April 2017

Roundtable Bulletin[1]

GEOPOLITICS AND FINANCIAL STABILITY

Today many people feel they are victims of globalisation. They are unable to understand the benefits of trade and feel they have 'lost control'. Even though the world at large has benefited over the long run from open trading arrangements, the rewards have not been evenly distributed. There have been winners and losers from globalisation and the losers have not been compensated. 70% of the population in the industrial countries is worse off than in 2009. Their incomes have fallen and some have lost jobs: yet this job destruction is not understood. In addition the 1% who have gained the most have failed the 99%. The elite have been inattentive to the issues, particularly to the question of income distribution.

This has triggered a reaction against the elite. There are three elements in the populist political reaction now felt in many countries in Europe and in the USA. First, they have reacted against the system at large. Second, people believe that they will be better protected by closing borders and rejecting multilateralism. Third, these concerns have led to strong calls for protectionism and to a revival of nationalism.

Brexit was a manifestation of a rise of nationalism; it was a reaction to immigration, particularly from Eastern Europe and an expression of a desire to get a better deal in Europe. This latter is a delusion. The UK cannot both recover sovereignty and enjoy the benefits of an economic union it is not a part of. It will have to wake up to this reality and this may trigger nationalistic reactions.

The US displays some similarities. There is a reaction to lower incomes and de-industrialization that are attributed to globalisation; this reaction also denotes a desire to return to the past, to recover "American values" and to put America first. President Trump wants to bring manufacturing back to the US, but the US may not have a comparative advantage in manufacturing. As a result nationalism may lead to slower growth. Equally the US is losing its status as a country that provides a moral benchmark. Demagoguery is taking its place. It is unclear too where regulation will go, but there is a risk that the emerging market economies (EMEs) will be reluctant to adopt international standards if the US rejects them.

What seems clear in UK and USA is that there is a desire to be a master of their own destiny that will give rise to tensions. Such tensions could well spill over into forms of financial instability.

In addition the following specific issues have emerged in the mature economies:

- It is ironic that populism and protectionism have flourished at a time when the US is the fastest growing of the industrial countries and it has become independent of imported energy.

[1] Synopsis of themes considered at roundtable discussions in April 2017. The views expressed do not necessarily reflect those of the participants. Roundtable discussions take place semi-annually. Participants included Jacques de Larosiere, Donald Kohn, Guillermo Ortiz, His Highness Mohammed Sanusi II, Andrew Sheng, Sir David Walker, Dr Aziz Zeti. The discussions are moderated by Dr Gavin Bingham and Sir Andrew Large.

- Populism can lead to the emergence of strong men. The question is whether institutions are well enough embedded to prevent their rise or moderate their behaviours.
- The rapid expansion of social media in the last five years has permitted the disaffected to communicate with each other. Their alienation is founded on mistrust. Companies are not trusted in part because of share buy-backs and other financial operations driven by myopia and short-termism, encouraged by an undue focus on quarterly earnings and an attempt to manipulate them.
- Much has been done to make the financial industry trustworthy but there is a paradox. In the past banks were trusted but they were not trustworthy. Now they are trustworthy but are not trusted. This can spill over to central banks; they need to be attentive to their position.
- Multinationals do not tend to engage with local economies. They are criticised for failing to make fiscal contributions in countries where they operate. New business models are needed in which companies are locally more accountable.
- The present malaise is diverting attention away from collective areas of major concern such as climate change which risks remaining unaddressed.

Conditions are different in EMEs. Their citizens have clearly benefited. Since the early 1980s more than 400 million people have been lifted out of deep poverty (living on less that USD 1 per day). Losers however exist, and they feel that they have not been compensated. Long term recipients of direct foreign investment have run huge balance of payments deficits, including through outward dividend payments. Yet the companies do not re-invest the returns from such investment locally.

Some EMEs have themselves seen the migration of production to even lower cost countries, stimulating the need for significant flexibility. Unlike the reactions in the mature world, they have not closed their economies but rather moved into new areas, with investment in training and education.

Low for Long and QE: the implications for central banks and financial stability

The unintended consequences of quantitative easing (QE) for financial stability suggest four areas of concern. Policymakers need to mitigate risks in each of these areas.

Market and investor related issues

QE has reduced interest rates along the yield curve by lowering term and risk premia. In this respect, it has been a success and facilitated the financing of government debt. However concerns arise in several areas.

Market dynamics and herd behaviours are hard to model. The risks of volatility in the provision of essential services or to the resilience of banks are difficult to determine. Several factors could exacerbate volatility, even if it is not clear where the disequilibria are. Investors' risk appetites have been compromised by both a search for yield and an indifference to liquidity and credit risks. Dangers of fire sales are therefore greater, even though in terms of distortion some prices, such as real estate, do not seem high relative to bond rates. The quantum of market liquidity has been compromised by post crisis regulatory reforms affecting banking structure [Volcker, Vickers etc.] and regulatory capital [Basel etc.]. Banks can no longer so easily act as market makers.

These concerns evoke several notable responses:

i. At present we do not know whether exit from QE will have adverse consequences for financial stability. Yields have in fact risen slightly but they are still close to record-low levels. A positive sign is that stress tests in Europe suggest that banks can weather QE exit.

ii. An interesting feature is the differential dynamic experienced in Europe and the USA. In the Eurozone, some two thirds of the issuance of government debt has been purchased by the ECB. QE is intended to prompt private investors to move into corporate debt and equities. This has happened in the US but not in continental Europe. In Europe low rates have had the perverse effect of prompting saving. Because investors earn so little on their assets, they save more to build up their asset holdings.

Compromised banking model and issues from the rise of 'non-banking' and FinTech

Concerns exist that banks' profitability, business models and resilience are compromised at the zero bound given the difficulty of levying fees and charging negative interest. Customers are turning to non-banking alternatives both for credit and to secure returns on liquid assets [in place of deposits]. Some of these alternative suppliers are regulated; others are not. At a different level the resilience or solvency of insurers, especially providers of guaranteed-return products, has been compromised by the lower returns on the assets that regulators require them to hold, with potentially damaging consequences.

At the same time FinTech developments have raised questions about the role that banks will play both in payments and wealth management. Distributed ledger technologies offer both an opportunity and a threat. The segregation of investment advice from execution and custody calls into question the sustainability of the traditional asset management practices of banks.

Asset managers act as facilitators of the investment strategies chosen by investors but they may take correlated positions when they use similar models or approaches. This can lead to crowded positions. And where securities are created, new points of potential failure arise in relation to supporting infrastructure: the concentration of risk in clearing houses is a concern.

Our understanding of financial stability implications of the 'rise of the non-bank' is more limited than it is for banks. We have some understanding of the causes of, and mitigants for, bank runs: but less in relation to risks arising from investors, shadow banks, or those beyond the regulated boundary.

Against this background the following reflections are salutary:

- Banking institutions with diversified balance sheets and diversified activities (with no more than 20% of their revenue arising from any one activity) have done well. None have confronted existential issues. The problems have occurred in institutions focusing on a narrow range of activities. Concentration creates problems. The BCBS's solution is more capital. This is an indirect and slightly naïve approach as it does not address the underlying problem.
- Regulators' responses to the new conditions are not focused enough on issues related to asset market liquidity. Gating of funds placed with asset managers who do not have enough liquidity is one possible response. When applied to funds specialised in commercial real estate, the measure worked well and did not spill over to other market segments or have adverse systemic consequences.
- Several regulatory deficiencies are notable in the face of the threats:
    - Clearing houses need stricter supervision, with more emphasis on financial risk management while not ignoring operational risks.

- There are questions about the adequacy of risk management in the face of a rise in interest rates affecting the market value of holdings of long-term debt.
- Resolution arrangements are inadequate in most European jurisdictions, with the possible exception of the UK.
- Present accounting conventions remain a source of confusion in insurance.
- Gating requirements set by supervisors will need to be further examined. This could be welcomed by the asset management industry since no asset manager wants to be a first mover.

The challenges for central bank finances arising from QE

QE has led to an enormous increase in the size and composition of the central banks' balance sheets. They now hold portfolios of longer term assets of varying risk characteristics funded with short-term liquidity placed with them by banks. On the one hand it seems difficult to return to previous balance sheet constellations quickly as central banks will not themselves want to engage in 'fire sales' of their QE assets. On the other, they will incur losses on their holdings in mark-to-market terms as interest rates rise back to what were normal levels before QE.

The issue may be one of perception, not reality. The 'solvency' of central banks is not the issue. Central banks can and have operated with negative net worth. Some can draw on seigniorage. All benefit from a government guarantee. Policy considerations and in particular the need to meet an inflation objective will dominate the need to make transfers to the state; failure to deliver price stability would generate greater calls for accountability than a decline or disappearance of transfers to the government.

Political issues and independence

A range of concerns have been expressed regarding the consequences of QE, including asset price distortion. This gives rise to special pleading that may have been exacerbated by tendencies towards populism.

It has perils for central banks as the agents of QE particularly since QE gets central banks confusingly close to the fiscal arena. This raises questions of compromise of their independence. For example, when central banks buy large proportions of their government's debt issuance, they enter into the fiscal arena. Rising interest rates would increase the cost of servicing the debt and lead to fiscal upheaval. Equally should trade wars occur, central banks will inevitably get drawn in to the necessary response. In addition, losses that central banks might incur as they manage their balance sheets down in exiting QE may be misunderstood and could lead to calls for curbs on their independence.

Without a solid communication strategy, central banks are vulnerable. It is important for central banks to communicate in normal times as well as in crisis. It is crucial for them to explain what they are doing, so that there are no surprises for stakeholders. Having the media's understanding is essential.