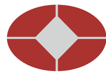

The risk of complacency and self-delusion

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There are many recognised short-term risks in today's global economy: new financial crises in highly indebted emerging market economies (EMEs), a bond yield snapback in advanced economies (AEs), old and new geopolitical tensions disrupting a fragile recovery or even an "unknown unknown" new event. There are also important long-term issues such as the environmental consequences of our present growth model, which might affect climate change. But perhaps the most significant risk for financial markets now is the risk of complacency and self-delusion. Some of this is partly related to markets' hope that short-term policies at odds with well established economic principles are sustainable. But it is also partly related to markets' bet that muddling through policies in increasingly fractured societies without undertaking sustainable structural reforms can still produce interesting short-term returns.

Let's start with the current outlook. Is there finally a light at the end of the Global Financial Crisis (GFC) tunnel? Perhaps yes: there are finally some signs of rebound in activity in the United States and Europe[2]. There is now more reflation talk instead of the recent fear of deflation. There is an improvement in unemployment rates. And there is more optimism in markets, with a rise in equities and higher confidence. The puzzling element in the midst of this new optimism is that policy uncertainty is very high but volatility is very low (Graph 1, right and bottom panel). What is really going on?

Naturally, after electoral "surprises" in the United States and in Europe, markets are tempted to see mainly the positive side and forget the downside risks.

In the United States, a positive reading by markets is pricing in a more business-friendly stance and the end of the policy gridlock of the last years. Overall, it points to a more balanced macroeconomic policy stance with some expected tax cuts and some additional fiscal stimulus on infrastructure spending together with the continuation of monetary policy normalisation. All this is making equities go up (particularly banks and energy), pushing headline inflation up while core inflation remains well behaved. This is also occurring under skilful management by the Federal Reserve of expectations and communication to markets. Business confidence has strengthened. Of course, there is also a negative reading: there could be a bond yield snapback if the Fed falls "behind the curve", with core inflation picking up with too much additional fiscal stimulus under a tighter labour market.

In Europe too, there are positive developments. The ECB successfully eased monetary conditions through various programmes and pronouncements, including the famous "whatever it takes" speech, to contain the pressures of the sovereign debt crisis. The establishment of the Single Supervisory Mechanism and the move towards banking union has made the banking system safer. Yet the downside risks have not disappeared. Structural problems, such as low productivity growth and difficulties to reform, remain.

[1] The views expressed here are our own and do not necessarily represent those of the Bank for International Settlements. We are grateful to Amy Wood for research assistance.

[2] BIS Quarterly Review, March 2017.

Monetary policy can buy time, but unfortunately, it was not enough to fully undertake the necessary structural reforms. As political will fell short, monetary policy became "the only game in town". And public discontent that is shifting electorates to various forms of "populism" could pose further risks to social and economic stability.

In spite of policy uncertainty, market sentiment is buoyant — Graph 1

Manufacturing and services PMIs[1]
Diffusion index
Advanced economies:[2] / EMEs:[3]
Manufacturing
Services

Consumer confidence[4]
Points of standard deviation
Germany
United Kingdom
Japan
United States

Unemployment rate[5]
Per cent
Global[6]
EMEs[8]
Advanced[7]
Small open[9]

Inflation
yoy changes, in per cent
AEs[2]: Headline, Core
EMEs[3]: Headline, Core

Stock prices
1 Jul 2015 = 100
S&P 500
Nikkei 225
STOXX Europe 600
MSCI EM[4]

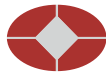
Market and policy uncertainty
Percentage points / Index
Lhs: VIX
Rhs: Global policy uncertainty[2]; US policy uncertainty[3]

The vertical lines indicate 23 June 2016 (UK referendum on EU membership) and 8 November 2016 (US presidential election).

[1] A value of 50 indicates that the number of firms reporting business expansion and contraction is equal; a value above 50 indicates expansion of economic activity. Weighted average based on GDP and PPP exchange rates of the economies listed. [2] XM, GB, JP and US. [3] AR, BR, CL, CN, CZ, HK, HU, ID, IN, KR, MX, MY, PE, PL, RU, SG, TH, TR and ZA. [4] Normalised data, measured as the difference between the indicator and its historical average (since January 2016). [5] Total number of unemployed expressed as percentage of the labour force. OECD forecasts for 2016. [2] Aggregates for respective groups of economies, weighted averages based on GDP and PPP exchange rates. [6] Advanced economies and emerging market economies. [7] AU, CA, CH, DK, GB, IS, JP, NO, NZ, SE, US and XM. [8] AR, BR, CL, CN, CO, CZ, HK, HU, KR, MX, MY, PE, PH, PL, RU, SA, SG, TH, TR, TW and ZA. [9] AU, CA, CH, DK, IS, NO, NZ and SE.

Sources: S Davis, *An index of global economic policy uncertainty*, www.PolicyUncertainty.com; Bloomberg; Datastream; OECD, *Economic Outlook*; national data; BIS calculations.

Risks are also present in the European financial system. Low and negative interest rates put banks' and insurance firms' profits under pressure. The task of adjusting business models to this environment has

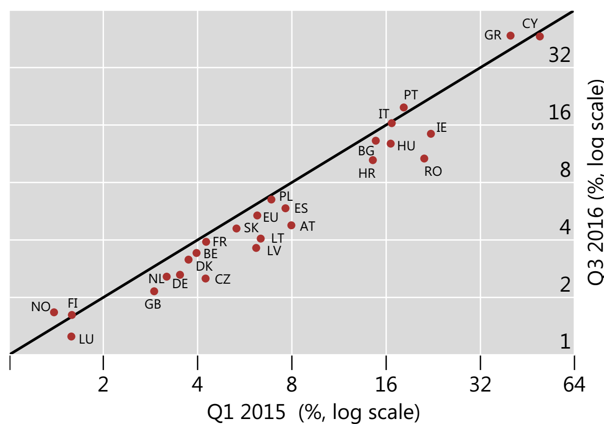


only just started. Non-performing loans (NPLs) remain high in some countries, weighing on banks' balance sheets. The reasons are complex: in some places, the slow recovery and low interest rates disincentivise write-offs; elsewhere, the tax treatment of write-offs or the difficulties of contract enforcement are the impediments. And where NPLs remain high, monetary transmission and financing of new investments also remain impaired (Graph 2, left-hand panel).

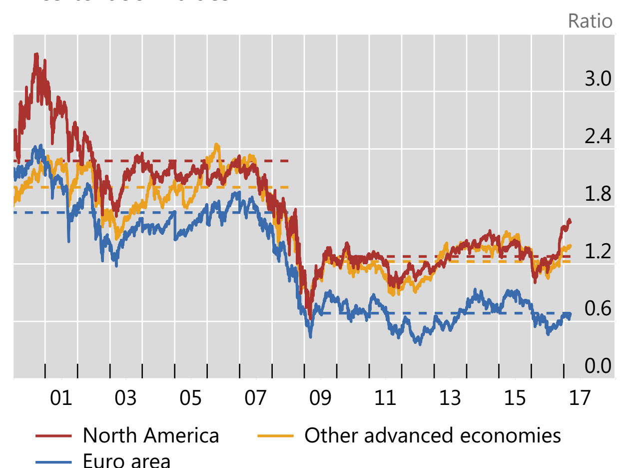
Banks' price-to-book valuations declined after the financial crisis in all regions (Graph 2, right-hand panel) but remained well below unit level in euro area banks (blue line). The fact that valuations are lower today than before the financial crisis does not necessarily represent a problem: it is in fact consistent with requiring bank shareholders to shoulder more of the risk of bank operations. However, very low price-to-book ratios, for instance those below unit levels, can signal two problems. The first, forward-looking, problem is that bank business models are not yet able to produce returns that would match what equity investors expect. The second, backward-looking, problem is that banks face impaired balance sheets, which lowers their valuation in spite of their future profit-generating ability. Hence, banks need to both clean their balance sheets (while regulators help the process by removing the legal obstacles) and adjust their business models to increase profitability. And regulatory reforms need to be finalised to ensure that internationally active banks are safe and operating on a level playing field.

Banking sector vulnerabilities are still present, particularly in Europe — Graph 2

Ratio of non-performing loans to total loans



Price-to-book values



Sources: European Banking Authority, *Risk Dashboard*; Datastream.

As we know well in Europe, many commentators highlight the need to work towards completing the common currency area with a common budget framework, proper institutions with authority to decide on fair and efficient fiscal transfers, and enforcing banking rules and common supervision mechanisms.[3] All this should strengthen and simplify the euro zone decision-making process for the common good. Last but not least among global short-term risks is the accumulated dollar debt of emerging market economies (EMEs), especially in the corporate sector. The amounts are lower but still sensitive to higher interest rates and a stronger US dollar.

[3] See M Brunnermeier, H James and J P Landau, *The euro and the battle of ideas*, 2016; and J Pisani-Ferry, *The euro crisis and its aftermath*, 2014.

But above all these short-term risks that can result in either more positive or negative scenarios, there are perhaps more serious policy risks. We are witnessing a departure from the policies of trade integration and multilateral cooperation that have been our successful recipe for the last 50 years. Is it purely rhetorical or real? Temporary or lasting? Is it linked to the current backlash against globalisation? Therefore there is a disconnect between market exuberance and policy uncertainty. There are indeed threats to trade, financial integration and international cooperation that benefited both AEs and EMEs. These threats are increasing.

These new (or old?) ideas might compound the consequences of recent political events that might not be really factored in by markets. There could be more complex consequences of Brexit than anticipated so far; there could be heightened "trade tensions" with the imposition of new tariffs and non-tariff barriers. This is not fictional: it is already producing real consequences such as the sudden stops of foreign direct investment (FDI) in some EMEs, and this is not the usual sudden stop of financial flows.

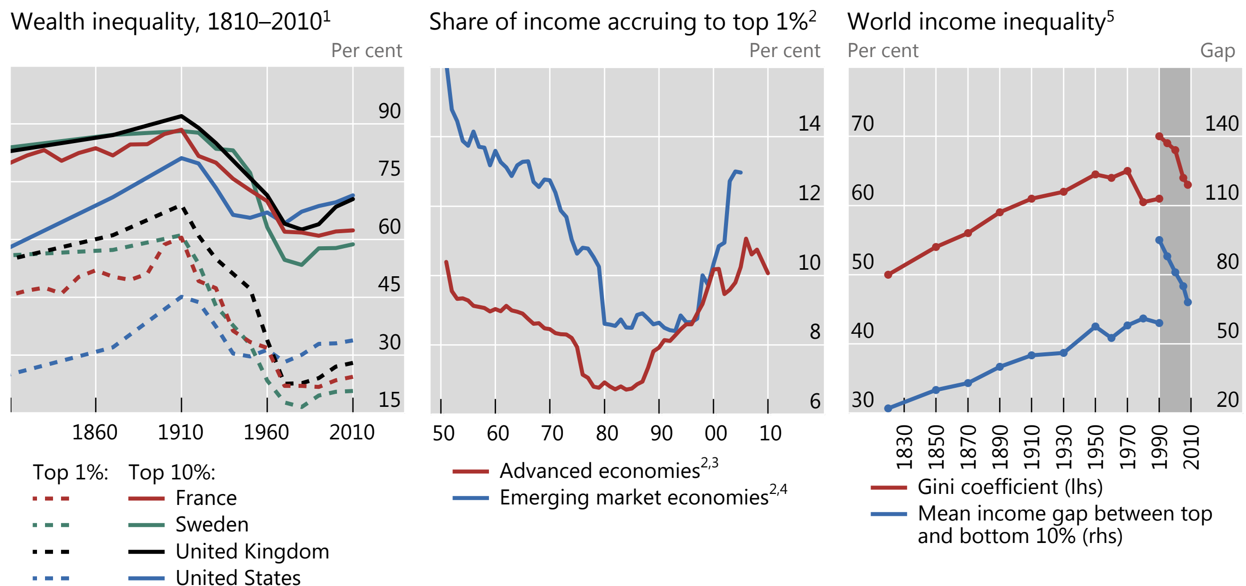
We dealt with these issues in EMEs. The experience there in the last decades has been that the various forms of "populism" and "protectionism" did not contribute to improve societies' well-being; quite the opposite. But these very same temptations are now appearing prominently in the debate in AEs. Trade and financial integration are not an automatic win-win in any social and economic setup. They always come with trade-offs: efficiency gains versus distributional consequences. Efficiency gains produce structural transformations of production and employment. These changes obviously affect the "employability" of workers in AEs. Undoubtedly, and concomitantly with trade and financial integration, inequality has increased steadily over the past decade (Graph 3, left-hand and centre panels). While structural transformations always have these distributional consequences, we should not forget that not only globalisation but also technological change played a role in increasing inequality.[4] What is important to bear in mind is that these distributional effects could (should) be dealt with using adequate policies (fiscal transfers, retraining labour etc). The key is how the economy can adapt and how to make benefits greater than costs with more inclusive policies and retraining. We should not forget either that globalisation helped to reduce global inequality, ie inequality across countries (Graph 3, right-hand panel). Although discontent in large pockets of society can create blocking coalitions and paralyse economic reforms, it should be possible to engineer some goodwill to work for the common good and improve social welfare.[5]

4 See J Stiglitz, *Globalization and its discontents*, 2002.

5 See D Rodrik, *The globalization paradox*, 2011.

Income and wealth inequality has been decreasing across countries but increasing within countries

Graph 3



[1] Excluding capital gains. [2] Simple average of the economies listed. [3] Australia, Canada, France, Germany, Ireland, Italy, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom and the United States. [4] Argentina, India, Korea, Malaysia, Singapore and South Africa. [5] Calculated from Bourguignon (2015)..

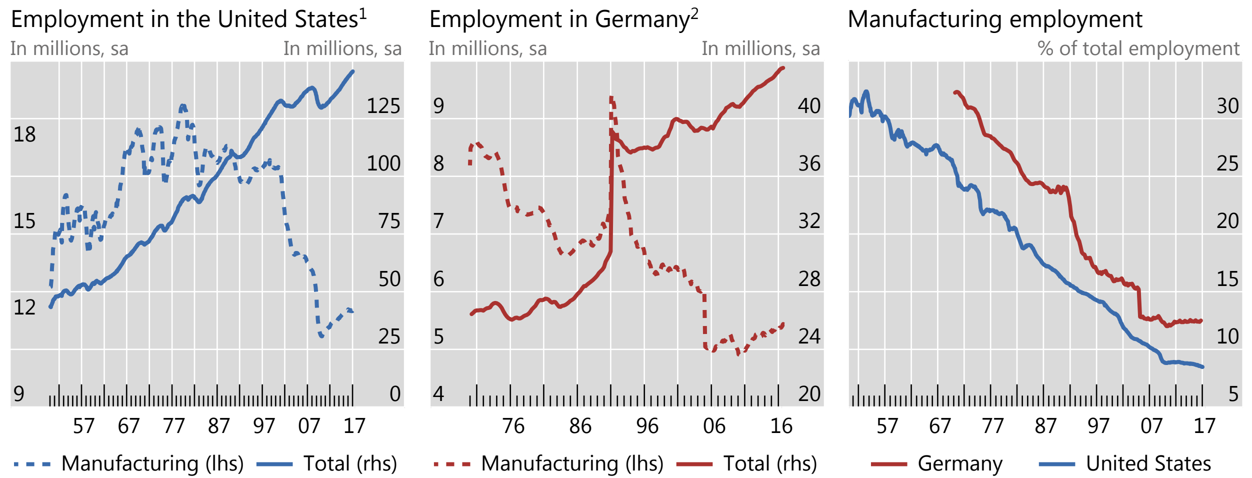
Sources: F Alvaredo, L Chancel, T Piketty, E Saez and G Sucman, Global inequality dynamics: new findings from WID.world, 2017; F Bourguignon, "A turning point in global inequality … and beyond", in W Krull (ed), Research on responsibility. Reflections on our common future, CEP Europäische Verlagsanstalt Leipzig, 2011; F Bourguignon, The globalization of inequality, Princeton University Press, 2015, p 27; F Bourguignon and C Morrisson, "Inequality among world citizens: 1820–1992", American Economic Review, vol 92, no 4, 2002, pp 727–44; C Lakner and B Milanović, "Global income distribution: from the fall of the Berlin Wall to the Great Recession", World Bank, Policy Research Working Papers, no 6719, December 2013; A Maddison, Monitoring the world economy, OECD Development Centre, 1995; T Piketty, Capital in the twenty-first century, 2014.

In any event, given what we know and the results of past experiments, it is important to defend the net positive effects of trade and financial global integration. Trade and/or finance stoppage as a response might be a lose-lose proposition. It might lead us to lower growth, higher inflation, higher interest rates and financial fragmentation, especially in areas that have worked hard to integrate, such as the euro zone. Returning to any form of "protectionism", can lead to trade sanctions that can disrupt global value chains (GVCs), which could spill back to the AEs. And a fading of the recovery in the US and Europe can reignite the deeper problems of the weakening of the middle class and the political polarisation that pose further risks. Finally and moreover, there seems to be a tendency to mix the backlash against globalisation with suspicion of experts, including central banks. Therefore, the actions taken by policymakers, especially central banks, during the GFC in particular to preserve the functioning of markets and avoid another Great Depression need to be defended.

Blaming trade, financial integration and globalisation for manufacturing job losses and greater inequality is an oversimplification. A large, diversified literature from many angles supports the view that an essential part of the shift in the productive structures of AEs is largely due to technological change. That affected all the highly productive AEs (Graph 4). It is important to acknowledge that these structural changes substituted manufacturing jobs with other jobs in other sectors. It is even more important to stress that corrective policies to tackle job losses and inequality could have been strengthened. They should have improved skills and human capital. This could have been accompanied by higher investment in the quality of infrastructure in areas with high unemployment and with an increase in social inclusion

through efficient, targeted and well tested policies. It might not have solved all problems, but it could have helped to reduce tensions.

Employment in manufacturing in Germany and the United States Graph 4



[1] Total non-farm employment. [2] Before 1991, data for West Germany; for employment in the manufacturing sector, the data have an additional break in 2005 due to an NACE reclassification.

Sources: OECD, *Main Economic Indicators*; Datastream.

Undertaking the above agenda of policies and reforms requires hard work. It is tempting to focus on short-term returns and disregard the potential downside risks. Thus, markets' leaning towards complacency and short-termism might be the most significant risk today: self-delusion will not get us very far. Some exuberance today cannot replace the need to fix our economies, increase productivity and mend the social fabric with more inclusion and fairness. It is with markets' cooperation and alertness that policymakers will be more capable to act for the common good.