The future of globalisation and challenges for advanced economies

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An ECB colloquium held in honour of Vítor Constâncio

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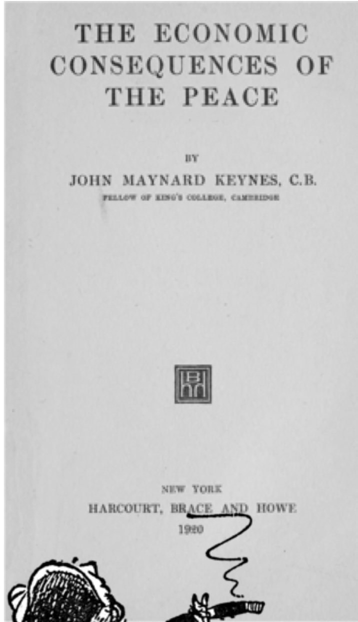
Globalisation cannot be taken for granted

In **1920**, Keynes wrote in *The Economic Consequences of the Peace*:

« What an extraordinary episode in the economic progress of man that age was which came to an end in August, 1914! … The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, ….; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble, in their prospective fruits and advantages; ... »



THE ECONOMIC
CONSEQUENCES OF
THE PEACE

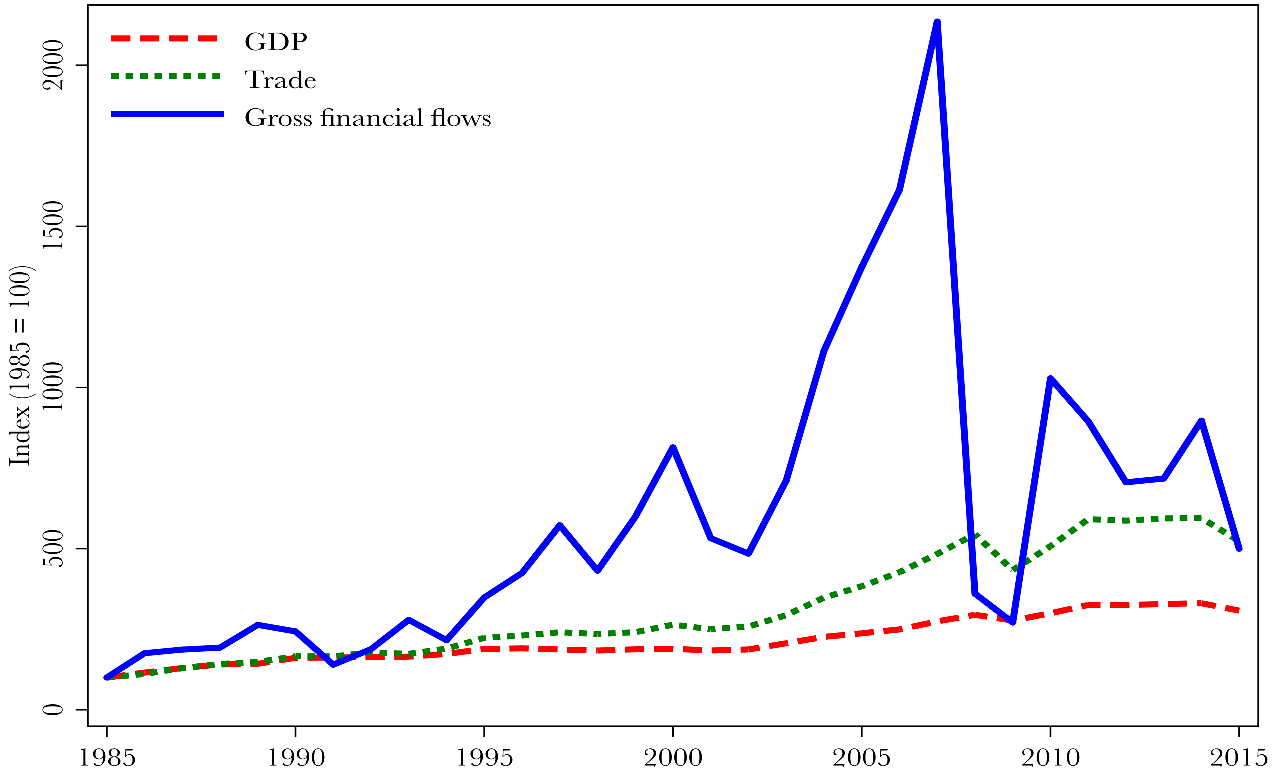
BY

JOHN MAYNARD KEYNES, C.B.

NEW YORK
HARCOURT, BRACE AND HOWE
1920

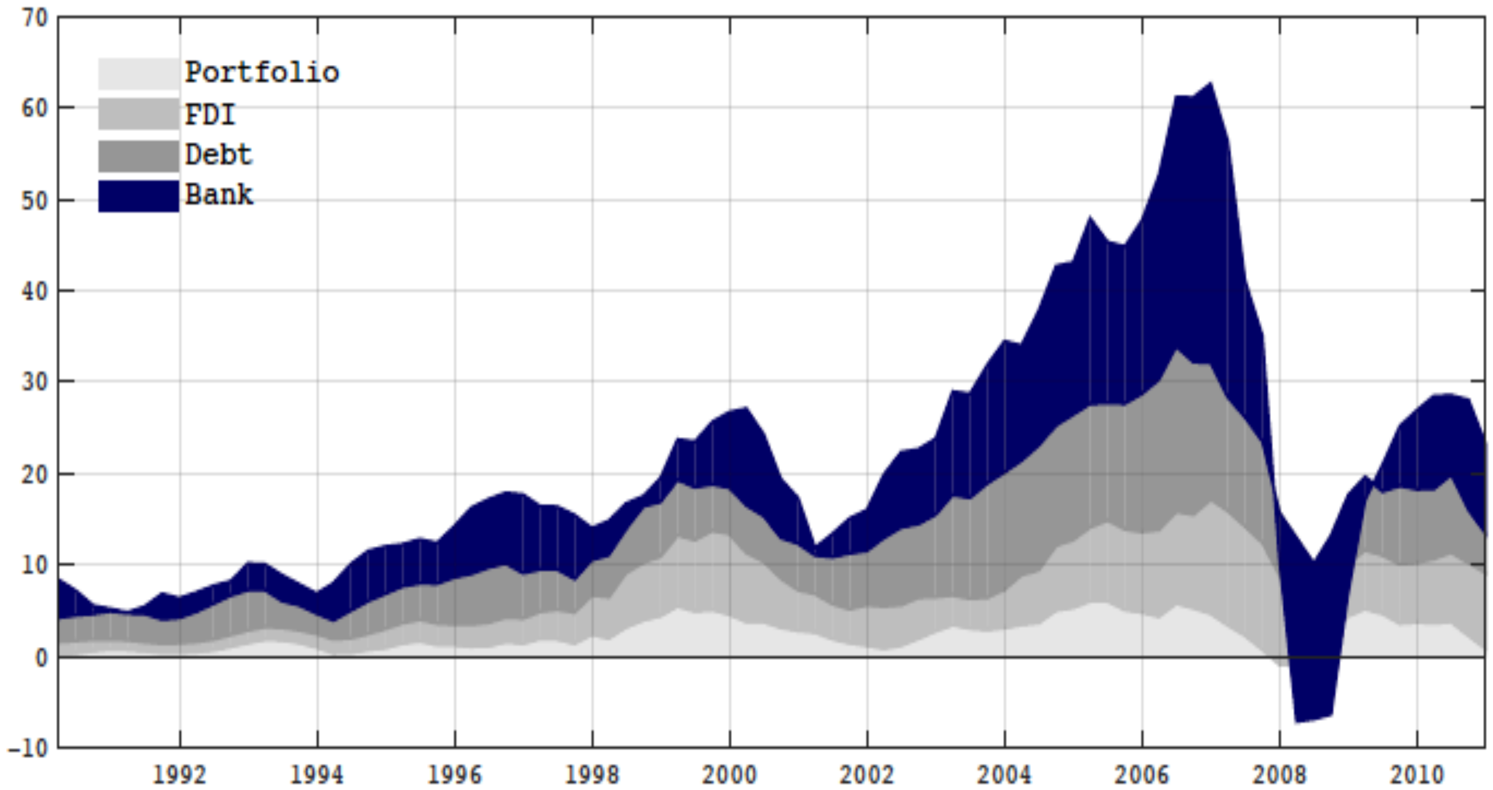

FREE SOUP

Financial globalisation is upon us



Source: Obstfeld and Taylor (2017) from IMF data. In Adrian (2018)

Flow Components



Source: Miranda-Agrippino and Rey (2015)

Global Financial Cycles

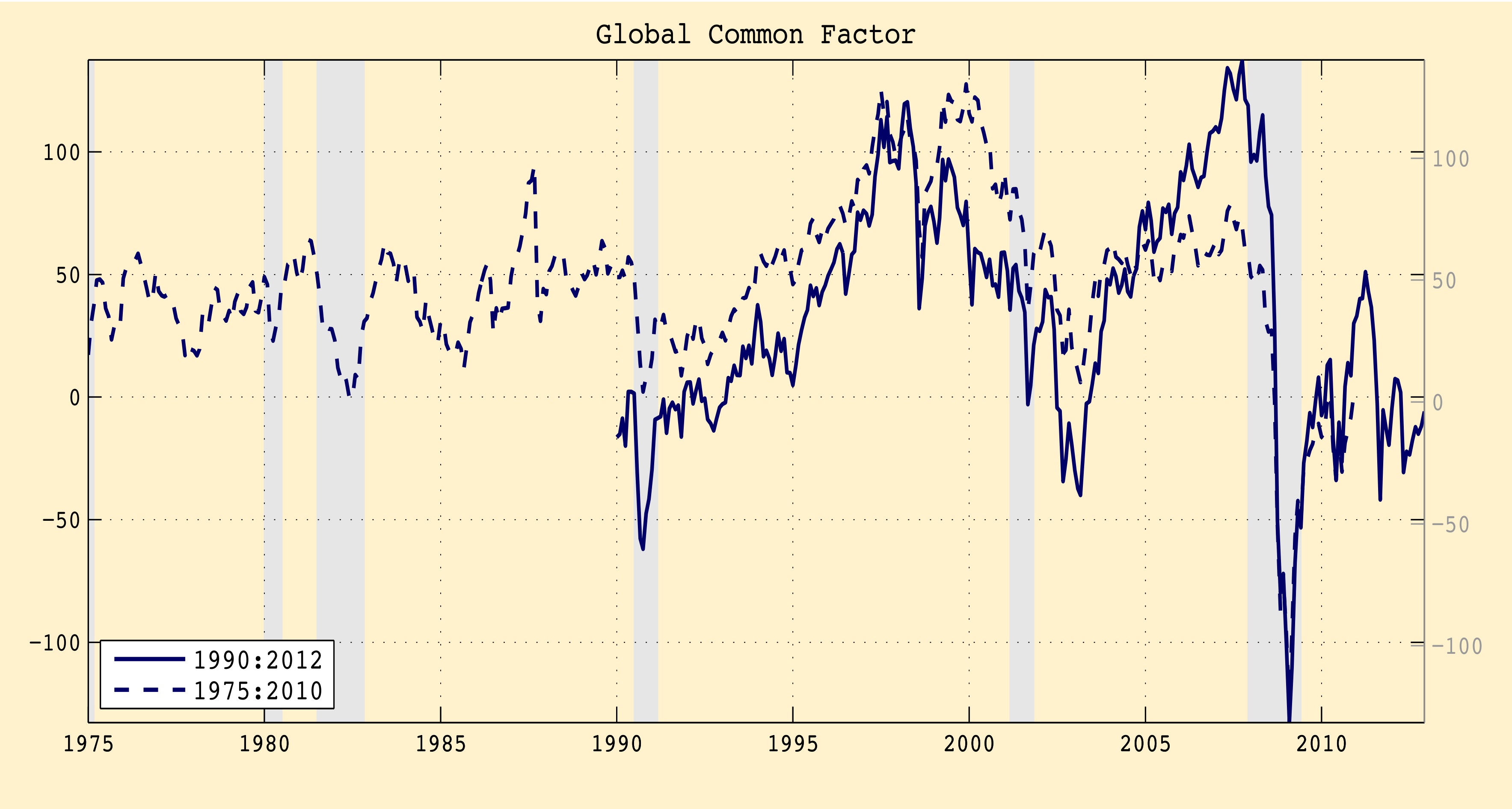
- Fluctuations in financial activity (risk taking, credit creation, asset prices, capital flows, spreads, leverage) on a global scale (Rey (2013)).

- Growing body of evidence on the importance of Global Financial Cycles:

  - Macroeconomic data (one global factor in asset prices explains about 25% of fluctuations in risky asset prices around the globe,…)

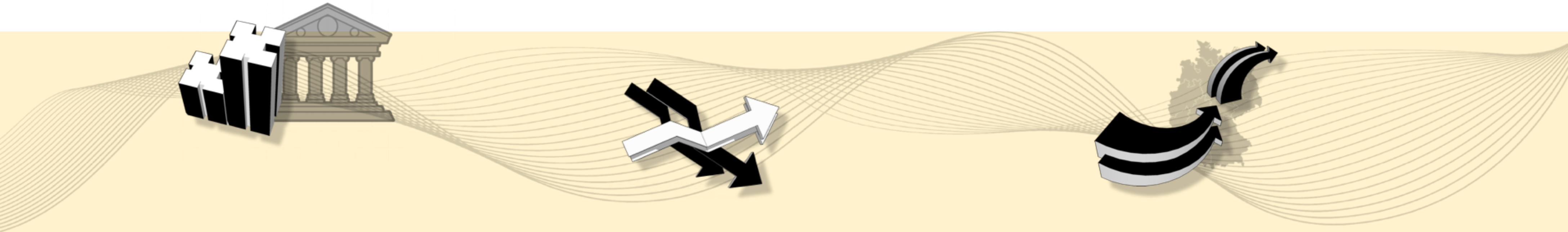
  - Microeconomic data: detailed data on Turkish banks (Baskaya et al. (2017)) find that 43% of local credit growth is explained by capital flows.

Global Factor in Risky Asset Prices



Source: Miranda-Agrippino and Rey (2015)

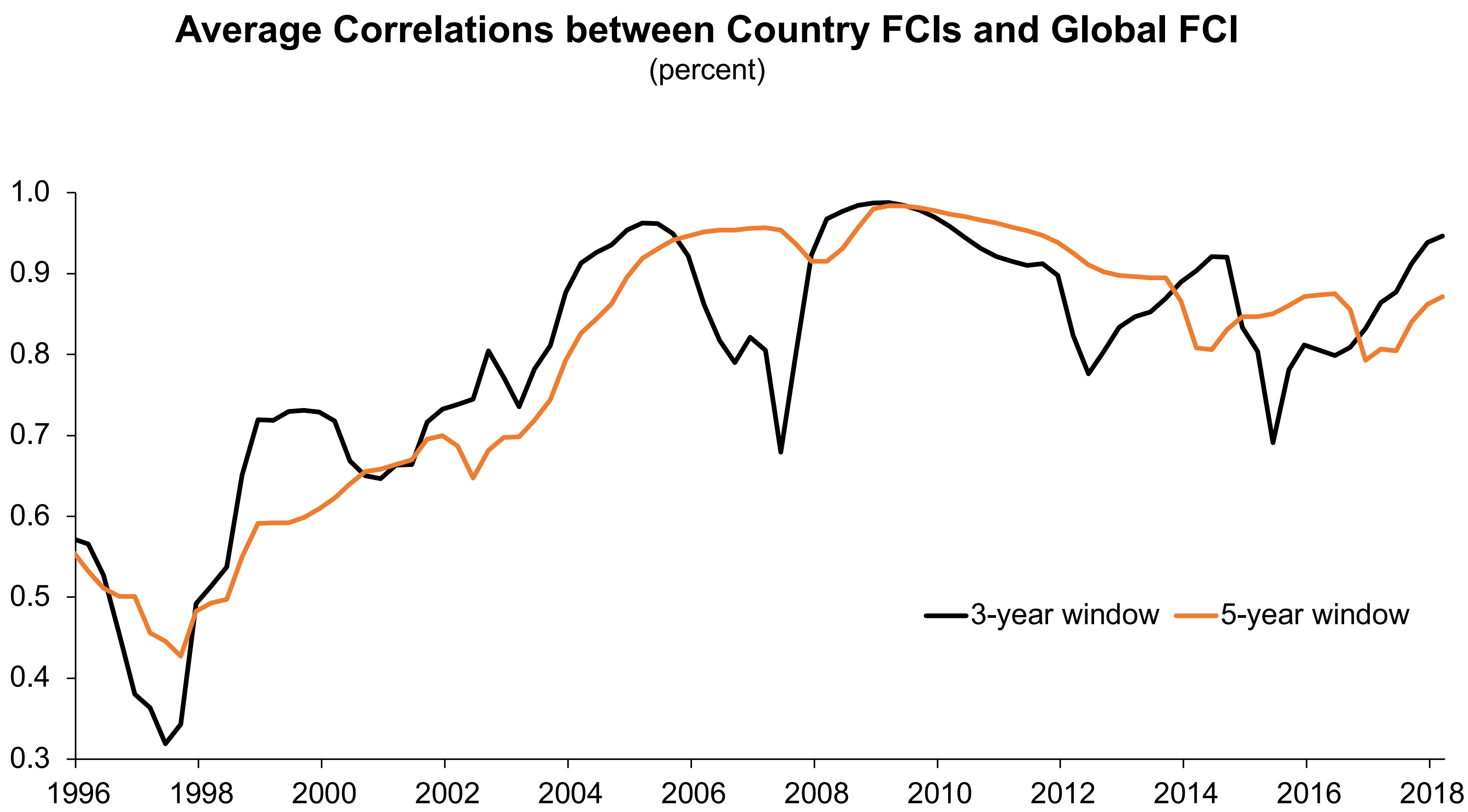
Global Financial Cycles



- Growth of credit and of leverage of large banks tend to be synchronised across main financial areas
- Risky asset prices move up and down together
- Gross financial flows move together into and out of countries.

Source: Rey (2013)

Global Factors and Domestic Financial Conditions



Source: IMF staff, GFSR April 2018. Adrian (2018)

What drives the Global Financial Cycle?

- Miranda-Agrippino and Rey (2015) shows that US monetary policy is a driver of « **global risk appetite** »

- In particular, US monetary policy affects **leverage** of US broker dealers *and* of large Euro area and UK banks.

- Research Network of Central Banks **meta-analysis** of effects of foreign monetary policy on domestic lending: ”Most teams identified significant effects of US monetary policy, and some teams also found effects from **euro area, UK and, Japanese policy**”.

Global Financial Cycle: Booms

Crises are booms gone bust

“History illustrates that there is a spontaneous tendency for finance to increase leverage and maturity transformation without considering the potential social costs of an overall excess of credit and debt and the crashes that may follow.”

Vítor Constâncio, Speech, Rome 9 November 2017, The future of finance and the outlook for regulation

Global Financial Cycle: Booms

Plan of action:

"… macroprudential policy is now available and is the most effective tool for safeguarding financial stability. This is because policy instruments directly address excessive leverage behaviour and do not have the same cost or negative spillovers of a "leaning against the wind" policy."

Vítor Constâncio, Speech, Financial stability risks and macroprudential policy in the euro area, Frankfurt 14 March 2018.

Work ahead of us

- Which early warning tools should we use to identify early enough the dangerous booms? (« bad booms »)
- Early warning indicator models are unstable (macro variables co-move a lot) and not that robust: they overpredict crises, miss some.

Possible solutions:

- Use more micro level data (in particular on intermediaries balance sheets). Track better on which balance sheets the risk concentrates. Coimbra and Rey (2017) shows that the skewness of the leverage distribution of intermediaries is linked to systemic risk.
- Use more robust techniques (learning algorithms)

- Emphasize more the interaction between fiscal instruments and macro prudential policy.
- More debate on the impact of mortgage subsidies on financial stability

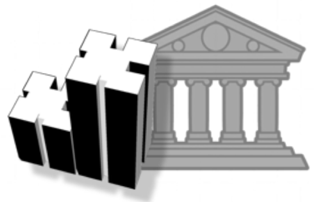
Global Financial Cycles: Busts

- Busts: The 2008 crisis has many similarities with Great Depression. « Roaring 1920s » and « Exuberant 2000s ». (Gourinchas and Rey (2017))
- In both cases large busts because of massive leverage.
- Plausible interpretation of current low real rates is period of deleveraging post the 2008 crisis (similar as in the 1930s).
- Macroprudential policies can help reinforce expansionary monetary policy during busts by reducing countercyclical buffers (provided they were up!)
- Important role for fiscal policy as well.

Conclusions

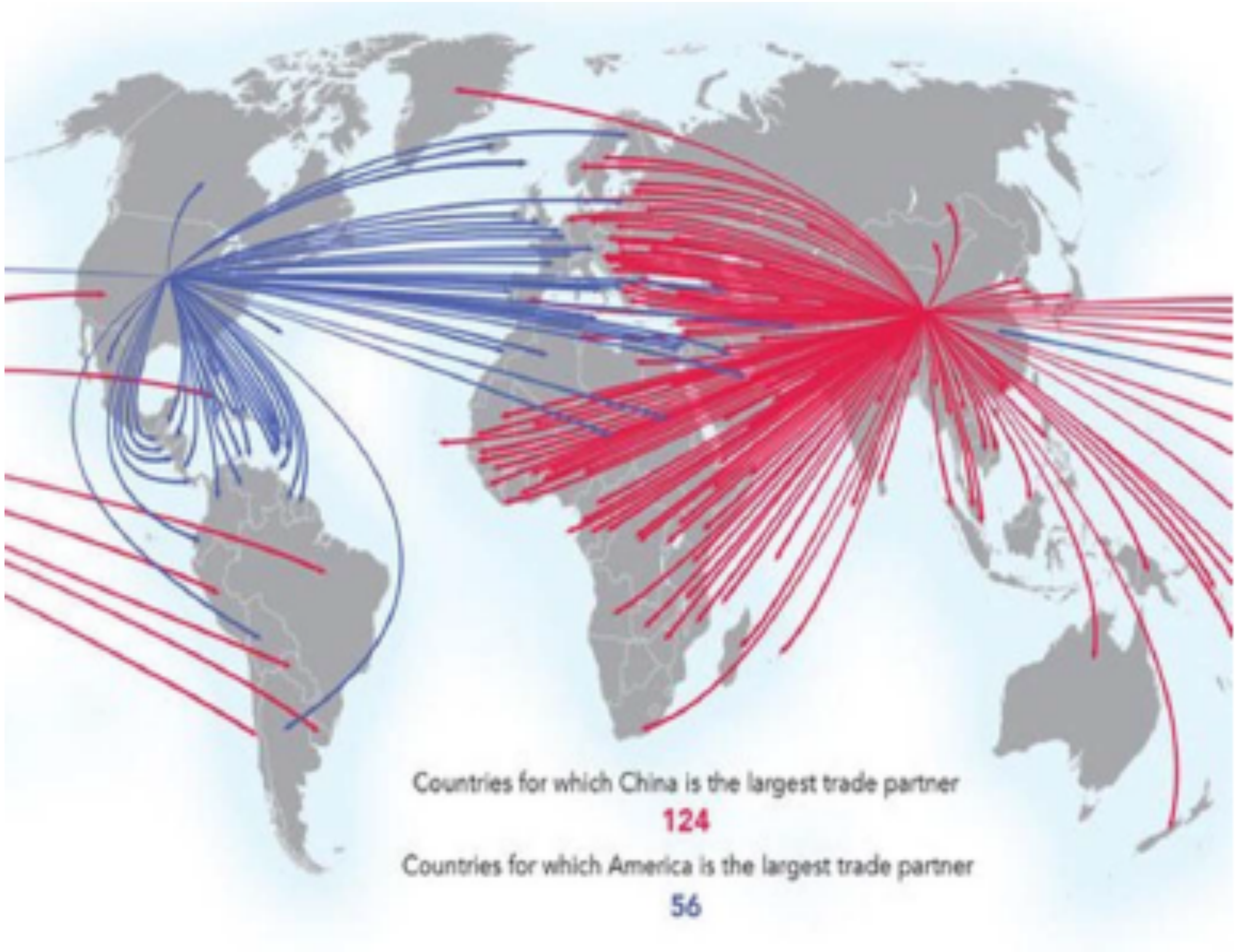
"We should not allow the memory of the financial crisis we went through to be dissipated in the fog of vested interests."

Vítor Constâncio, Speech, Rome 9 November 2017



- Current situation: global risk appetite may be about to decrease. Until recently Fed tightening partly offset by ECB, Bank of Japan and Dollar weakness.
- Many countries did not put up the counter cyclical buffer and have public finances depleted by past recent crisis.
- There is little fiscal space and little macroprudential space if risks materialize.

Who knows what financial globalisation will look like?



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