Terrence J Checki: Observations on the global economy and financial system

Remarks by Mr Terrence J Checki, Executive Vice President of the Emerging Markets and International Affairs Group of the Federal Reserve Bank of New York, at the IIF Annual Meeting of Latin America Chief Executives, Santiago, Chile, 6 March 2013.

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Good afternoon. Thank you, Tim (Adams), for the kind introduction. Let me take this opportunity to congratulate you and wish you well as you take the helm of the IIF (Institute of International Finance).

It is a pleasure to be here in Santiago, and to see so many old friends among the distinguished participants. Having spent much of my early career in this part of the world during difficult times, it is gratifying to be reminded first hand of the progress the region has made. That progress is especially evident here in Chile.

In my remarks this afternoon, I thought I would offer a few reflections on the current state of the global economy and financial system, and some of the challenges going forward.

Let me note, for the record, that my comments this afternoon are personal, and should not be taken as reflecting the views of the Federal Reserve Bank of New York, or the Federal Reserve System.

As we all know, the mood in global markets has improved quite a bit since the middle of last year: stocks are up, spreads are down, volatility is lower, and capital market activity has picked up. A big part of that reflects recent success in averting tail risks that were weighing on investor confidence.

Europe's common currency hasn't fragmented, the U.S. didn't go over its fiscal cliff, and China hasn't had a hard landing.

But in each of these cases, there is plenty of unfinished business, and important challenges remain.

In the euro area, while there are grounds for cautious optimism, much remains to be done to restore confidence and growth.

Fiscal adjustment is far from complete and is likely to continue to weigh on growth for some time to come. Financial conditions in the periphery have improved, but remain much less supportive than in the core. Plans to build a banking union and deepen economic, fiscal and political integration remain very much works in progress. And, as the elections in Italy have reminded us, there is an important political counterpart to the economic and financial challenges and risks confronting the region.

In the U.S., we are only part way toward addressing our fiscal challenges. Recent measures are chipping away at the deficit, but the approach hardly corresponds to anybody's ideal of efficiency. While there is little mystery about what ultimately needs to be done, we simply have not yet mustered the political will to make the compromises needed to get there.

And, unfortunately, with deadlines coming – and one just having passed for decisions on mandatory spending cuts and spending and borrowing authorizations – we can't be comfortable that this is going to go smoothly.

Finally, in China, while the policy cycle has turned and the economy appears to have reaccelerated, the authorities there will need to continue to deal with new challenges, including rapid growth in non-bank finance, increased leverage across the economy, and maintaining equilibrium in the midst of rapid structural change and increasing complexity.

So, while global growth appears to be picking up (after a lackluster 2012 which saw Europe and Japan contracting in the second half of the year, and a second consecutive year of slowing growth in the emerging market economies) the pick-up is likely to be only moderate; and significant economic slack in the mature economies (high unemployment, large output gaps, etc.) seems likely to be with us for some time to come.

Against this backdrop, developed economy central banks are continuing to take extraordinary measures to support growth. Policy interest rates are close to zero, and central bank balance sheets have grown to unprecedented proportions via asset purchases and lending.

As you know, the Fed is in its third round of large scale asset purchases. The Bank of England and Bank of Japan (BoJ) have been expanding their balance sheets as well, and markets expect the BoJ to engage in stepped-up asset purchases in the months ahead. And while the ECB's (European Central Bank) framework is less focused on quantitative targets, there is little doubt that the ECB's willingness to expand its balance sheet through lending and through the OMT (Outright Monetary Transactions program) has been a key support to stability.

This activism has some observers asking – with some justification in my view – whether central banks are trying to do too much.

Concerns are being raised as to whether price stability and financial stability are being put at risk, and about potential spillovers into currency markets.

Monetary policy is, after all, a blunt instrument. It supports investment and consumption in the real side of the economy by stimulating financial activity, by lowering borrowing costs and boosting financial wealth. But, as we have learned the hard way, easy monetary and credit conditions are also the stuff out of which credit excesses and bubbles can form

So the question many central banks face is whether the benefits of further easing are worth the potential costs: in essence, will we get enough risk-taking on the real side of the economy, before we get too much on the financial side?

Of course, this is not a static calculation. Sound structural policy can improve the odds that monetary stimulus feeds through to the real economy. After all, firms' decisions to invest, hire more workers and expand their operations depend not just on the cost and availability of funds, but also on the opportunities and the uncertainties in the business environment.

Is enough being done on this score? From my vantage point, it is far easier to see areas in need of improvement on the structural side than to detect any clear momentum toward addressing them.

In the U.S., greater clarity around policies in areas such as trade, tax reform, energy, environmental regulation, and the strategy for fiscal adjustment would help extend investment horizons, increasing the prospect that accommodative financial conditions will have their intended effect.

In Japan, the new government is talking about structural reform, and policymakers have identified many areas where the business climate could be improved. In fact, I suspect that Japan's success in durably boosting growth will hinge as much or more on progress on the structural front, as on developments in monetary or fiscal policy.

Robust regulation and oversight can also improve the cost-benefit calculus. Here, let me say a few words about the ongoing global regulatory reform process.

As you know, the scope and scale of the regulatory response to the crisis of 2008 has been quite ambitious – some would say too ambitious. Nonetheless, the scale should be understandable against the backdrop of the weaknesses revealed in the crisis, and the economic and financial fallout that resulted.

And the reality is that a great deal has been accomplished, both in establishing goals, and in progress toward those goals. That is not to suggest that I am equally enamored with everything that has been done, or the way in which it has been done.

The reform effort has many moving parts, and further efforts are clearly needed to ensure that those parts fit together, and that the various parties work together. And these reforms are yet to be fully implemented, let alone tested over a full credit cycle.

Of course, building a stronger system is not just about regulatory reform. Changes in institutional governance and culture are also needed. Many of the problems that surfaced during the crisis and more recently reflect a culture that emphasizes short-term gain over institutional sustainability – a culture in which regulation is viewed as an obstacle to be arbitraged or circumvented, rather than as an additional check on broadly shared objectives.

That needs to change if progress is to take root. Making sure that happens will require a realignment of incentives, and strong leadership from the top.

All of this will take time. The question is, how much time do we have?

While risk-taking has been somewhat constrained in the aftermath of the crisis and the resulting uncertainties in the macro environment, we are beginning to see signs of things heating up in some areas of the markets: e.g., record issuance of junk bonds and emerging market debt, including enthusiastic take-up for issuers from “frontier markets” with little to no prior presence in the capital markets; increased leveraged buyouts; weakening covenants; and a rebirth of the collateralized loan obligation market.

Complacency at this point would not be a good thing.

When I think of the risks ahead, my concern goes less to countries, institutions or particular markets, and more to the broad set of challenges associated with the eventual normalization of the policy measures which are being taken now, especially in the context of markets that may be frothier than what we see today, and in ways that may not be fully apparent given all the new incentives being created for “innovation” in intermediation and in the nature and location of risk taking.

Tightening cycles tend to bring surprises. And in the upcoming cycle, both central banks and markets will be operating in unfamiliar territory. Minimizing potential fallout for markets and for the economy will require deft management, and skillful and disciplined communication on the part of policymakers.

That said, at least for now, inflation risks appear contained. Notwithstanding the additional liquidity, inflation in the advanced economies is running toward the low side of desired ranges – and in Japan, well below. Financial markets show little evidence of longer-term inflation expectations becoming less firmly tethered. And when the time comes for normalization, there are a number of powerful tools available to keep them in check.

Finally, on the issue of currency spillovers: this is a topic where, at least so far, the rhetoric appears to have substantially outpaced the reality. The talk about so-called “currency wars” strikes me as having gotten a little ahead of itself – better for capturing headlines than for accurately describing recent policy or the current situation.

There has long been acceptance of the fact that central banks should be free to cut or raise rates in pursuit of domestic policy objectives, even though such actions might indirectly impact exchange rates. Now that some central banks are constrained by the zero lower bound, it seems only natural that this understanding should carry over to domestic asset purchases for domestic policy purposes. Such purchases represent just another channel to influence local financial conditions and thereby spur growth.

This is quite different from deliberately targeting exchange rates through exchange market interventions or other means, which could indeed be problematic.

The current system of market-determined exchange rates among the major advanced economies brings to mind the old quip about democracy being the worst possible system...except for all the others. While it is hardly perfect, it does work to smooth adjustments across countries facing different macroeconomic circumstances and provides domestic policy makers with important and necessary room for maneuver.

Let me close with a few thoughts on the emerging world, against the backdrop of trends and challenges facing the mature economies.

As we all know, the role of the emerging markets has changed dramatically over the last decade and a half. The emerging market economies are now an increasingly important source of dynamism, stability, and profitability for the world economy and financial system.

This progress is the result of policy improvements that have reduced the imbalances and fragilities that fed past boom-bust cycles; greater openness to international trade and deeper economic and financial integration; and, for commodity exporters, some good fortune in the form of strong prices.

Nonetheless, while trend growth in the emerging market economies has substantially outpaced that in the mature economies, the emerging market economies generally continue to accelerate and decelerate in step with the mature economies. So much for decoupling.

This continuing close correlation reflects the fact that stronger emerging market growth has been built upon deeper economic and financial integration with the mature economies...as well as with each other.

Against that backdrop, spillovers from the mature economies clearly played a part in the recent slowdown across the emerging world. But something more appears to be going on as well.

As a general matter, the emerging market economies appear to be operating closer to capacity than the mature economies. Emerging market economy labor markets generally look somewhat tight by historical standards, and while emerging market inflation is down, it is still an issue for a number of countries.

This suggests that capacity constraints and structural issues have been playing a role in the recent sluggishness, and that somewhat slower growth may be part of the new normal for the emerging market economies as well.

How much slower will in part depend on policy choices in the emerging market economies. Just as in the mature economies, there is room for emerging market economies to boost potential growth through structural reforms, such as measures to improve the investment regime for infrastructure, improve public services and the business climate, and overhaul tax systems.

Having said all that, it is completely understandable that there is uneasiness in much of the emerging world with what is going on in the developed economies.

Over the years, the emerging markets have learned about financial stability the hard way, from their own crises and those of their neighbors. They have had too much experience with the aftermath of excessively loose fiscal and monetary policy, and political gridlock.

Those experiences have engendered a cautious approach to fiscal and monetary management and financial sector oversight that has served countries well during the volatility of recent years. It has also made them understandably uncomfortable with the risks they perceive in the developed economies.

The fact of the matter is that the potential spillovers do pose risks for everyone, developed and emerging.

The large and volatile capital flows encouraged by accommodative financial conditions in the developed economies, and the attendant pressures they put on credit markets, asset prices, and currency values do add to the challenges countries face in containing external vulnerabilities.

And the failure to address underlying vulnerabilities in the developed economies does expose the EMs to the risk of sudden reversals in capital flows.

Having spent much of my career working with emerging market policymakers, I have a lot of sympathy for these concerns, and the policy challenges they present.

Regrettably, there are no easy answers here. The reality is that, if policy were less accommodative in the developed economies, global growth would inevitably be slower, and the EMs would face another set of side effects including weaker demand for their exports, potential spillovers from renewed macroeconomic weakness or recessions in the developed economies. And, perversely, yields might still remain quite low and capital flows even more volatile.

Lest you get the wrong impression: I do think that the EMEs have a valid complaint but, in my view, it has less to do with monetary policy than with the incompleteness of the policy response in the mature economies in a range of other dimensions I alluded to earlier.

Let me put it another way. Some countries in the developed world have been treating structural illness with cyclical medicine for a fairly long time. Larger and larger doses of "medication" have been required, over time, to produce smaller and smaller effects. The efficacy of this course of treatment remains to be seen, as do its potential side effects, some of which could be quite important.

Let me close with a simple thought. Policymakers are fond of talking of economic and financial frameworks, which conveys a rather appealing sense of structure, stability and order. But the reality is that we are linked together in a complex economic and financial eco-system where everything hinges on, and changes in relation to, everything else.

The emerging markets have a great stake in the success of the developed economies in meeting their challenges – and the developed economies' stake in the success of the emerging markets is no less great. Global prosperity is and will remain a joint and common endeavor.

And, as the financial crisis and the Great Recession have painfully reminded us all, past performance is not a guarantee of future success.

Thank you.