

Comments on “The global impact of risk-off shocks”

by Piti Disyatat¹

In this paper, Caballero and Kamber study how monetary policy frameworks influence the impact of risk-off shocks for a broad set of advanced market economies (AEs) and emerging market economies (EMEs). It is a very interesting and thought provoking paper. The key propositions of the paper are: (i) risk-off shocks have become more benign post-Great Financial Crisis for EMEs; (ii) this is attributable to unconventional US policies (so-called policy-put frameworks); and (iii) stronger country fundamentals imply more resilience to risk-off shocks. The overall conclusion is that policy easing in the United States, particularly unconventional ones, has been good for all. This is a good story. But is it too good to be true?

1. Empirical issues

The key empirical issue is identification. There are two parts to this.

The first has to do with the identification (and hence the interpretation) of risk shocks using the VIX Index. There is a tendency to view the VIX as exogenous. But it is not, varying as it does with underlying economic developments and vulnerabilities. Thus, the omission of controls for macro and financial vulnerability such as news, valuations, credit growth and risk spreads makes interpretation difficult. Relatedly, we know that the VIX reflects both objective risk and the price of risk (risk aversion). Which one do we care about? It might be worth decomposing the VIX and exploring their separate impacts along the lines of Bekaert et al (2013).

The second part concerns identifying the role of monetary policy in the vector autoregression (VAR). The paper simply attributes the shape of impulse responses to monetary policy. For example, the negative response of the 10-year bond yield to risk shocks is taken to be evidence of monetary policy working to cushion the adverse impact. But there is no clear reason why this should be the case, especially in the zero-lower bound period where policy rates cannot move and the VAR contains no other policy variable such as central bank asset purchases or balance sheet size. How do we know that the reaction of bond yields and the other financial variables in the VAR is due to monetary policy rather than just a reflection of market response to risk-off?

More critically, the presumption that differences between the pre- and post-Great Financial Crisis (GFC) subsamples reflect differences in monetary policy reactions is problematic on two levels.

First, the nature of shocks may be quite different. Not all shocks are created equal and similar-sized VIX shocks can have different implications. For example, the VIX spiked up by about the same amount during the 11 September 2001 attacks in the United States and the 6 May 2010 “flash crash” in US equity markets. But one was a

¹ Bank of Thailand.

geo-political shock while the other a purely financial shock. Are these two events really comparable in terms of their effects on confidence and the economy?

Second, similar-sized shocks can have vastly different impacts because the propagation mechanism is different. This can be due to changing context, behaviours, perceptions, preferences and, of course, policy regimes. But without controls for these, how can we attribute all the differences to different monetary policy regimes? For example, the fact that equity valuations post-GFC were lower may explain why equity prices do not fall as much in response to risk-off shocks in this period.

Either way, differences in the nature and the propagation of shocks makes comparison between two periods difficult. Indeed, the fact that the persistence of VIX shocks are found to be different in the two samples is precisely an example of why it is difficult to compare responses across regimes.

2. Conceptual issues

In terms of the conceptual issues, there is a distinction to be made between risk-centric and finance-centric views. The paper stresses the importance of the market for risk. I come from a perspective that emphasises the importance of financing. At some level, this is just semantics: what the authors call risk, I call financing. One can talk about the demand and supply of risk vs of financing, a risk gap vs a financing gap and so forth. But at a deeper level, there are some key differences in perspectives.

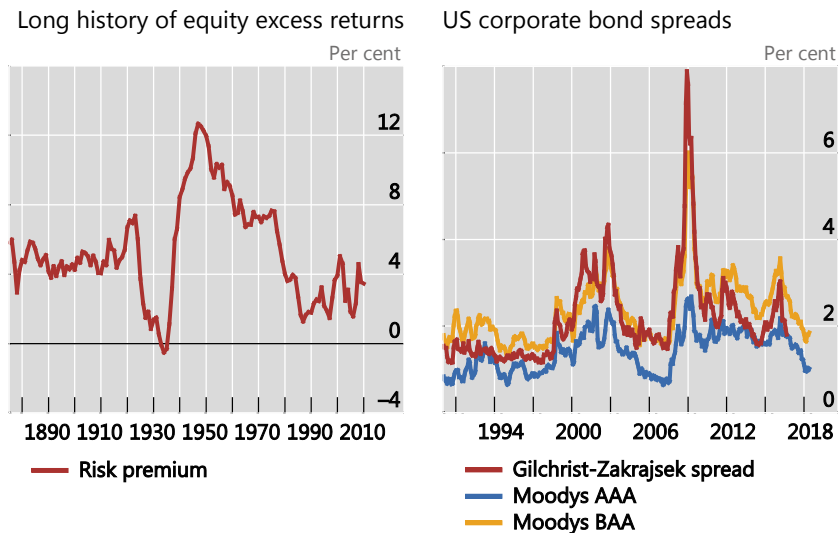
In the risk-centric view, output generates risks that needs to be absorbed. In the finance-centric view, financing generates output. Without financing, no production takes place. Borrowing and lending, and hence trust, is essential. The conceptual premise of the paper is that firms produce as much as is demanded and do not require financing. There is really no borrowing and lending. Thus, the underlying framework is real rather than monetary.

One manifestation of this is that it views the decline in real interest rates over the last decade as an equilibrium outcome driven by real factors. In the model, the only way to reconcile this is to have an excess supply of risk or an excess demand for safe assets. In other words, the last 10 years have been a period of risk intolerance. This implies that risk spreads should rise as people seek safety.

The finance view sees the decline in real interest rates as partly driven by policy and that this forces adjustment in risk markets in the form of risk spread compression as people search for yield. We have been in a period of ever greater risk-taking. Looking at the data for the United States in Graph 1, the proposition that risk premia has been exceptionally high is questionable. Whether it be excess equity returns or corporate bond spreads, risk premia do not seem particularly high over the last couple of decades. In fact, risk spreads have compressed significantly in two phases since 2000, punctuated by the GFC. Both of these phases coincided with periods of accommodative monetary policy.

The second distinction worth highlighting is between shocks and vulnerabilities. The framework of the paper focuses on risk shocks taken to be exogenous. But these could be endogenous. Sharp declines in asset prices usually do not come out of nowhere. Often, they are the culmination of vulnerabilities built up over time. Thus, rather than shocks, it may be better to think of vulnerabilities. And these could be endogenous to policy. This could give rise to a trade-off between low risk today at

the expense of high risk tomorrow (see Rungcharoenkitkul et al (2019) and Adrian and Duarte (2018)). The idea is to relate the busts to the booms that preceded it, rather than just thinking of busts as random shocks. Here it is good to remind ourselves that risk is not volatility. And indeed, low volatility often means higher risk. One could, in fact, argue that monetary policy, especially during the post-GFC period, has suppressed volatility and built up risk.



Sources: Jordà et al (2017), Gilchrist and Zakrajsek (2012), Bank of America Merrill Lynch, Bloomberg, FRED, BIS calculations.

Finally, this is another model that views zero-lower bound as the root of all problems. While it is certainly true that the zero-lower bound limits stimulus, it is a leap to presume that everything would have been fine if only central banks could have lowered rates more. This neglects the role of stock variables and supply-side problems that may explain the persistence of the output shortfall. Debt overhangs need to be worked out, resource misallocations resolved. Again, this is an outcome of viewing crises as shocks rather than the result of accumulated vulnerabilities that generate path dependency (see Juselius et al (2016)).

3. Policy implications

Turning now to the policy implications. Essentially, the paper is arguing that put-policies, particularly monetary easing, are good and beneficial to both AEs and EMEs. With respect to the impact on EMEs, I would raise three questions.

First, the paper focuses on the capacity of monetary policy frameworks to offset volatility shocks but neglects the possibility that the framework itself may contribute to the likelihood of and susceptibility to shocks. Indeed, the monetary spillovers documented can be viewed as the reason to worry rather than to cheer. The 2013 taper tantrum, for example, can be seen as an episode where put-policies, rather than alleviating the effects of risk-off shocks, sometimes are the shocks!

Second, the horizon of analysis matters for the assessment. As mentioned earlier, to the extent that put-policies build up vulnerability to risk-off shocks, the benefit

from US monetary easing is a veil because although it helps at the moment of the shock, it also contributes to the susceptibility to those shocks over time. Indeed, one wonders whether the susceptibility to capital outflows and exchange rate depreciations would have been less without prior put-policies. This relates to the importance of linking booms and busts as noted before.

Third, I wonder if it is too early to judge the benefits of cleaning through put-policies. The post-GFC period of analysis is one of policy easing. One could say that, so far, we have been in a risk-on regime all along, punctuated by some hiccups. The true risk-off regime starts now when monetary policy is normalised. We are just in the beginning of that globally.

Finally, I also fear that high reliance on put-policies contributes to central banks becoming the only game in town. This could contribute to elevating overall system risk and vulnerability in the long run.

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