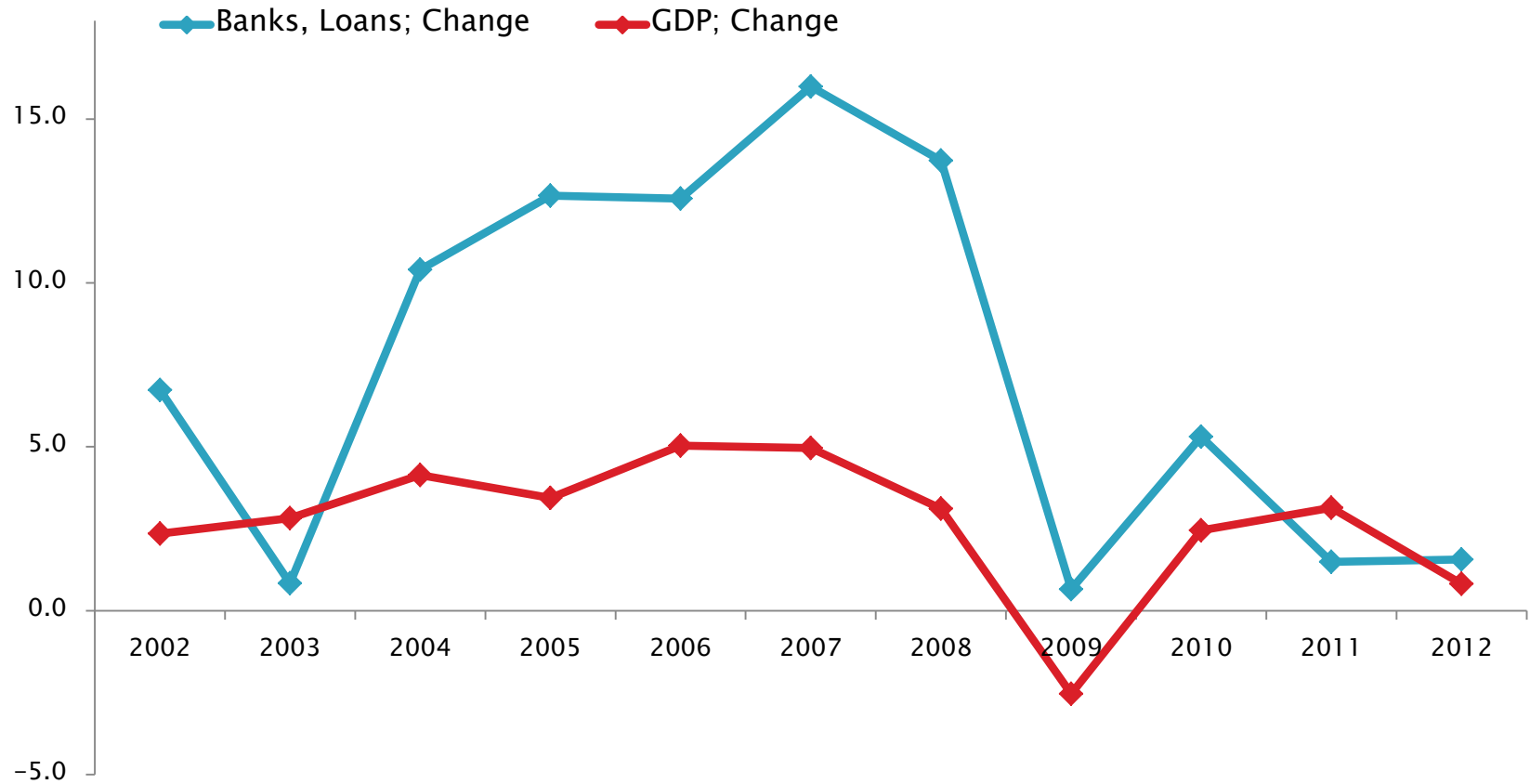
2. What caused the GR and keeps financial systems quite fragile?

- Deregulation
- Easy money policies
- Financial innovation
- Increasing connectivity (Haldane)
- A drifted financial cycle and massive resource misallocation (BIS) –see figures (the story of a big bubble)

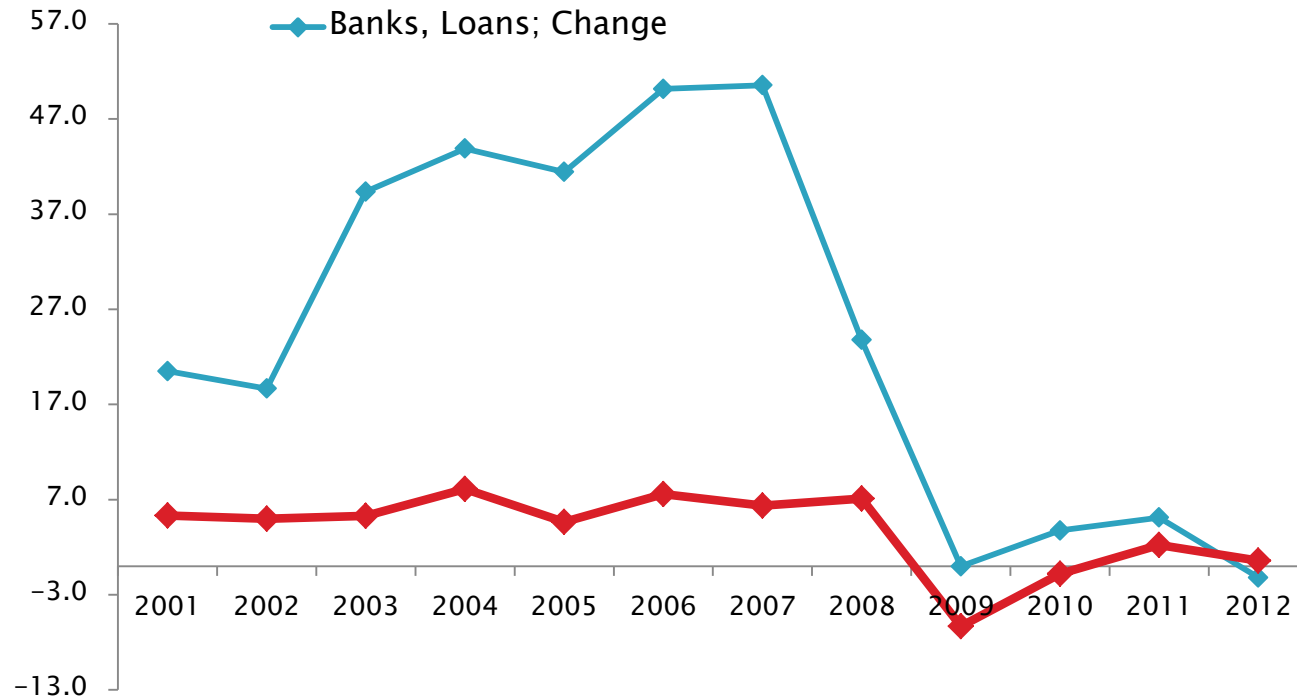
Credit and economic growth: Spain, Portugal, Italy, Greece, Cyprus



Credit and economic growth: Croatia, Hungary, Slovakia, Austria



Credit and economic growth: Bulgaria and Romania



3. The current context

- Anemic economic growth; very low inflation
- High connectivity, high volatility
- “New” systemic risks...high fragility
- Disruptions, *sudden stops* (liquidity traps)
- New technologies and financial markets
- Change in business models

3.1 Macroeconomic context

- **Demand side/ savings glut: “*the new normal*”**
- **Low inflation/deflation; *liquidity traps***
- ***Hysteresis* (potential GDP-- Summers)**
- **Legacy of resource misallocation (Borio)**
- ***Debt-overhang* (Rogoff), deleveraging (Koo)**
- ***Uncertainty*; impact on investment and saving**
- **Ultra-low interest rates**
- **Unconventional policies**

3.2 Macro-prudential context

- **Unfinished regulatory reform** (ex: capital and liquidity requirements – Banks' models)
- **Complexity**: a challenge for both regulators/supervisors and CEOs (*conformity*)
- **Large entities** and systemic risks
- **Migration of risks** (capital markets)
- **Fintech** and new risks; **parallel currencies?**

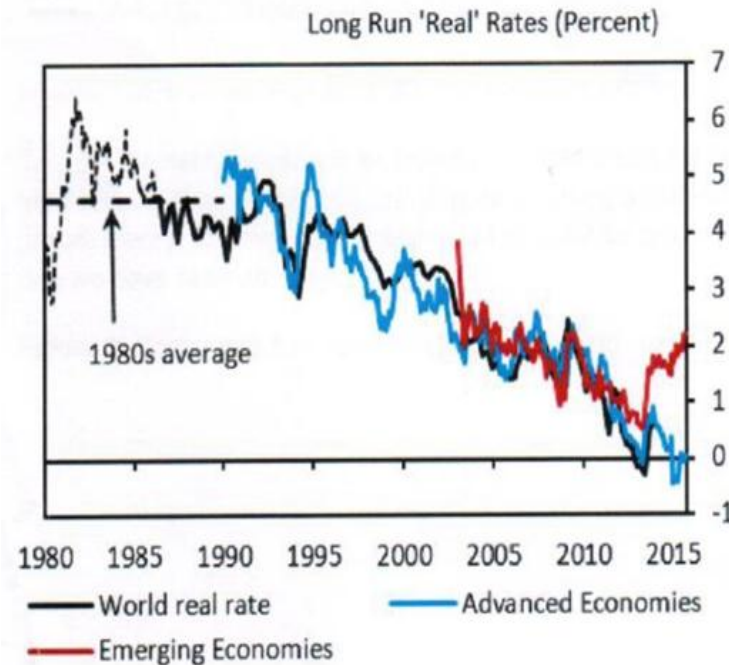
4. Why ultra-low interest rates matter

- They mirror **large dysfunctions in economies**
- **Side effects:** bubbles, distributional impact, instability in EMs, high volatility, resource misallocation (BIS, Caruana; White)
- Banks' and non-banks' **balance-sheets** (PPFs, insurance companies -- *the double hit*)
- **Policies are groping in the dark** – unconventional tools

4.1 What drives real interest rates: *structural/secular trends*

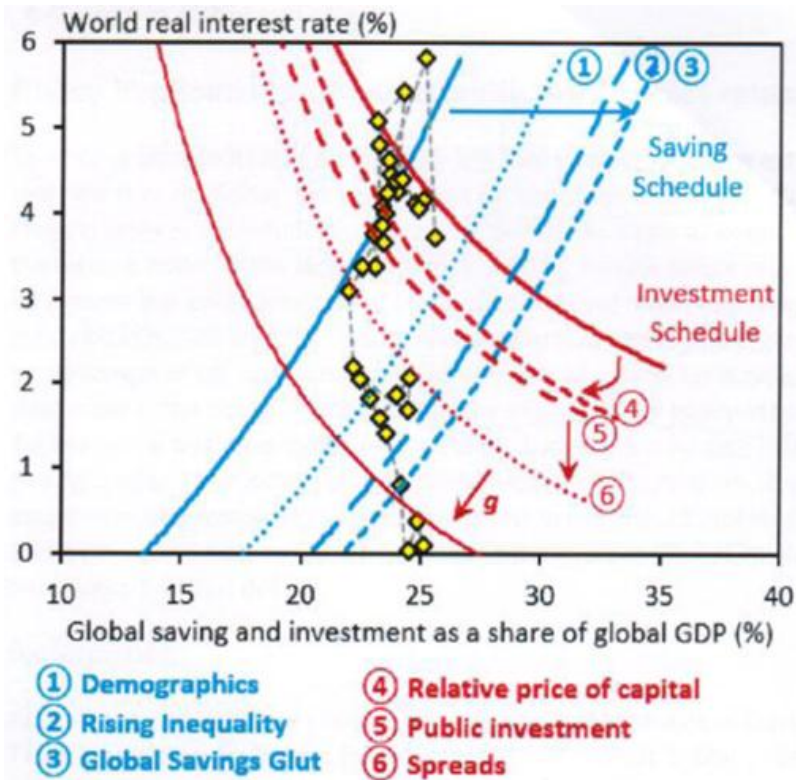
- **Demographics (dependency, aging)**
- **Income distribution/inequality (OECD, IMF)**
- **Productivity gains slowdown (OECD, EC, IMF)**
- **An “educational plateau” (Gordon)?**
- **Global competition (*savings glut*/Bernanke)**
- **Cost of capital; safe assets scarcity (Caballero)**
- **The Crisis: growth prospects are dim**
- **Saving and investment propensities shift**

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....

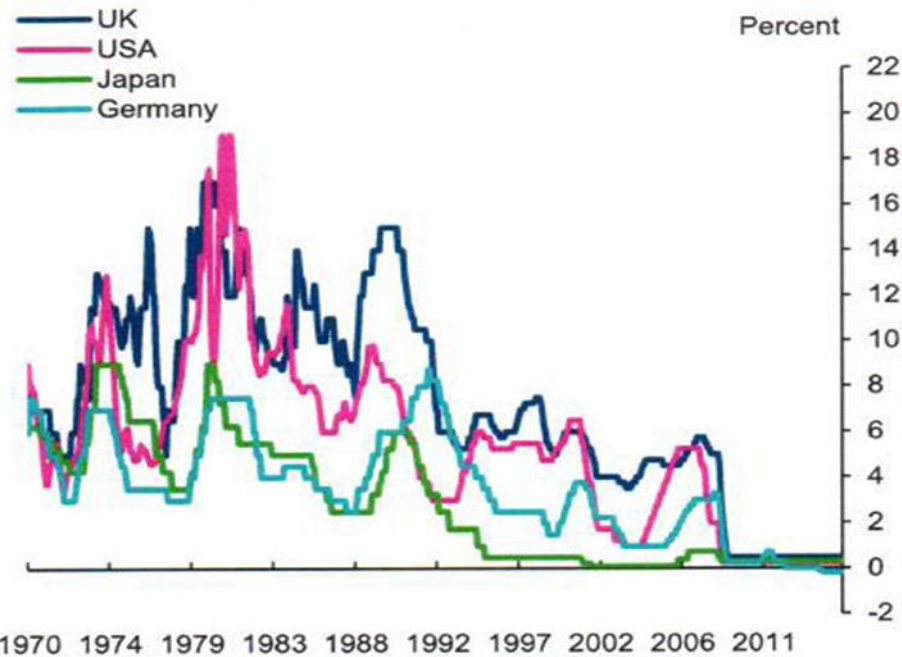
Shifts in desired savings and investment



Sources: Rachel and Smith, 2015

Policy rates since 1970 (Haldane, 2016)

Chart 3: International policy rates since 1970



Source: Datastream; Bank calculations.

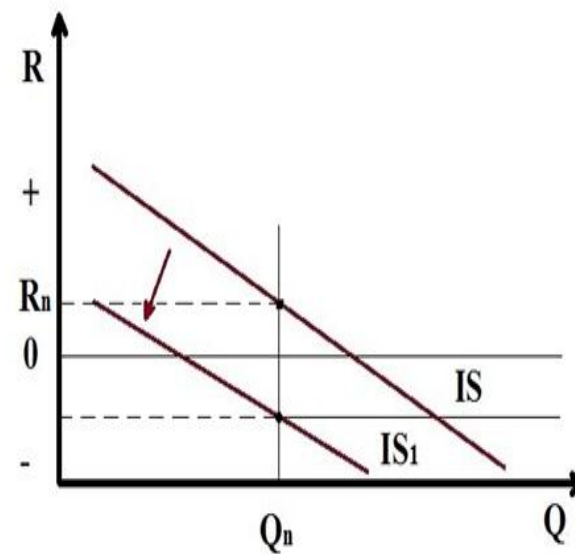
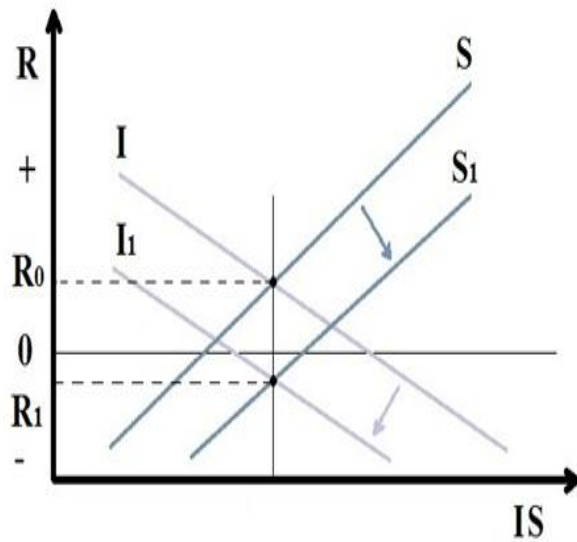
4.1.1 What do central banks?

- **CBs are hardly behind the fall of long term real interest rates**
- However, a role in **amplifying the *global financial cycle*** –*easy money*(resource misallocation...***financialization***....over-debt)
- **2 key questions:** a/ do negative natural interest rates (Wicksell) make sense?; b/ can nominal policy rates be negative, and can they be effective?

4.2 Do negative natural interest rates make sense?

- **In a frictionless environment they do not make sense;** natural rates should be positive and balance S and I at full employment of resources (*time preference*)
- **With large resource underuse, after a big crisis, rates can be significantly negative**
- **When inflation is very low, the ZLB bites and policies can turn unconventional(QE)**

Negative real interest rates as I and S curves shift



4.3 Are negative nominal policy rates feasible, are they effective?

- Bank of Japan, BoE, ECB, Danish CB, etc
- **Questionable effectiveness due to side effects (*a big trade-off*/Summers) and bad transmission**
- **Proxy for “competitive devaluation”?**
- Low rates and un-conventional measures have **diminishing returns**
- **Fiscal policy activism** (Summers, DeLong, IMF), **structural reforms, policy coordination**

4.3.1 Low inflation and regime shifts (I)

- If severe unemployment is dismissed, why inflation does not pick up? And why are inflation expectations persistently low? It may be that, as James Bullard argues, there is need for another narrative .
- The latter should be centered on a Fisher equation ($i = i_r + \pi \text{ exp}$), where (i) is the nominal interest rate, (i_r) is the real rate, and ($\pi \text{ exp}$) is expected inflation;
- With persistent low inflation, and when output and unemployment gaps disappear, Taylor's rule turns into a Fisher equation
- Since the real rate is determined by markets, the "pegging" of policy rates can be put in relation with enduring low inflation expectations
- It may be that markets take their cues from resilient low policy rates
- There can also be a "*regime shift*", which depends on productivity growth, real interest rates on short term government bonds, and the state of the business cycle.

4.3.1 Low inflation and regime shifts (II)

- **Optimal monetary policy is regime dependent. But, would this policy rate pegging and its impact on inflation expectations imply that policy rates need to climb again in order to move inflation expectations upwards? This would fit into BIS' view that policy rates need to move upwards to combat new speculative bubbles**
- **But, what if markets would not see it as a credible policy change, and inflation expectations continue to stay low due to low economic growth, low productivity, demographics?**
- **And what if raising the policy rate would be, yet, premature by risking a new recession (like in Sweden a few years ago)? In any case, this is a huge policy conundrum**

4.3.1 Low inflation and policy regime (III)

At zero interest rate policy (ZIRP) a Taylor rule collapses into a Fisher equation. Thus, $i = i_r + \pi(\text{exp}) + \mu \pi(\text{gap}) + \beta Q(\text{gap}) = i_r + \pi(\text{exp})$, where i is the nominal policy rate, $\pi(\text{exp})$ is expected inflation, i_r is the real interest rate, and output and inflation gaps are considered. When the unemployment and the inflation gaps close the Taylor rule turns into $i = i_r + \pi(\text{exp})$, a Fisher equation (James Bullard, “A tale of two narratives”, Saint Louis Fed, July 2016).

4.4 Could CBs engineer rises in real rates?

- **In the short run yes** -via massive sterilization
- **But that would likely trigger a new big recession, chain defaults, another banking crisis, etc (a Swedish lesson)**
- Economic conditions remain fragile; **a new recession could happen be IRs pretty low**
- **Policy rates should be raised carefully provided circumstances justify it...(Fed's moves are critical)**

4.5 MPs in European emerging economies (EEEs) (I)

- EEEs have undergone large macroeconomic adjustments in recent years.
- EEEs' overall public and private debt is almost half as a share of GDP compared to developed EU countries (their legacy problem is much smaller)
- Their USD exposure is relatively low/impact of Fed policy changes
- But they are facing significant dilemmas:

4.5 MPs in EEEs (II)

- If inflationary pressures grow, should their CBs raise policy rates while the ECB and other central banks continue setting very low? (speculative capital inflows).
- Is it reasonable to foster a reduction of currency substitution (euroization) by all means when euro adoption is mandatory at one point (the room for maneuver of monetary policy)?

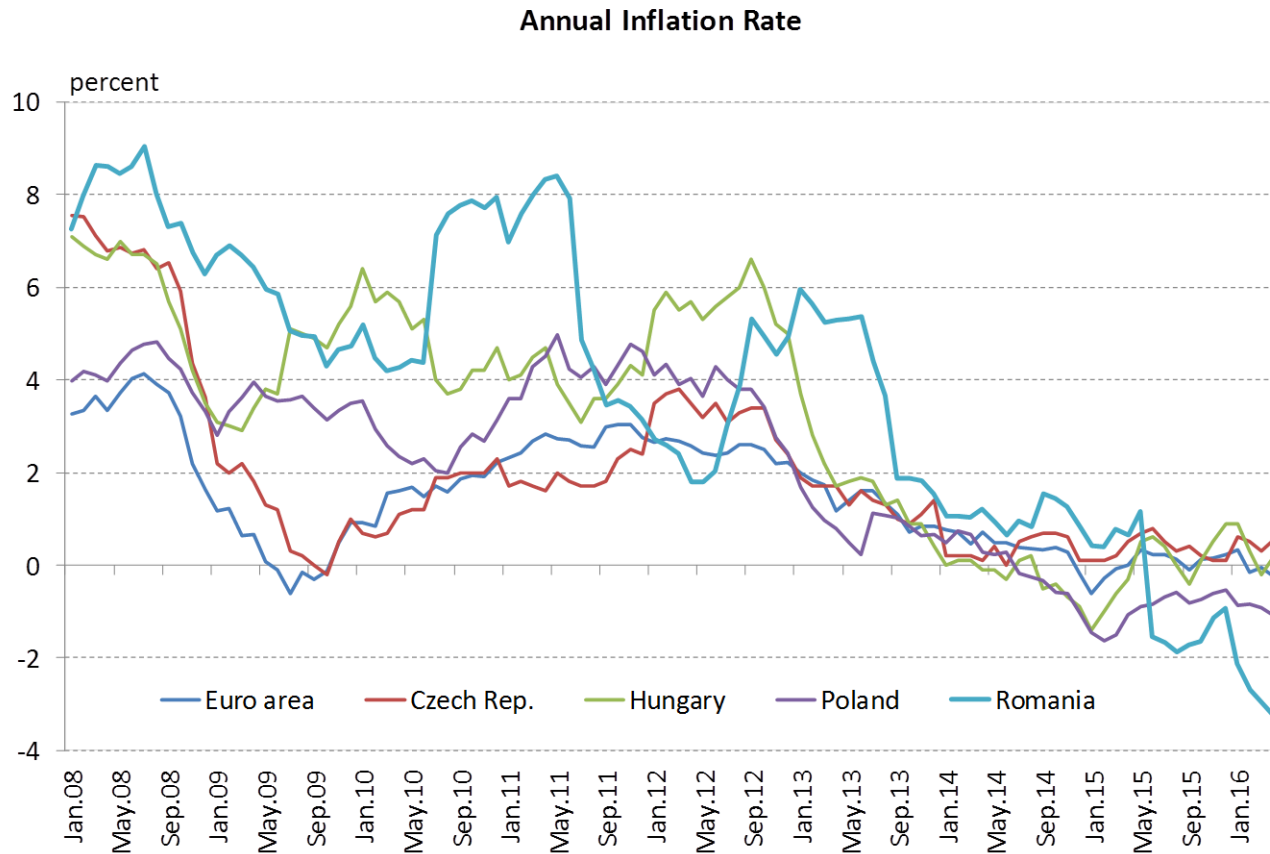
4.5 MPs in EEEs (III)

- If the *Impossible Trinity* is actually a dilemma (Helene Rey), then capital controls (as macro-prudential measures) may be needed. These measures require a good coordination among central banks, regulators
- Similar ECB facilities to those available in the euro area, given integrated markets, heavy presence of foreign banks in non-EZ banking sectors, high currency substitution

4.6 Policy rates in Romania(EMs)

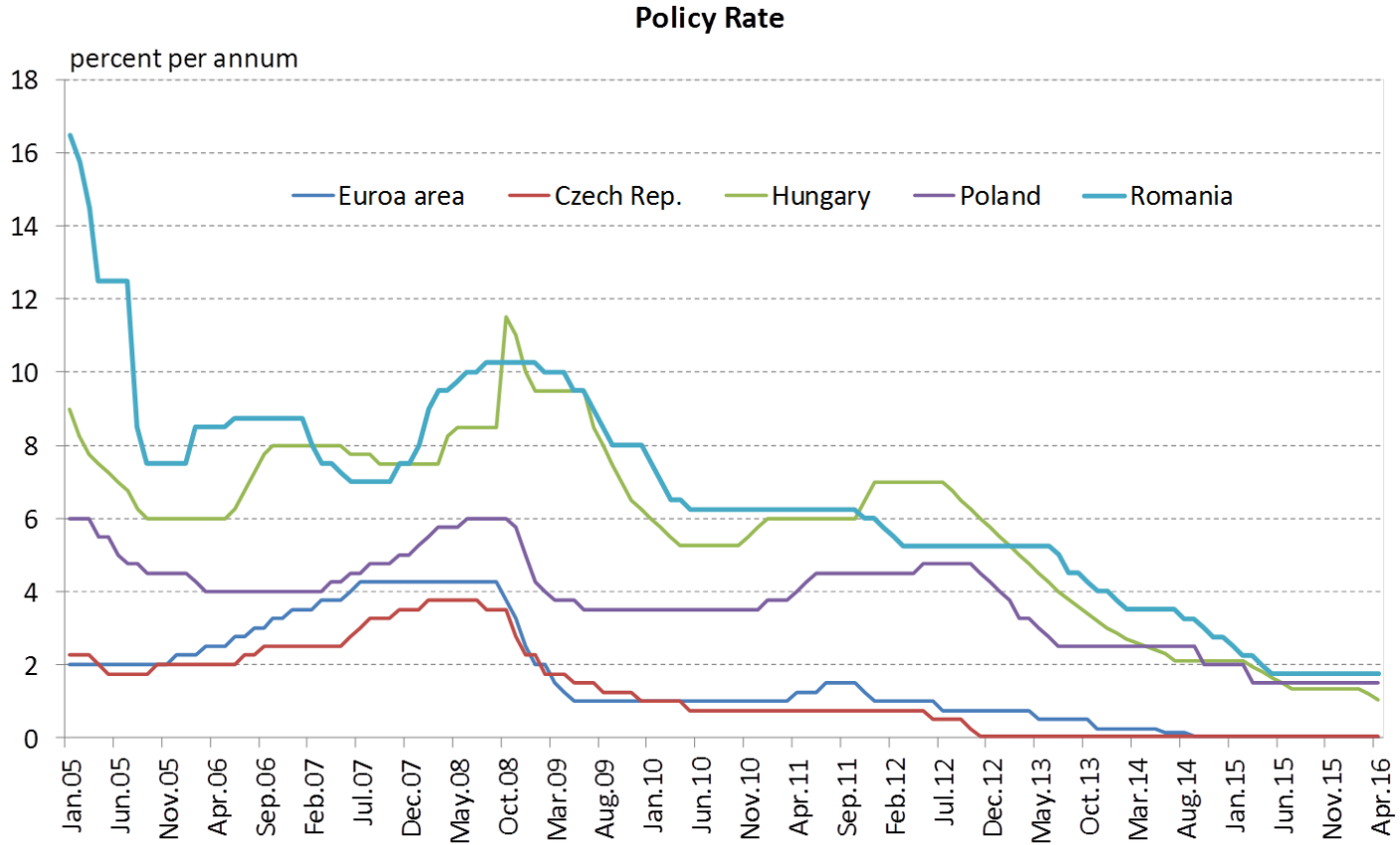
- **Conventional policies still available**
- Negative inflation: massive tax cuts (figure)
- Underlying inflationary pressures
- **Policy rates in neighboring economies/ECB rates constrain local monetary policy/MP** (a high policy rate differential is unworkable)
- Local money market rates reflect excess liquidity

Inflation



Source: central banks' websites

Policy rates



Source: central banks' websites

4.6 Policy rates in Romania (II)

- **MP can try to contain inflationary pressures, but can hardly offset budget policy slippages**
- **It would be good to have *fiscal space* when a major slowdown sets in (structural budget deficit has jumped to above 2.5% of GDP due to massive tax cuts and pay rises)**
- **Fiscal revenues at 28% of GDP --lowest in EU**

5. Banks under siege

- More severe **capital and liquidity requirements** (credit supply)
- **Less credit demand** (*debt-overhang*)
- Ongoing **balance-sheet repair** (FS-ECB report)
- **Reputational damage** (business conduct)
- **Competition** from *shadow banking*
- **Capital markets as alternative funding**
- Technological innovation; **fintech**

5.1 Risks abound

- **Capital markets are not devoid of systemic risks** (“too big to fail”, *sudden stops*/remember money markets tremors)
- “Credit cycle” in *shadow banking too*
- **CCPs as purveyors of systemic risks** (capital and liquidity requirements needed)
- **Do capital markets need a LoLR?**
- What kind of securitization....

6. Macroprudential policy (MPP)(I)

- MPPs need to consider drivers of financial cycles, whether there are policy drifts that derail these cycles;
- What drives the global financial cycle is critically important; the role played by market-makers' policies; for what could appear a justified macro-prudential measure to a major central bank, may cause tremors in other markets;

MPPs (II)

- There is, arguably, an optimal degree of financial liberalization, for emerging economies in particular (one reason being that they cannot borrow in their local currencies);
- Targeted capital controls can play a useful role in underpinning financial stability in economies that can be ravaged by massive flow reversals.

MPPs (III)

- There is need to think about and try to shape inter-connectedness (Haldane and May);
- The reform of 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;

7. Fintech and central banks (CBs)

- Supply creates its own demand
- It is still small scale; it can help SMEs
- Block-chain technology of interest to CBs
- **Banks will continue to dominate funding(EU)**
- Attention to frauds, illicit operations...
- Parallel currencies (bitcoin) and “parallel banking”? Low interest rates favor it.
- **Fintech be regulated (John Williams, SF Fed)**

8. A policy agenda

- Monetary policy rethinking? (White, Williams, Blanchard, etc)
- Financial stability: the big trade-off debate (Summers, Borio, Carmen Reinhart)
- Finance and banking reform (radical proposals: Admati and Helwig, Adair Turner, the Chicago Plan revisited, Mervyn King, etc)
- Repair of the euro zone
- A New Bretton Woods?

Challenges

- **Highly uncertain global environment**
- **Cognitive models** under question
- **Low economic growth** and **low inflation**
- **Disruptions** (*sudden stops*); **social strain**
- **Systemic risks**
- New technologies and “parallel markets”
- ***Complexity*** and ***fragility*** an issue for regulators/supervisors, CEOs (*compliance*)

- **Thank you**