BIS Annual Conference on

"Low for Long or Turning Point"

Discussant Comments for Session 3 on

"What Are Interest Rates So Low"

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It is such a pleasure and honor to be here. Huge thanks to Claudio, Jamie, Hyun Song and other BIS colleagues for inviting me to this wonderful event. I greatly appreciate the opportunity to participate in such a stimulating conference. It is also a privilege to be asked to provide some comments in this session on Ricardo Caballero's three interesting papers.

My remarks will be organized around the what, why, and so what of relating to – and here I am quoting Ricardo – "the world economy experienced a prolonged period of risk intolerance." I will approach this from the perspective of a capital market observer and participant who has followed closely the impact of unconventional monetary policies, including large-scale asset purchases by systemically-important central banks.

My particular interest today is in the issue, and again I quote, that "the key tension that asset prices have the dual role of equilibrating financial markets and supporting aggregate demand." Moreover, given the forward-looking spirit of this gathering, I will also pose the question of what may happen if we run the current policy regime forward. – with particular emphasis on cumulative effects and feedback loops which, I believe, are taking some economies closer to tipping points. Indeed, rather than signal a generalized increase in risk intolerance, as Ricardo suggests, we could well be in the midst of a new period of excessive risk taking – one in which high financial risk taking has become dangerously decoupled from economic risk taking, opening up two potential outcomes depending on the policy response beyond the world of central banking. They carry similar probabilities but very different outcomes when it comes to economic, financial, institutional, political and social factors.

The What

When it comes to the what, Ricardo's work documents:

- The secular decline in real interest rates to persistently negative real levels and, in some cases, nominal too;
- Shows that it has been generalized across maturities and advanced economy jurisdictions – the so-called Triffin dilemma for fixed income securities that serve, or are perceived to serve as a true "store of value;"
- That itis part of what he suggests "may well be a recurrent global safety traps environment," reflecting both supply and demand influences that have

reduced the availability of safe assets around the world, and in advanced economies in particular; and.

- That the phenomenon has both a public and private component.

Given my own perspective, I find it interesting that the analysis places a lot less weight on the information content of spreading contradictions on the ground, especially if we consider the dramatic changes in traditional historical correlations. There are, in my opinion, signals rather than noise and they include:

- The behavior of both the term premium on government bonds and the flattening of the yield curve versus the valuation of stocks;

- The decoupling of financial risk taking (high) from economic risk taking (low);

- The promise of ample liquidity inherent in the proliferation of ETFs in traditionally less liquid asset classes (such as high yield corporates and emerging markets) versus experience, particularly at times of change in the paradigms governing the general market behavior;

- The discrepancy between soft and hard data;

- The unusual uncertainty in national politics and cross-border economic relations versus notably low actual and implied market volatility;

- The persistence of negative interest rates in systems that are now challenged to provide longer-term financial protection products to households (such as life insurance and retirement); and, more generally and linking to the earlier sessions,

- The step decline in r* in a system built on the presumption of a notably higher level.

The Why

On the why, Ricardo's emphasis is primarily on structural and secular issues such as demographics and regulation that, in his analytical framework, have resulted in the supply of safe assets not keeping up with global demand. There is little discussion of the role of policy issues and choices, including the earlier pursuit by emerging economies of high self insurance and, since the global financial crisis, central banks being de facto forced into a prolonged period of "being the only game in town" policy-wise. The latter has led to unprecedented policy experimentation, with both rates and balance sheets, turning quite a few previous improbables and unthinkables into reality.

With that, I wonder whether the analysis may underplay the role of policy choices that have accentuated the structural and secular factors that are correctly identified. These policy issues speak not only to trade-offs within the direct scope of monetary policy as mentioned by Jamie in his introductory remarks but also, and more importantly, the excessive reliance on central banks when compared to other policymaking entities that can pursue structural reform, more responsive fiscal policies, targeted debt reduction measures and greater global policy coordination.

The So What

All of which takes us to the so what.

Ricardo shows that the “volatility stabilization” of financial assets has coincided with a period of increasing return on capital and, more importantly, that actual and potential consequences are a mix of benign, concerning and damaging. It is a mix that gets more worrisome the closer we get to, and stay at the effective lower bound. There, “any further intensification in the shortage of safe assets has destabilizing macroeconomic consequences” – including pushing the global economy further away from its potential.

In terms of solution, Ricardo’s work identifies four channels:

- through the exchange rate mechanism;
- through greater issuance of public debt;
- through the production of private safe assets; and
- through changes in the regulatory framework.

Ironically, I get to some of Ricardo's policy prescriptions, and add a few, but using a different route that involves some reverse causality compared to his analytical framework. Importantly, rather than reflect a "natural" process driven just by secular and structural factors, what Ricardo identifies may well also involve the impact of a prolonged phase of non-commercial activities in financial markets: directly through interest rate setting and balance sheet management, and indirectly through forward guidance.

A notable part of what Ricardo picks up is the persistent use of a partial instrument for desirable growth and economic wellbeing objectives, and doing so for a long time and in such a way that Ben Bernanke's characterization of the "benefits, costs and risks" have gradually evolved in a more worrisome fashion. In sum, rather than serve as the bridge to more comprehensive policies, as originally intended, unconventional monetary policy has become too much of a destination.

Considered through this prism, the shortage of safe assets is not just an outcome but also part of the transmission mechanism of central banks' policies. And it has unintended consequences, together with collateral damage.

All this speaks to the urgent importance of a policy handoff: from prolonged excessive reliance on central banks to a broader policy response that deploys pro-growth structural reforms, more active fiscal policy where there is room, targeted debt reduction, and better regional and global economic architecture and cooperation.

If the handoff occurs in a timely fashion, the "Triffin Dilemma" that Ricardo identifies would be solved in an orderly fashion as low growth and insufficiently inclusive growth yields to high and more inclusive growth, as artificial financial stability becomes genuine, and as the scope for a "beautiful normalization" (to adapt Ray Dalio's term) becomes more of a reality.

However, if the handoff remains elusive, low growth would risk turning turn into periodic recessions, artificial financial stability would give way to unsettling volatility, the effective lower bound would become more of a binding constraints, and central bank effectiveness would erode further.

Conclusion

The data on government yields may be seen by some to reflect a period of risk intolerance which is supported by a decline in the supply of safe assets and an increase in demand. But the underlying influences go beyond that, reflecting an unbalanced policy mix that has put way too much of the burden on unconventional monetary policy. The result is another period of excessive financial risk taking that is continuously fueled by the liquidity trade.

It is a configuration that speaks to the contradictions that I mentioned at the start of my presentation. And the longer it persists, the greater the likelihood that, for central bank policy, what Ricardo labels the "safe assets shortage conundrum" risks going from being an outcome to becoming a notable problem in itself.

Thank you very much.