Erkki Liikanen: Globalization – declining risks but increasing uncertainty?

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Introduction

Globalization is the big story of our times. Forces of globalization change the domestic inflation process and the way in which monetary policy measures are transmitted in the domestic economy. The uncertain nature and magnitude of these changes makes the job of the central bankers more demanding. But at the same time, globalization has helped central bankers by exerting some dampening effect on prices.

On balance, the low and stable inflation we have witnessed in recent years gives confidence that central bankers can cope with this uncertain and changing operating environment as long as the process of globalization remains orderly. Therefore, I will not today talk much about how globalization is changing the domestic inflation process and the transmission mechanism of monetary policy.

Instead, in my remarks today, I will mainly talk about how globalization is changing the landscape of risks and what this implies for central banks and other policymakers. In particular, I will discuss the somewhat paradoxical phenomenon of a broad-based decline in risk premia at the time when uncertainty, i.e., those risks that cannot be readily quantified, may in fact be increasing.

Globalization: the big picture

It is often claimed that there is nothing new about globalization. While this may be true in some sense, it seems to me that the current phase of globalization differs markedly from the previous ones in its extent, speed, intensity and impact.

It is not possible to pinpoint the exact start of the current phase of globalization. But still, we can say that, the demise of centrally-planned economies – most notably the internal transformation of China and the dissolution of the Soviet Union unleashed the forces of globalization which had been building up during the 1980's.

The obvious result of this was that the former communist block countries opened up and became integrated into the world economy. The failure of the centrally-planned economic models profoundly changed the political landscape in already democratic countries. Specifically, it enabled and prompted them to adopt increasingly market-oriented policies conducive to competition and improvements in productivity.

The point which I want to stress here is that, although globalization is nowadays often seen as an inevitable and irreversible "force of nature", its present phase was triggered by political events and needs some global institutions and international political support to be sustained.

If the collapse of central planning was the main trigger, then rapid advances in technology have been the main driving force behind globalization. In particular, the explosive development of information and communication technologies has played a central role. By reducing dramatically the cost of transporting and sharing information and services, it has made the world more interconnected and interdependent than any reasonable observer could have thought possible just 20 years ago.

Unprecedented economic benefits

The economic benefits of globalization are clear and widespread. The ongoing global economic expansion is the longest in 30 years. The robust global growth is reducing the number of people living in extreme poverty. And, for the first time in decades, the average incomes of developing and developed countries are converging.

Forces of globalization have intensified competition and fostered rapid improvements in productivity; these factors have exerted downward pressure on prices. Financial globalization, in turn, has contributed to a broad-based decline in risk premia on various markets and asset classes, which has enabled much greater access to financing for households, firms and countries around the globe.

On the whole, despite many structural changes brought about by globalization, the economic environment has become more stable and seemingly more predictable. We have witnessed what has been rightly coined "the Great Moderation", a significant decline in variability of both output and inflation.

A significant part of the credit has been attributed to improved monetary policies. Institutional reform and thereby enhanced credibility of monetary policy has anchored inflation expectations, and this has been a major factor in ensuring the low level of long-term interest rates.

So why the rising anxiety?

Despite these resoundingly positive effects, anxiety about globalization and uncertainty about its continued smooth progress is on the rise. One much-publicized source of concern is global current account imbalances and the risk of their abrupt and disorderly unwinding.

Moreover, two other “imbalances” seem to be emerging.

First, uneven distribution of benefits of globalization, combined with increased feeling of job insecurity, is starting to erode also middle classes' support for globalization in some countries, notably in the United States. This disillusionment of the key segment of the electorate raises the specter of protectionism.

Second, there are indications that the narrowing of risk premia observed in many markets and asset categories may not be fully on a sustainable basis. This implies the possibility of an abrupt and broad-based widening of risk premia. Given the unprecedented degree of financial interdependence, the consequences might be serious.

So, somewhat paradoxically, we are in a situation in which the baseline economic outlook remains benign, and many measurable risks remain low or are even receding, while uncertainty, i.e., those risks that cannot be readily quantified, timed, priced or hedged in the markets, may in fact be on the rise.[1]

It is this apparent dichotomy and its implications that I will focus on in the rest of my remarks. I will first look at in more detail the various forces that have been driving down the risk premia. Then I will discuss what implications and challenges the constellation of low risks and heightened uncertainty has for central banks. I will conclude by highlighting some broader policy implications.

Declining risk premia

A broad-based compression of risk premia has been an important force in supporting global growth in recent years. Much of this decline in price of risks seems to have reflected developments that are on a sound basis.

- "The great moderation", lower volatility of output and inflation, has played an important role in reducing risk premia, in particular inflation risk premium. Central banks have clearly contributed to this by credibly anchoring inflation expectations.
- Whether reflecting a "savings glut" or "monetary overhang", the ample global supply of funds – as reflected in the growth of monetary aggregates and their counterparties – has also contributed to lower long-term interest rates, as well as the compression of risk premia more generally.

[1] According to Frank H. Knight’s famous distinction, "risk" refers to situations where the decision-maker can assign mathematical probabilities to the randomness which he is faced with (e.g., risk premia and volatility based on historical data), while "uncertainty" refers to situations when this randomness cannot be expressed in terms of specific mathematical probabilities (e.g., disruptive unwinding of global imbalances, possibly accompanied by unprecedented widening of risk premia). To put it slightly differently, uncertainty is a type of ambiguity where the probability of an act or outcome cannot be calculated whereas a risk has some element of calculation - there is a certain probability of some known act or outcome occurring.

- Improved market liquidity, reflecting a host of different factors, such as development of market infrastructure, broadening of investor base, and more prudent macroeconomic policies in many emerging market countries, has reduced liquidity risk premia.
- More prevalent use of portfolio diversification has increased demand for assets that have relatively high unsystematic risk, pushing down the price of idiosyncratic risks in many asset categories (e.g. equities and sovereign debt). This is reflected especially in emerging markets.
- Financial innovation, such as unbundling of risk with the help of some time complex derivatives, has improved the allocation of risk bearing and increased demand for many types of risky assets. This has exerted downward pressure on various risk premia, most notably credit risk. Similarly, increased ability to transfer risks through securitization has reduced risk premia.

Most of these developments are welcome and reflect improved fundamentals and development and innovation in financial markets. At the same time, some of these may not be permanent and others may help feed some unsustainable developments with systemic implications. As such, they need careful monitoring.

There are also some more worrying developments that have compressed risk premia. One such development has been "search for yield", or higher returns in riskier assets, in its many manifestations.

- In some cases, declines in risk premia arising from search for yield may have been reinforced by circular relationships between cause and effect. That is, perceptions about lower risks may have shaped the reality, leading to self-reinforcing cycles of narrowing risk premia.
- There is a risk that modern quantitative risk management tools could in some cases be contributing to excessive compression of risk premia. If used mechanically, falling volatility leads to an increase in a trader's risk budget, which in turn may encourage further risk taking, thus contributing to the compression of risk premia. Measuring on the basis of past developments, statistical tools may also underestimate risks stemming from rare, but big events – such as natural catastrophies or major political events.
- In some cases investment managers' incentive structure leads a rational manager to take knowingly excessive risks.[2] Raghuram Rajan has written and spoken extensively about how some investment managers may be tempted to take excessive hard-to-quantify "tail risks" that pay positive return most of the time to compensate for relatively rare but very negative returns. The situation is exacerbated because other managers may take on board increased risk just in order to avoid performing poorly relative to their peers.

It is impossible to know how wide-spread this type of unhealthy risk taking is, or what is its significance in quantitative terms. However, this type of behavior is likely to be most prevalent during times of abundant liquidity and general stability, i.e., conditions that we currently have. Moreover, it seems likely that the volume of funds managed by managers with potentially unhealthy incentive structures has grown with the increased popularity of hedge funds.

But increased uncertainty about durability of benign conditions?

To sum up, there has been a broad-based decline in many measurable risks and much of this development reflects factors that are welcome and sound. Moreover, the markets seem to expect that global economic conditions will remain broadly favorable going forward. At the same time, one could argue that uncertainty may in fact have increased.

One source of uncertainty is that the decline in risk premia may have become excessive due to unhealthy under-pricing of risks. The increasingly integrated global financial markets imply that a major

[2] See e.g., Rajan, R.G. (2005); "Has Financial Development Made the World Riskier", paper presented at the Jackson Hole symposium sponsored by the Federal Reserve Bank of Kansas City, August 25-27, 2005; and Rajan, R.G. (2007); "Financial conditions, alternative asset management and political risks: trying to make sense of our times", Banque de France, Financial Stability Review – Special issue on hedge funds, No. 10, April 2007.

retrenchment of risk taking in one market has a potential to feed rapidly to other markets. Therefore, a large enough shock could bring about a broad-based and potentially disruptive widening of risk premia.

A related concern is that the resiliency of the new global financial system in the face of a major shock remains untested. Financial innovations have enabled transferring various risks to the investor with the biggest appetite for a particular type of risk. During calm and predictable market conditions, this compresses risk premia. At the same time, financial innovations may well have created new types of systemic risks that will only become evident in more turbulent conditions.

Finally, the combination of large global imbalances and signs that political support for globalization may be beginning to wane is a clear cause for concern and a source of uncertainty.

We should avoid sounding alarmist, but one of the lessons of history is that when the consensus view is becoming very optimistic, a prudent person should become worried.

Implications for central banks

What does this dichotomous view of the word, a benign baseline underpinned by continued smooth globalization and the apparent increase in uncertainty mean for central banks?

I will look at this only from two different angles. First, what would an increased uncertainty and possibly more adverse operating environment imply for central banks? And second, I will briefly touch upon the role of monetary analysis in the apparently low risk environment characterized by heightened uncertainty.

Key trends in central banking: increased independence and transparency

During the past couple of decades there has been a clear trend towards greater central bank independence. The increased independence has naturally been accompanied with mandates that have given more clarity to central banks' objectives and required from them increased democratic accountability and transparency.

Over time, many central banks have chosen to define their objectives more narrowly than their mandates in some cases would absolutely require, including through the adoption of quantitative definitions of price stability, or numerical inflation targets.

There has also been a general trend towards greater transparency. Central banks have become much more open about their analysis and decision making. In general, the central banks have sought to become more predictable. To this effect, many central banks have started to publish macroeconomic forecasts, together with their underlying assumptions and other supporting analysis. Central banks have also increased transparency by holding press conferences following the meetings of their decision making bodies, publishing minutes, or releasing written statements explaining the policy stance.

Much of the recent debate has centered on the issue of how and to what extent central banks should communicate on their views and intentions regarding future interest rates. A few have started to publish their views on the future path of short term interest rates. Most central banks have, however, opted for qualitative statements regarding their future intentions.

To sum up, in the past couple of decades we have witnessed a trend towards independent central banks that are becoming increasingly specific and open regarding their objectives, analysis and intentions. In a significant and successful act of delegation, political decision-makers have been giving central banks more leeway to act, while central banks have accepted – not involuntarily – constraints of various degrees of rigidity regarding their policy goals.

Are we likely to see these trends continue going forward, even in the face of heightened uncertainty? To answer this question, it is useful to recall the main forces that have underpinned these trends during the current phase of globalization.

Role of monetary policy research

The evolution of central banking during the past two decades has been greatly influenced by findings of monetary policy research. The findings have underscored the need to insulate monetary policy decision making from political pressures and the importance of clearly defined objectives in stabilizing inflation expectations. Moreover, after research in the early 1980s suggested that central banks could influence the real economy only by being unpredictable, it is nowadays generally accepted that central banks should focus on achieving price stability, and there it pays to be predictable.

Here it is important to note that although more transparency does not imply any explicit commitment from the part of a central bank, transparency goes hand in hand with consistency. Therefore, in many respects, the tradeoff between transparency and opaqueness is similar and parallel to the more "traditional" tradeoff between (binding) rules and discretion.

Role of economic and political operating environment

During the current phase of globalization central banks have greatly benefited from a confluence of benign economic and politically environment.

As noted earlier, central banks clearly contributed to the Great Moderation. However, the causality ran also the other way round. Namely, by making the central banks' economic environment increasingly predictable, the Great Moderation driven by forces of globalization enabled and encouraged central banks to become more transparent and specific about the objectives and intentions.

Increasingly benign economic environment played also a role in the trend toward more independent central banks. This is because without the increasingly predictable environment brought about by the Great Moderation, political decision makers would have been less likely to put their trust in the central banks ability to deliver on their mandates at politically acceptable cost.

Against this background, one could argue that if the central banks' operating environment were to become more uncertain and less benign, we could well expect to see a reversal in trends described above.

The increase of political pressure in less benign and less predictable environment is inevitable and largely beyond central banks' control. However, it underscores the need to give central bank independence solid legal basis when times are good. Without the support of solid de jure independence, de facto independence enjoyed during "fair weather" may vanish with arrival of "rainy days". But de jure institutions are durable only if supported by a well-rooted policy culture and a general consensus of the public at large. When central banks invest in public trust by demonstrating their transparency and accountability, and by promoting economic literacy, they are in fact investing in financial and macroeconomic stability "for the rainy day".

Financial stability and role of monetary analysis

Financial globalization and the related phenomenon of declining risk premia have required central banks to attach increasing weight on financial stability considerations.

Therefore, let me just make a few points about financial stability from central banks' perspective, and the role of monetary analysis in this context.

One set of important issues relates to the need to ensure that central banks' role in, and strategies for crisis management and resolution are sufficiently clear. While moral hazard considerations demand some constructive ambiguity vis-à-vis the markets, it is imperative that the rules of the game and the division of responsibilities is made clear among the relevant authorities.

Another set of important issues relates to crisis prevention. While most issues in this area belong to the realm of supervision, in which central banks' competences vary widely, I would like to highlight one aspect that is directly related to monetary policy – namely that of the role of monetary analysis.

As we all know, instability in the short-run relationship between money and inflation has resulted in much pressure to downgrade the role of monetary analysis in monetary policy deliberations at various central banks.

I concede that the relative value of monetary analysis may well have declined with respect to analysis of short-term pressures on price stability. At the same time, monetary aggregates, credit growth, asset prices etc. contain valuable information that remains relevant for assessing longer-term future inflation developments and, importantly, potential emerging threats for financial stability.

First, I would argue that "money matters" especially during conditions of possibly excessively compressed risk premia. Indeed, here I would like to quote Charles Goodhart who in his recent paper notes how in booms "*official policy rate may rise, but risk premia may fall. Against this background it would be short-sighted not to cross-check for the combined effect that a combination of official policy measures and changing risk aversion may have by looking carefully at the time path of the monetary aggregates*."[3]

Second, uncertainty underscores the need for a broad-based monetary analysis that takes into account other relevant economic information. In addition to monetary aggregates, and perhaps even more importantly, such an analysis needs to pay particular attention to credit developments. Clearly, the rate and composition of credit expansion can contain valuable information about factors affecting developments of risk premia. Moreover, such analysis can offer hints about possible build up of uncertainty.

Broader policy implications

While the exact anatomy of the next major crisis can not be known in advance – otherwise the crisis could be avoided – it seems reasonable to assume that one feature could well be a possibly broad-based reversal in risk premia resulting in financial instability. Moreover, the policymakers have to be prepared for the various challenges arising from weaker economic growth.

We have a shared obligation to address tensions that could conceivable trigger adverse outcomes. Much can also be done to minimize the damage caused by adverse events by increasing the resilience of the systems and ensuring orderly resolution of crises. This calls for strengthening policies and institutions, both at international and national levels.

International level

The multilateral arrangements, which play an important role in underpinning global growth, need to be safeguarded and strengthened.

It goes without saying that we need a successful completion of the WTO Doha round.

I would also want to emphasize the importance of the IMF. First, despite its shortcomings, the IMF's surveillance can play a role in reducing the risk of disruptive adjustments, including as regards global imbalances. Its FSAP (Financial Sector Assessment Program) contributes to more resilient financial systems. Moreover, the IMF can provide a unique forum for crisis resolution. As we all know, many important reforms, both related to the tools at the IMF's disposal as well as the IMF's governance structure, are now at a critical juncture and compromises are needed to make progress.

Another issue is the need for strengthened supervision of cross-border financial institutions. We need more clarity on how to divide the tasks, powers, and responsibilities between different countries in supervising cross-border financial institutions and dealing with these institutions in financial distress. We have been making progress on these issues within EU, but more work is clearly needed within EU as well as at the more global level. In particular we have to think of ways to close the gap, on the one hand, between legal powers and mandates and, on the other hand, the abilities and responsibilities of the home and host supervisors. (These issues are already particular relevant for the Nordic and Baltic region where cross-border ownership of financial institutions is perhaps ahead of that anywhere else in the world.)

National level

There are some issues that relevant for all countries, despite big differences in country-specific circumstances.

First, there is a need to reduce fiscal vulnerability through sufficient fiscal consolidation and prudent debt management practices. In the event of a crisis, fiscal balances could be hit through many channels: weaker economy, higher debt service as a result of higher interest rates and possibly also

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[3] Goodhart, C.A.E (2007) "Whatever became of the monetary aggregates?", National Institute Economic Review, 2007; 200; 56.

weaker currencies. Moreover, possible problems in the domestic financial systems could also force governments to incur additional liabilities.

Second, there is a need to reduce financial sector vulnerability through enhanced supervision. One key challenge related to the financial sector is to ensure that domestic private sector balance sheets are resilient enough to withstand interest rate shocks.

Some issues are of particular relevance to those countries that are still in the process of fully integrating to the global financial system. In other words, those countries whose access to global financial system could be interrupted, or become severely constrained at a time of a crisis.

The only way to fully and securely integrate into the global financial system is to build strong enough institutional infrastructure that ensures a well-functioning domestic financial system, even in times of stress. Rick Mishkin, who has worked extensively on globalization and financial development, put it well when he argued that the following steps need to be taken to ensure a well-functioning financial system: i) develop strong property rights; ii) strengthen the legal system; iii) reduce corruption; iv) improve the quality of financial information; v) improve corporate governance; and vi) get government out of the business of directing credit.[4]

Clearly, many countries here in Latin America have in recent years made impressive progress in implementing institutional reform on many areas mentioned in this list. For this, and for increasingly prudent macroeconomic policies, the markets have rewarded them handsomely in the form of declining cost of funding and more secure access to international and domestic capital markets. These achievements should be consolidated.

Concluding remarks

In my remarks today, I have discussed the important role of uncertainty in the interplay between monetary policy and its economic and political operating environment.

During the current phase of globalization central banks have benefited from a very benign economic and political environment. This benign environment, characterized by declining risks and increased predictability, has underpinned and strengthened the trends toward more independent and transparent central banks. Current economic outlook remains generally favorable and many measurable risks remain low or are even receding. However, I have argued that uncertainty, or those risks that cannot be readily quantified, may in fact be on the rise.

If this uncertainty were at some point to translate into a more unpredictable and less benign operating environment, we could expect to see breaks or even reversals in some of the key trends I have discussed. This could apply to development of risk premia, evolution of central banking, and the political support for domestic and multilateral institutions that have lent support to the current phase of globalization.

This all emphasizes the need to take advantage of the current favorable conditions by solidifying the gains made by strengthening institutions that have been underpinning the favorable developments, both at the global and national level.

The founder of Intel, Andy Grove, titled his memoirs: "Only the paranoids survive"

Central banks' operating environment appears more stable and predictable than that in the IT business. Nevertheless, we have to avoid the risk of becoming complacent. Therefore, we have to be willing to continuously question and reassess our analysis and the way in which we conduct monetary policy. In this regard, events such as this where central bank practitioners, members of academia and representatives of financial institutions can come together to exchange views about the topical issues/challenges are most valuable.

With these remarks I wish to conclude and thank our hosts for organizing this excellent conference.

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4 See Mishkin F.S. (2006), "The Next Great Globalization, How Disadvantaged Nations Can Harness Their Financial Systems to Get Rich", Princeton University Press.