



BANK FOR INTERNATIONAL SETTLEMENTS

The end of complacency: exiting a “Goldilocks moment” without creating a new “Minsky moment”

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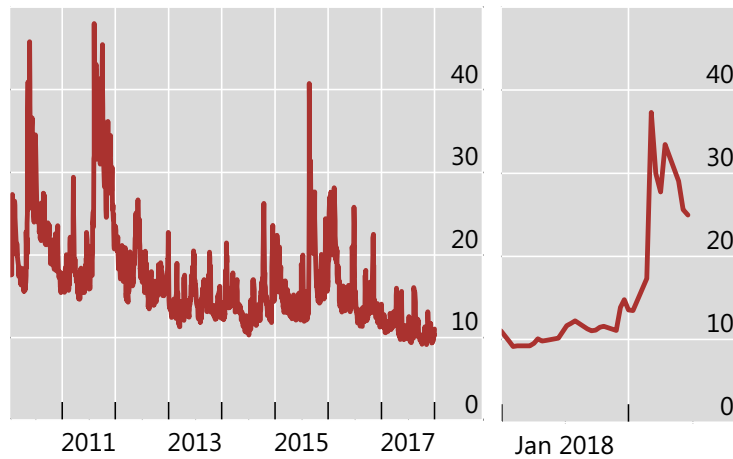
(*) The views expressed here are my own and do not necessarily reflect those of the BIS.

Are we well equipped to deal with new repeated episodes of market turbulence (such as last week)?

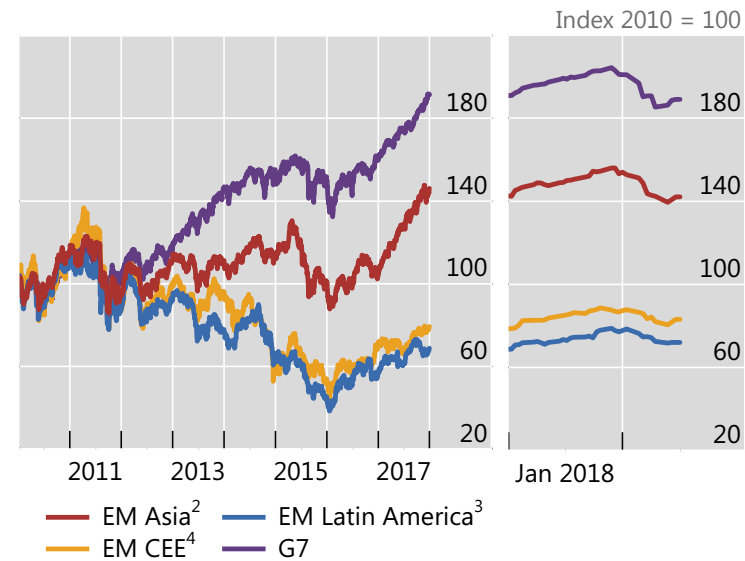
- “Technical corrections” in equity markets are normal, sometimes welcome (end of complacency?) but could be prelude to more vol as excess valuations can be corrected more abruptly
- If corrections trigger contagion to other markets or too abrupt adjustment → financial stress might arise → how big? How to react?
- Context of limited policy space (high debt, close to ZLB), uncertainty about future fiscal-debt nexus in some AEs; about if/when inflation shows up → and about what would be MP reaction then?
- Multiple equilibria situation could make markets over-react

Volatility is baaaaacck..... with a vengeance?

Volatility index (VIX)¹



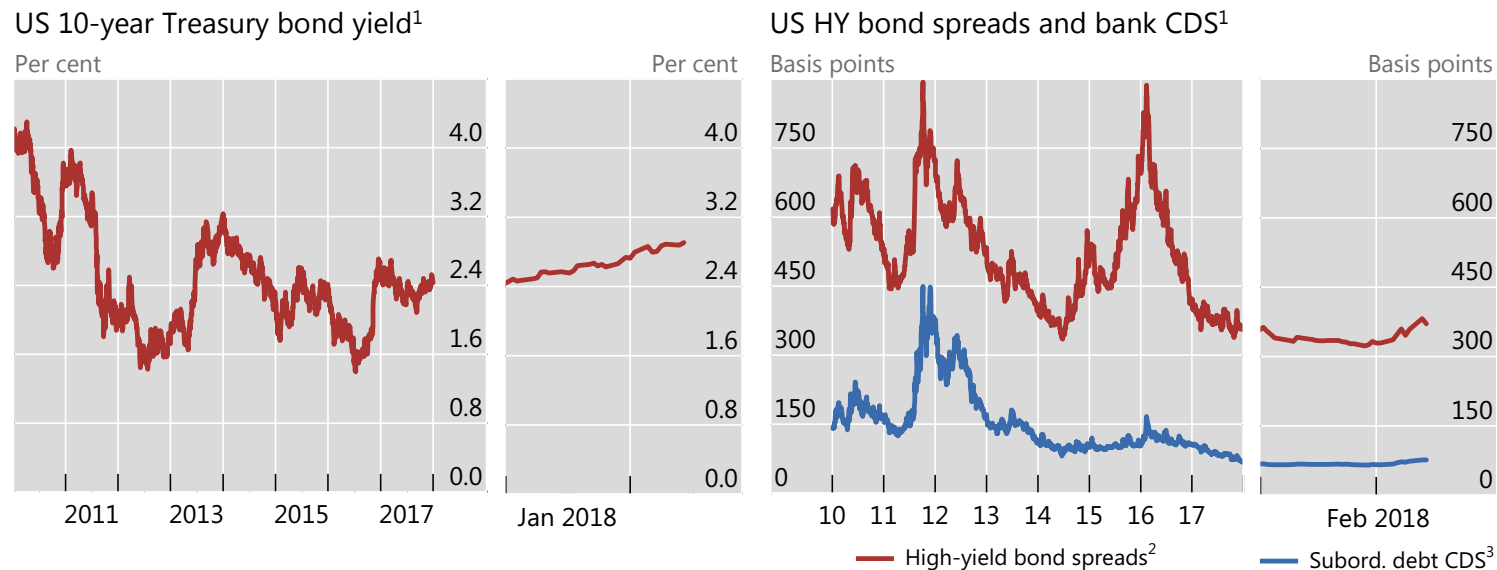
Equity market indices (USD)¹



¹ Data as of 13 February 2018. ² CN, IN, TW, ID, KR, MY, PH, TH. ³ PE, BR, MX, CL, CO. ⁴ RU, CZ, HU, PL.

Sources: Bloomberg; Datastream; BIS calculations.

Treasury yields continue increasing but the rise in bond spreads and bank CDS is modest

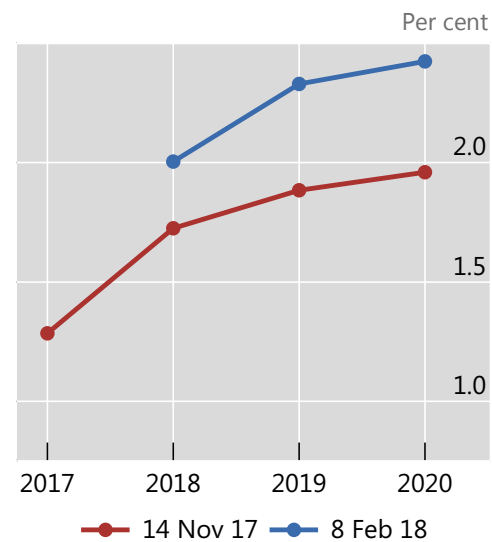


¹ Data as of 12 February 2018 ² Option-adjusted spreads over government bonds. ³ Bank CDS premia, five-year; simple average of 6 major banks in the country.

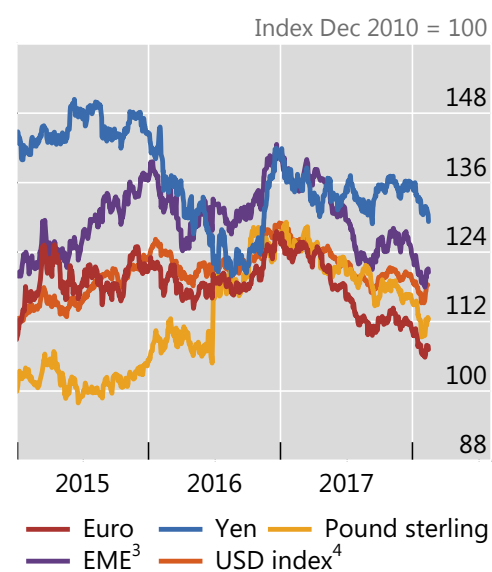
Sources: Federal Reserve of New York; Bloomberg; Datastream; Markit; BIS calculations.

Puzzling? Fed hikes re-priced; but dollar weakened while EMEs attracted funds

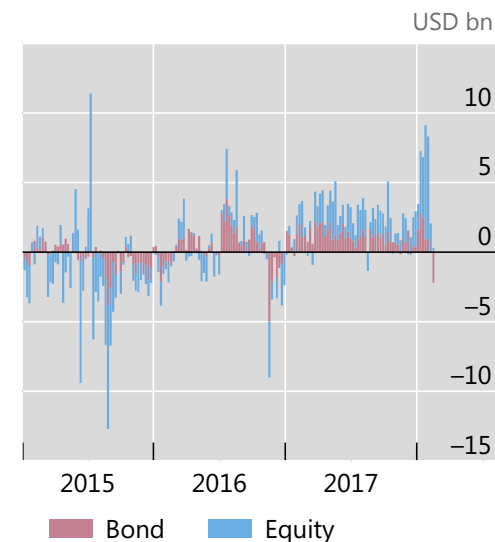
Fed funds futures¹



US dollar exchange rates²



Flows into EME portfolio funds⁵

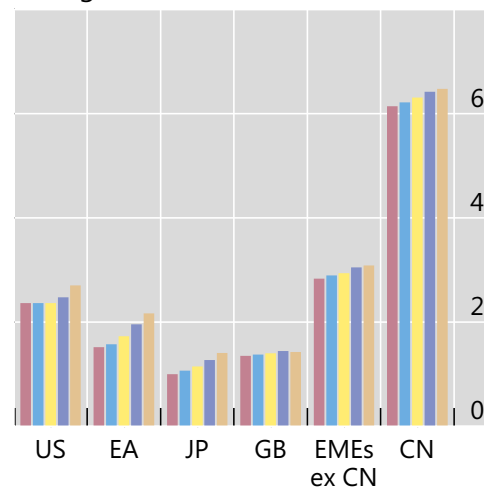


¹ For market expectations, fed funds 30-day futures implied rate; for 2017, December 2017 contract; for 2018, December 2018 contract; for 2019, December 2019 contract; for 2020, August 2020 contract. ² Data as of 13 February 2018. ³ Median of the countries. ⁴ Trade-weighted broad US dollar index. ⁵ Data cover net portfolio flows (adjusted for exchange rate changes) to dedicated funds for individual EMEs and to EME funds with country/regional decomposition. Data as of 15 February 2018.

Sources: Datastream; EPFR; national data; BIS calculations.

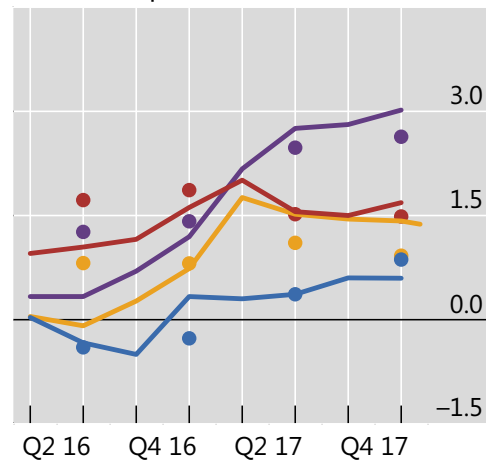
Indeed could be classic “technical-healthy” correction...

GDP growth forecasts for 2018^{1,2}



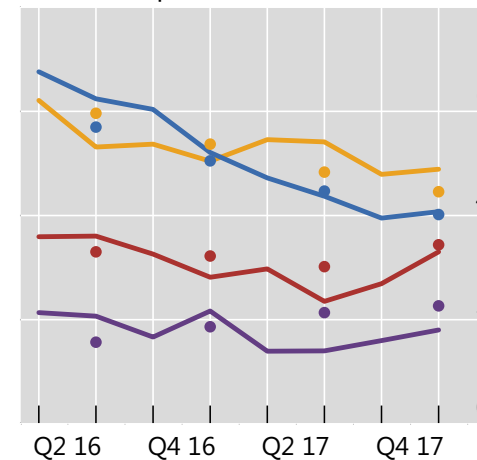
Q1 17 Q2 17
Q3 17 Q1 18

Consumer price inflation: AEs³



Headline: Core:
 — United States ●
 — Japan ●
 — Euro area ●
 — United Kingdom ●

Consumer price inflation: EMEs⁴



Headline: Core:
 — Emerging Asia⁵ ●
 — Latin America⁶ ●
 — EEMEA⁷ ●
 — China ●

¹ Quarterly averages of monthly Consensus forecasts of annual average growth in 2018; Q1 2018 data based on forecasts up to January 2018. EMEs excluding China comprise Emerging Asia, Latin America and other EMEs. ² Regional aggregates are weighted averages based on rolling GDP and PPP exchange rates. ³ Based on CPI indices; for US, based on personal consumption expenditure. ⁴ Regional aggregates are weighted averages based on rolling GDP and PPP exchange rates. ⁵ HK, IN, ID, KR, MY, PH, SG, TH, TW. ⁶ BR, CL, CO, MX, PE. ⁷ CZ, HU, IL, PL, RU, TR, ZA.

Sources: Consensus Economics; national data; BIS calculations.

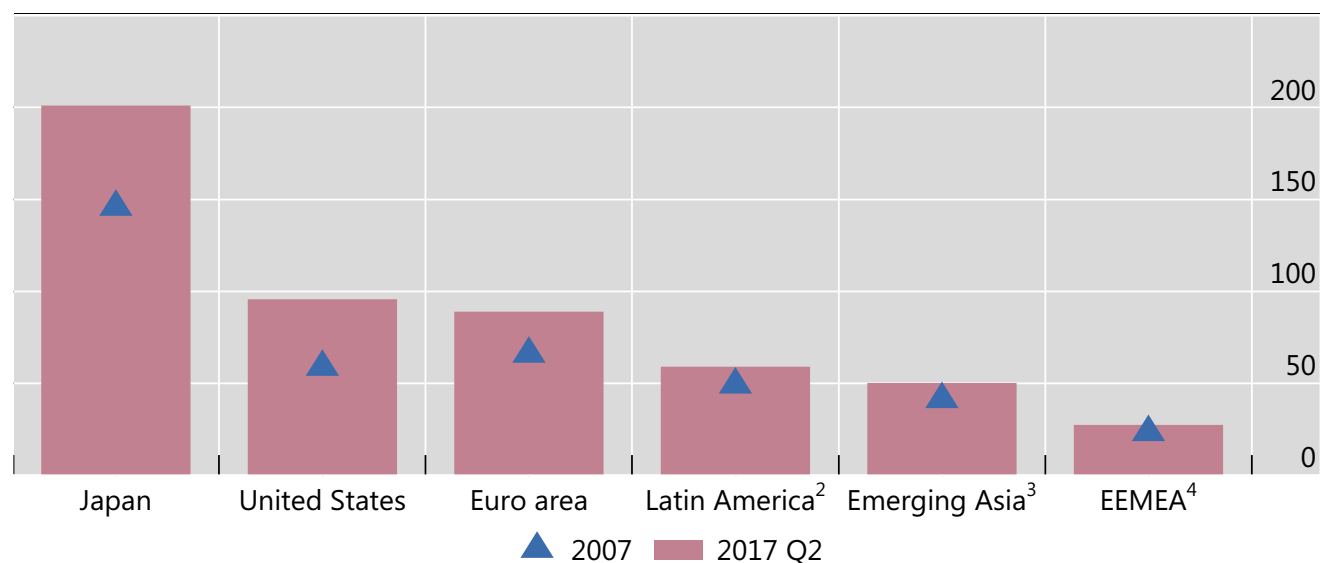
... but the risk remains that financial conditions tighten more abruptly

- Unusual MP tightening in the US with a loosening of financial conditions: reversal at some point but when and how?
- Term premia moving up: gradual slope increases; but snapback depends on markets' anticipations of risk and/or inflation
- US fiscal bound to deteriorate; combine unwinding UMP & US Treasury issuance strategy (short-long end?); political uncertainty
- Wages up; would it bring higher core CPI back? No? Yes? When?
- And if snapback occurs, could trigger obvious financial stability concerns: private sector leverage is high; increasing in some countries; public debt is high too...

High debt brings to AEs familiar tale in EMEs of fiscal dominance; debt trap; and fiscal policy space has declined in most AEs

General government debt to GDP ratio¹

Graph 6

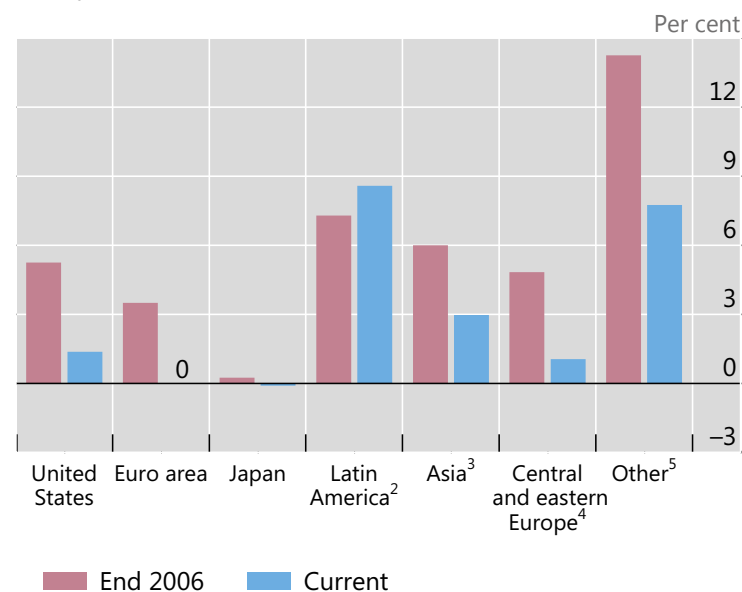


¹ Regional aggregates are weighted averages based on rolling GDP and PPP exchange rates. ² AR, BR, CO, MX. ³ CN, HK, IN, ID, KR, MY, SG, TH. ⁴ CZ, HU, PL, RU, TR, SA, ZA.

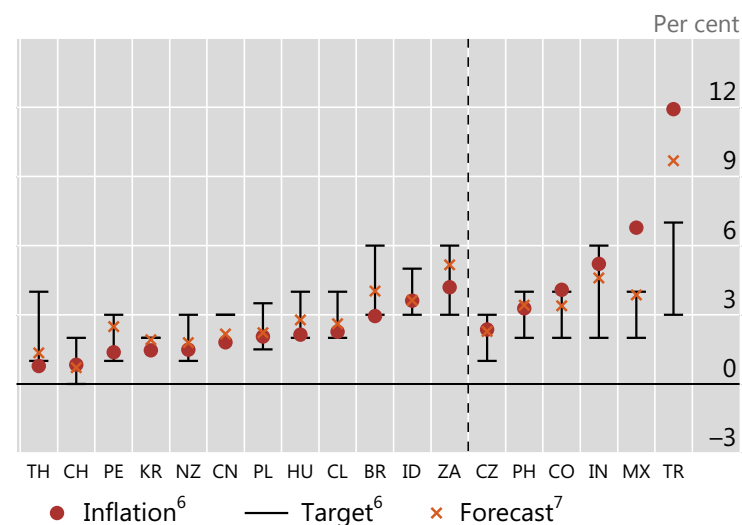
Sources: National data ; BIS.

Monetary policy still near ZLB in AEs; space appears small; changing com & FG entails risks/challenges

Policy rates¹



Inflation rates⁶



¹ Simple averages of the countries for the regional aggregates. ² Argentina, Brazil, Chile, Colombia, Mexico and Peru. ³ China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand. ⁴ Czech Republic, Hungary and Poland. ⁵ Russia and Turkey. ⁶ Consumer prices, year-on-year changes. ⁷ As of December 2017. ⁸ Consensus Economics forecast as of Dec 2017 for 2018.

Sources: Datastream; national data; BIS calculations.

Macroprudential policy space is gradually being built; but limited scope for action; toolkit has expanded but need more experience to coordinate with other policies

- Banking systems have become more resilient as the Basel III reforms are implemented
- Basel III introduced a broad-based countercyclical instrument: the countercyclical capital buffer (CCyB).
- So far only a few countries require a positive CCyB.

So are we in a kind of Catch 22?

- Inflation could (will?) come back; revival of old Phillips curve or new post-GFC normal? If inflation surges...
 - More aggressive hiking might prove difficult for CBs; fiscal dominance; debt trap; financial stability implications
 - Leaving inflation to run above “target” might de-anchor expectations; social consequences (inflation tax/inequality); ER effect → trade, “currency wars”?
- If snapback triggers new severe financial crisis, fiscal & MP buffers are small
 - So...
- Muddling-through? Gradualism, FG, hoping to avoid inflation spike & corrections that would trigger financial crisis; fragile multiple equilibria dependent on (actual/expected) sign of inflation

Lessons for policy (1): walking a thin line...

- CBs are beginning normalizing and facing a challenging task:
 - **Exiting “Goldilocks moment” without creating a new “Minsky moment”**
 - Meeting both their price & financial stability mandate without excessively aggressive usage of respective policy instruments but without losing credibility either...
- Bursts of volatility are normal when valuations are corrected; should not deter CBs from continuing policy normalization

Lessons for policy (2): looking for “unknown unknowns”

- The financial system is marked by local vulnerabilities, sometime “unknowns”, e.g., “subprime” exposure. The timing and severity of their manifestation are hard to predict. Where to look now post-GFC in 2018? Cryptocurrencies? ETFs? Shadow-banking?
- Risk surveillance should focus on identifying structures that might amplify local vulnerabilities.
 - Leverage
 - Algorithmic trading? Passive investment strategies? Cash management of open-end funds?

Lessons for policy (3): restore buffers, call for structural reforms and “exit center stage – only game in town”

- With all skilful com & FG, difficult to exclude an abrupt tightening of financial conditions with lasting real effects.
- Hope for the best, prepare for the worst; use the as-yet favourable environment to strengthen as much as possible fiscal and prudential policy buffers.
- “Never miss the opportunity of a crisis?” We did poorly on that during GFC; still time to envisage structural reforms to reduce cost of adjusting to shocks and address future daunting challenges (inequality, rapid new technological change and foreseeable impact on jobs in quality and quantity, aging society, climate change, etc...)
- CB should call for these and “exit center stage – only game in town”



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Thank you

