The threats of transition, and the need to speed up the building of a robust market infrastructure

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New strains have arisen as the big G7 countries recover at different speeds, and their supportive national policies are expected to change accordingly. (You may add China's soft landing to the list.) The global scenario has been shaped by such policies, especially those providing extraordinary monetary stimulus after the crisis. Their expected transition to normalcy requires both careful handling and a resilient financial background so as not to cause collateral damage, hurt (and delay) the recovery path, or even backfire.

Adverse reactions tend to follow (or anticipate) key reversals in monetary policy towards restraint when the currency affected is also a source of global liquidity. Initial repercussions are frequently non-linear and, as a by-product of increased risk aversion and differing risk perceptions, carry strong distributional effects among countries.

Robust market infrastructure is a must if the risks of fallout from a crisis are to be avoided when extraordinary expansionary policies are reversed. Stress can be short-lived and manageable if financial and market infrastructure weathers the storm, or perversely feed itself if serious flaws are exposed. If this is the case, stress can easily turn into real economic damage. Slow motion is advised for policy-makers, but it is not enough that authorities drive with caution – and communicate clearly – as long-term effects might be discounted by forward-looking markets, thus triggering dangerous non-continuous phenomena like asset liquidations, sudden stops or overshooting jumps. (This is why infrastructure is so important.) Ex ante confidence in each country's own resilience and in the strength of the international architecture can help deter contagion and diminish uncertainty, so it is optimal that the proper wiring is put in place well in advance (and, if possible, periodically stress-tested).

International cooperation and coordination do play a crucial role in the transition to normalcy, but they will not govern the process. At the end of the day, policies are set according to national circumstances, criteria and interests. International repercussions enter the equation, but they carry less weight than local factors. So accommodation should be the name of the global game. It requires the anticipation of inflection points, the assessment of their likely consequences, and the design and installation of well-thought-out shock absorbers. Final outcomes will depend not only on local decisions, but on global linkages and the functionality of the international architecture. Some bargaining space – nowadays lacking – would also be needed. As a world forum that covers all levels of dialogue and discussion – from the most technical to the political top – the G20 is the best-equipped to shoulder many of these responsibilities .

Even if it were not all encompassing, policy-makers and economic agents would benefit if a guide map could drawn up in advance of the next crisis, covering information on authorities' forward guidance, economic projections, exit routes, infrastructure reports, and market positioning and sensitivities, as well as their expected interactions.

The lessons of 2013

On 4 April 2013, the Bank of Japan launched its 'quantitative and qualitative easing' by announcing its intention to double the monetary base by year-end 2014, through purchases of bonds and other long-term financial assets. For a country one-third the size of the United States economy, the quantity of transactions involved – almost 70 per cent of the monthly Federal Reserve's QE3 program, at current exchange rates – was a huge endeavour. International spillovers were quick and visible: a steep fall in global interest rates followed across the board. Investors rushed to buy fixed-income assets and other risky instruments in 'the search for yields' – a race to anticipate the reinvestment needs of Japanese institutions as they gradually sell their assets to the Bank of Japan (and, given the limits of their local market, might have to channel some of their funds abroad).

Only days later, on 16 April, one high-ranking Fed official, Janet Yellen, warned of the risks of excessive leverage and risk-taking. By mid-May, when Ben Bernanke, the chairman of the Fed, picked up the same argument, everybody noticed. His comment on the possibility of a QE3 tapering was a huge shock. All of a sudden, yield hunters began to be haunted by rising yields. The April bonanza completely unravelled and turned into a nightmare for a wide spectrum of financial assets (with a strong bias against emerging markets).

This situation cannot be simply explained as a case of conflicting national policies or of coordination failure. Central banks' bond purchases (paid by monetary base issuance) always add to liquidity supply. A tentative switch to buying fewer bonds means liquidity is still being injected, albeit at a decreasing pace. So there was no direct conflict between the Bank of Japan and the Fed initiatives. Both institutions were planning to increase their home liquidity pool (though one was increasing its efforts while the other was considering a possible weakening, subject to economic conditions). Recent market volatility is thus not attributable to liquidity unwinding, as this is still yet to officially happen. More to the point: the zero interest rate policy followed by the Fed is independent of the QE3 program. Fed officials were crystal clear that short-term rates would remain unchanged. According to their projections, the Fed funds rate will not increase before 2015. But the market was unfazed by this logic. While short-term rates did not move, (risk-free) long-term rates skyrocketed. The mere mentioning of 'tapering', unaccompanied by actual policy action, was sufficient to trigger a huge reversal in financial conditions and deliver an undesired and unexpected effective tightening.

It was a reminder that monetary policy outcomes depend not only on central bank decisions but also on their interplay with investors and other economic agents. In fact, private sector portfolio shifts prevailed. Their selling pressure drove yields way up as they reallocated their exposure to interest rate risk (by adjusting duration, credit and even geographical exposure). Was it a sign of communication failure? Not essentially. Messages coming from Fed officials were contradictory, and their forecast of a short-term pick up in GDP growth was a mistake (corrected in their September meeting), but that was not the key issue. Monetary accommodation will not last forever: when it ends, a front-loaded response – and as a consequence, an overshooting of long-term rates – might be the rational behaviour of the private sector, as each individual agent tries to stay one step ahead of the pack and avoid taking capital losses. Private sector anticipation is the sensitive matter.

Certainly, monetary accommodation is not ending yet (and will not for years to come). According to Fed, monetary accommodation might be peaking soon (or getting closer to a peak), conditional to economic performance. But effective financial accommodation – the net outcome of the whole interactive process – could have its best days behind it if the private sector does not backtrack. Investors that sold long-term Treasuries in May sit on comfortable gains. Unless the economy tanks again, they earned a huge reward for their anticipation. On the other hand, nominal and real long-term rates are now higher than they need to be. Growth and inflation have remained subdued, and both could suffer. The October US Government shutdown did not help either. So there's a negative feedback process occurring. Paradoxically, the attempt to engage with the exit road from QE3 led to an unexpected tightening. The economy might weaken. Politics could have made the situation worse. You need a strong financial environment to digest such unforeseen (but, in retrospect, unavoidable) setbacks. If it proves vulnerable, the exit road from QE3 might even lead to a QE4 (as occurred with the two previous QE programs). So financial robustness must be in place when expansionary policies are cancelled, or you might be forced to stay with those policies (and, eventually, their net costs) for far longer than otherwise would be advisable. In a nutshell, policy would lose its natural economic conditionality and remain captive to financial stability uncertainties.

International reverberations from the talk of tapering were even more powerful than in the United States. Consider emerging market economies: capital inflows turned into sharp outflows without notice. Currencies and all types of financial assets were severely hurt as risk aversion erupted and global liquidity dried up. As commodity prices sank, second-round effects punished those countries heavily dependent on their export revenue. Not only long-term rates shot up; short-term rates escalated too. In order to stabilise financial conditions and expectations, despite the deteriorating economic prospects, some local central banks were forced to tighten up. Current account deficits provide easy targets for attack as they are considered a sign of vulnerability per se. In 'sudden stop' scenarios, deficits are bad, surpluses are good. End of story.

Not only monetary policy shifts will matter in the future. The pending G7 agenda of fiscal consolidation – in the United States, in Europe and in Japan – stands out as another source of likely tensions on the international economic horizon. And more so if Europe needs to restructure sovereign debts or to purge its undercapitalised banking sector.

Stronger infrastructure and early warning system needed

The path advanced economies' must take in returning to normalcy will be a multi-stage, multi-year process. Success at one stage will involve opening the door to new risks at the next level, as stimulus and support policies are gradually scaled down. Their removal might prove to be premature, poorly conducted, reveal hidden collateral damage, or trigger adverse side-effects (which might be unexpected, or the combination of a positive effect at national level with a negative spillover abroad). A resilient economy and market infrastructure – capable of resisting sudden shocks and tail events – should be a priority. Financial system strength is at the core of the transmission process when shocks occur, so it must be given preferential treatment. Issues to be addressed include speeding up the pace of installation of the basic bank regulatory framework, dealing with the risk imposed by systemically important financial institutions (SIFIs) – that is, attacking the 'too big to fail' problem – and curbing risks from shadow banking. Regulation is not enough for success; nothing replaces the role of effective oversight.

To address this, we recommend installing an early warning information system at the G20, to detect potential threats in advance and monitor them (along with their cross-connections), and, as far as is possible, to enable the drawing-up of a ‘spillover map’. A better understanding of the private sector’s reaction functions and its expectation building process is needed.

The choices for emerging markets

Unwinding unconventional monetary policies will not be an easy task. These are unchartered waters. But disengaging from conventional policies was never easy either. Remember 1994, when Alan Greenspan’s Fed tightened, triggering the Tequila Effect in Mexico and sending shockwaves throughout Latin America? Nowadays, self-insurance – mainly through foreign reserves accumulation, as a by-product of flexible exchange rates cum intervention – is the true line of defence of emerging markets. That means tying up national resources that could be more useful elsewhere, and creating a distortion in the balance of worldwide growth. A stronger international safety net could be a useful alternative for infrastructure building purposes if able to provide access to elastic external financing under conditions of stress (either through expanding IMF lending capacity, bilateral swap lines, etc.). Otherwise, less financial integration could work as a ‘second-best’ buffer.

Bear in mind that G7 extraordinary policies favour local currency appreciation, rising asset prices and faster credit growth, such that a sudden reversal is a recipe for trauma. If external financing dries up, emerging market countries will better absorb adverse shocks if they avoid current account deficits and carry a strong forex position in reserve. Due to well-known asymmetries in the international monetary system, macroprudential national policy could prefer an unbalanced approach (that is, a current account surplus rule) as a more sustainable growth strategy – more so if volatile times are perceived to lie ahead.

Notes

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