growth, uncertainty and the policy regime

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- **uncertain prospects on world growth (revisions)**
- **low inflation, even where GDP close to potential**
- **durably low real interest rates (equilibrium)**
- **global financial volatility**

three possible explanations – that lead to opposite policy prescriptions

- **excess debt (debt super cycle). Problem on the "liability side"**

- **uncertainty inhibiting investment (secular stagnation). Problem on the " asset side"**

- **monetary policies fueling excess liquidity : abnormally low interest rates and financial volatility and misallocation of resources ("BIS view")**

super debt cycle hypothesis : prescriptions

- priority is to repair balance sheets
- if necessary through debt reduction
- a new international debt regime (CACs, GDP index linked bonds – discussed in G20)
- accommodative monetary policies can only prolong imbalances and resource misallocation ("zombification")
- they Increase the risk of financial instability and reduce potential growth

secular stagnation : prescriptions

- keep monetary policies accommodative (to align policy rates on equilibrium levels)

- engage into public investment as private investment is inhibited (the "Kennedy Airport" syndrome)

- more generally, supportive fiscal policies (no obsession with debt)

- secular stagnation is my preferred hypothesis

- but the way we deal with debt – both in policy and statements- is crucial for getting out of the " low inflation trap"

- this is because of the nature of current uncertainty (where debt plays a role)

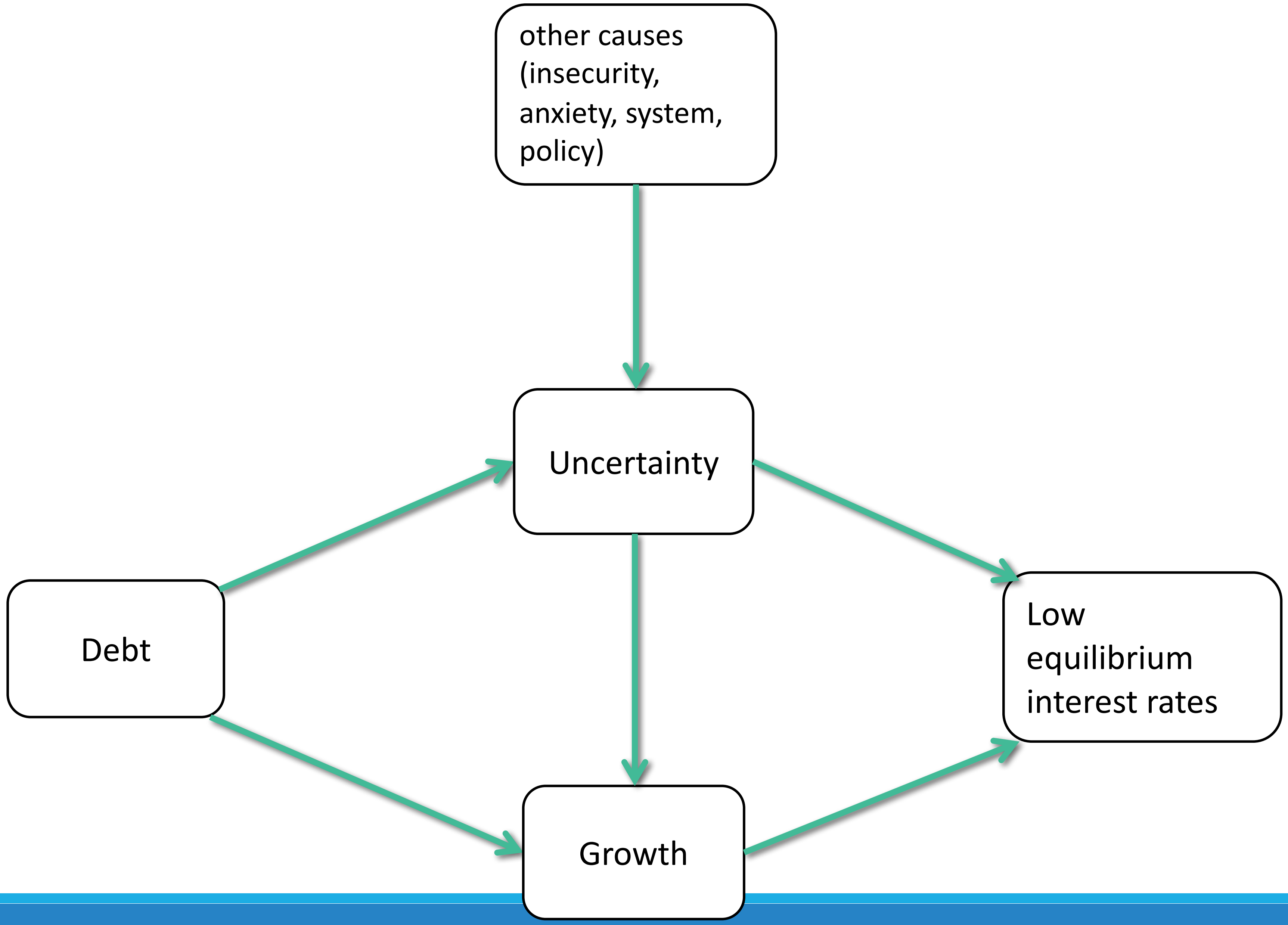
Why is "secular stagnation" an attractive hypothesis ?

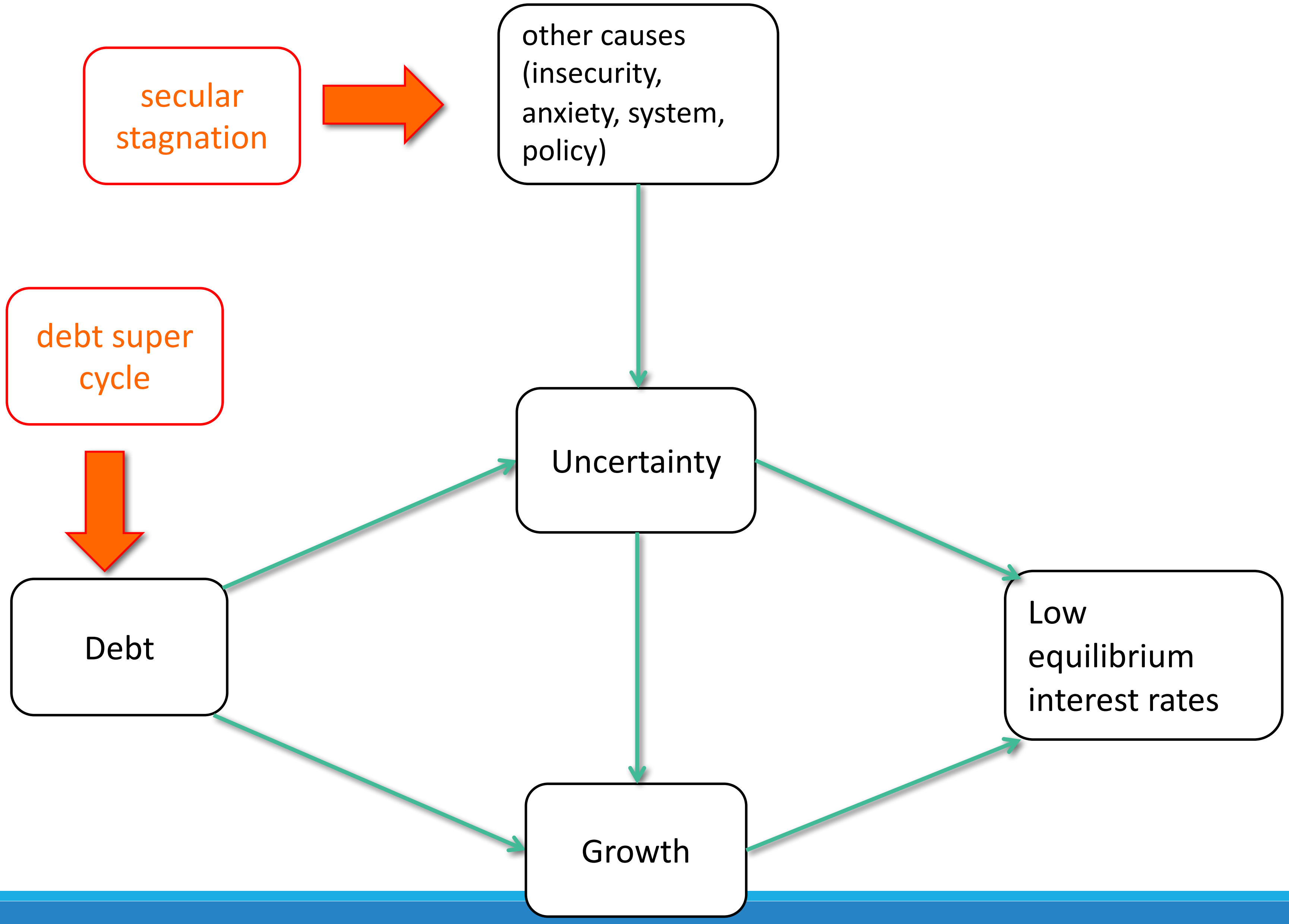
1. **Low levels of investment despite the most accommodative financial conditions in decades**

2. **Corporates are actually and spontaneously piling up more debt. No deleveraging. Debt does not seem to constraint investment**

3. **Part of this debt is high yield / light covenant and is used to buy back shares ("looting the future")**

4. **Profit shares are very high as well as cash hoarding ("dead money")**


other causes (insecurity, anxiety, system, policy)
Uncertainty
Debt
Low equilibrium interest rates
Growth


secular stagnation
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uncertainty and secular stagnation

- **uncertainty inhibits investment and stimulates saving : lower equilibrium interest rates**

- **an option value in waiting (investment has irreversibility attached to it)**

- **made even more attractive when the cost of opportunity of holding cash or liquid instruments is low**

sources of uncertainty : an unusual combination

- geopolitical / health - a new consciousness of "tail" – or "catastrophic"- risk (Gordon : permanently higher risk premia)

- technological (structural change)

- systemic– global financial integration/ (global monetary spillovers and capital flows volatility create uncertainty on the "structure of the world economy")

- economic inequality and insecurity

- policy induced

sources of economic uncertainty

1. **complexity**
2. **anxiety**
3. **policy**

complexity :structural changes in financial markets

- **maturity transformation increasingly performed by "funds"**
- **including cross border : role of portfolios flows in international capital movements**
- **an element of financial fragility**
- **and "non linearity"**
- **stronger reaction of asset prices to changes in risk perception (tamper and Bund "tantrums")**
- **amplified when interest rates are durably low (and risk premiums are drivers)**

R. Shiller : "Anxiety and Interest Rates: How Uncertainty Is Weighing on Us"

"Anxiety and uncertainty are weighing on individuals even where the overall economy is growing. Some of this angst is the fallout from advances in information technology.

Along with this enormous problem is the psychic cost of growing income inequality

I suspect that there is a real, if still unsubstantiated, link between widespread anxieties and the strange dynamics of the economic world we live in today <u>*— a link that helps to explain why it's not just short-term interest rates that are very low, but long-term rates, too".*</u>

- complexity and anxiety fuel each other

- impossible to ignore public opinions in thinking about global economic cooperation and architecture

- creates and "additional feedback loop"

uncertainty and the policy regime

- financial consequences
  - asset pricing is conditional on the policy regime
  - herding and co movements become more pronounced when fundamentals / policy regimes are uncertain
  - no stabilizing effect of arbitrageurs
- Real consequences
  - a pure "Keneysian" effect on marginal efficiency of capital : uncertain policy regime depresses long term "real" expectations

three examples of policy induced uncertainty

- **carbon prices**
- **capital requirements and capital structure for banks**
- **(China's) capital account and exchange rate regime**

how to contain policy induced uncertainty

- robust architecture : buffers. Increase in Forex reserves if not international regime of liquidity provision

- predictable reaction function for public authorities : importance of policy regimes
  - fiscal policy
  - monetary policy

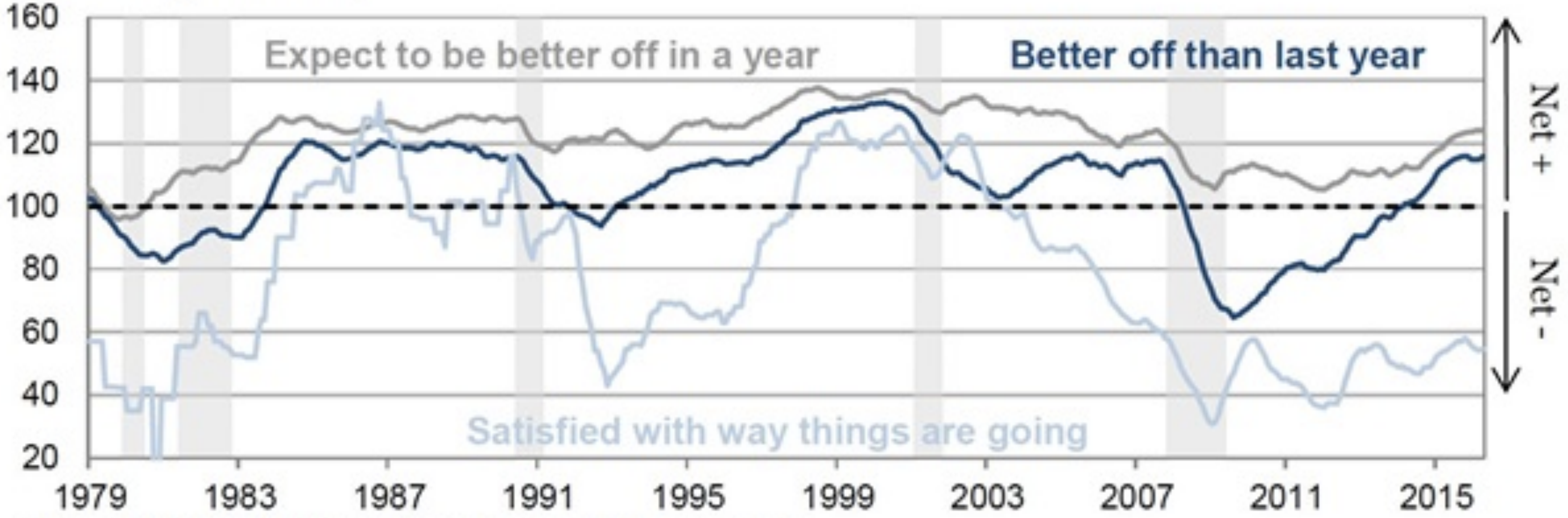
debt and uncertainty

- uncertainty creates the need for more "safe" debt (Forex reserves, collateral, flight to quality)

- divergences in debt regimes create:
  - additional uncertainty
  - less safe debt

Figure 1: Diverging attitudes

Attitudes towards personal finances and "the way things are going" in the U.S. have diverged recently.



Source: Michigan (Finances); Gallup (Way things are going).
Each line shows the percent who answered positively minus the percent who answered negatively plus 100. All shown as 12-month moving averages.

monetary policy and uncertainty

- monetary policy cannot fight uncertainty
- but monetary policy can aggravate uncertainty (if reaction function is ambiguous)
- importance of symmetric mandates
- pure data driven monetary policy may create uncertainty during exit from forward guidance (a shift in the policy regime)