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Major Challenges for Global Macroeconomic Stability – The Role of the G7

Financial Market Volatility and Global Policy Uncertainty: a Conundrum

Dinner Address by the Governor of the Bank of Italy

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After the turnaround that has been observed since the second half of 2016, there are encouraging signs that the global economy is continuing to gain positive growth momentum. Overall, financial market developments have been and continue to be favourable. The positive tone associated with widespread gains in stock markets, including in bank equities, and with higher long-term interest rates, also following the increase in market-based inflation expectations, has been accompanied by persistently low levels of financial market volatility.

In the same period, however, there has been a sharp rise in global policy uncertainty. This is a cause for concern: there is ample empirical support for the claim that economic policy uncertainty – if persistent – dampens economic activity and trade as well. Although the positive tone and low financial market volatility provide some comfort, we should be aware of the fact that economic policy uncertainty measures – with all the caveats that apply to news-based approaches – may capture longer-term concerns only partly correlated with perceptions of the short-term macroeconomic outlook on which financial markets tend to focus.

Rising policy uncertainty is clearly linked to the substantial changes that have occurred in the international political landscape in recent months. The unexpected outcome of the referendum on the United Kingdom's exit from the European Union has thrown a spotlight on the risk of a regression in the process of European integration. Much has been said about the difficulties and uncertainties of the Brexit negotiations. At the same time, nationalist and populist movements are on the rise in many countries within the Union, while political instability and tensions in nearby regions are high.

This year the number of refugees seeking political asylum could rise to new record highs: there is no need to stress the urgency of the migration problem, which concerns virtually all European countries, and some – like Italy − more than others. Indeed, in recent years it seems that a divide has emerged within the European Union on crucial issues such as the approach to migration inflows and the prospects for a unified defence policy. Last Saturday, the Declaration of European leaders on the occasion of the 60th anniversary of the Treaties of Rome pointed to a renovated sense of unity. But we cannot underestimate the risk of costly political paralysis in a year with a number of critical upcoming elections at a time when the challenges we face could not be more difficult.

Even if the recovery seems to be gaining momentum, the legacies of the crisis – most notably in the labour market and in the banking sector − are still weighing on the economy. All this looms over a European construction that is largely incomplete. We still need to take decisive steps to complete the banking union. The functioning of the Economic and Monetary Union is hampered by the lack of a common fiscal policy. Needed progress in these areas is complicated by a decline in mutual trust between countries and by the growing general dissatisfaction of the people with European institutions.

On the other side of the Atlantic, the new US administration is sending conflicting signals on a number of key issues. The details of the next fiscal package are yet to be defined. While the prospect of fiscal expansion may be boosting the business climate, this could have pro-cyclical effects at a time when the economy is almost at full employment. The new administration's stance on financial regulation is also not yet clear, but there is good reason to believe that a wave of regulatory easing, coupled with an expansionary budgetary policy, could lead the Federal Reserve to undertake a less gradual normalization of the monetary stance so as to avoid fostering imbalances such as those observed in the years immediately prior to the financial crisis.

If this proves to be the case, there could be negative international financial spillovers. But the most widespread concern is probably related to the US administration's stated intention of slowing down or even reversing the process of trade liberalization, which could trigger retaliation by other countries, with negative repercussions on productivity and growth worldwide.

Thus, as a result of these global developments, we are now seeing a very sharp increase in economic policy uncertainty in all the main advanced countries. During the first two months of 2017, the most often cited policy uncertainty index (the one developed by Scott Baker, Nicholas Bloom, and Steven Davis) reached its highest points since January 1997, the start of its time series, for both the global economy and the euro area. For the euro area, the index has been on the rise since mid-2014; its most recent movements largely reflect the upcoming elections in France and Germany. The index for the United States has reached its highest level in five years due to the key contribution of two categories: fiscal policy uncertainty and, especially, trade policy uncertainty.

It is well-known that economic uncertainty is a strongly countercyclical variable: it usually increases during recessions and decreases during economic expansions. Many studies, however, have shown that uncertainty is not just the consequence of the business cycle but is also one of its key drivers. Elevated uncertainty affects economic activity through two main channels. First, it weakens aggregate demand, as households postpone consumption decisions and increase precautionary savings, while businesses delay investment and hiring plans. Second, it hampers aggregate supply: by delaying investment and hiring, in fact, the quality and quantity of physical capital diminishes, while the process of reallocation of workers from less to more efficient firms – which is responsible for the highest share of productivity growth – freezes, causing a slowdown in productivity. Indeed, in Italy uncertainty has been a sizeable drag on investment growth, not only during the global financial crisis but also in its aftermath, thus being one of the main factors behind the lagging recovery of the Italian economy.

Notwithstanding a sharp increase in economic policy uncertainty, growth in the euro area has recently improved. This is to some extent surprising. While some analysts have argued that what really matters is financial uncertainty, which is currently low, as I have pointed out, evidence for the United States shows that economic policy uncertainty negatively affects employment and industrial production even when financial uncertainty is taken into account. My personal view on why high policy uncertainty seems to have had only a limited effect in the euro area in recent months is that its negative impact was successfully countered by the strongly expansionary monetary measures implemented by the ECB.

Indeed over the last few years the euro area has faced a very challenging environment. Downward risks to price stability increased sharply after mid-2014: as inflation fell, economic activity lost traction and monetary and credit dynamics remained weak. There was a material risk of expectations de-anchoring from levels consistent with price stability, as long-term expectations reached historical lows. In an environment of high levels of public and private debt, activating 'debt-deflation mechanisms' would have had very serious effects on the economy.

To combat these risks, the ECB Governing Council adopted a bold set of conventional and unconventional monetary policy measures. Official interest rates were progressively cut to zero on our main refinancing operations and to negative values (currently -0.40 per cent) on the deposit facility for banks, representing the truly 'non-conventional' element of our monetary policy. A very substantial asset purchase programme was then put into place, following the example of other central banks. (I would like to point out that – although this is a new approach for the euro area and is very broad and comprehensive, involving purchases of asset-back securities, covered and corporate bonds, and public sector securities in particular – this measure is not revolutionary for monetary policy: it certainly would have been regarded as 'conventional' in the 1960s and 1970s given the emphasis on changes in the composition of private sector balance sheets that prevailed at that time both in policy-making and in academic works on the transmission mechanism of monetary policy). Finally, we launched two series of 'targeted' long-term refinancing operations with conditions that rewarded banks for providing more credit to the economy.

The impact of the overall package has been considerable. Our purchases have significantly reduced yields in the market segments where we have intervened and, through the portfolio rebalancing channel, they have also bolstered the prices of a wider range of financial assets, with a positive impact on household consumption through the wealth effect and on business investment through the fall in the cost of capital. Credit supply conditions have gradually eased. The cost of loans to the economy has fallen to historical lows and financial fragmentation in the euro area has lessened. The combination of the decline in returns on fixed-income securities associated with our purchases and the reward system attached to our targeted refinancing operations has spurred the supply of credit to firms and households.

The significant improvement in financial conditions has gradually affected the economic outlook. Deflation risks have disappeared: according to the distribution of inflation expectations based on option prices, the probability of deflation, after reaching a peak of around 30 per cent in early 2015, has returned to levels very close to zero. Market and survey-based expectations on inflation in the short- and the long-term are recovering from the very low levels observed in the last two years; economic expansion is firming and broadening, mainly reflecting the recovery in investment and consumption and rising employment. Headline inflation has also increased, although largely on account of its most volatile components, like energy and unprocessed food prices.

Since underlying inflationary pressures continue to remain subdued and are expected to rise only gradually over the medium term, the Governing Council of the ECB is maintaining the very favourable financing conditions that are necessary to secure a durable, self-sustained and broadly-based convergence of inflation rates towards our price stability objective.

Notwithstanding the overall positive assessment of the effects of our actions, we are aware that prolonged recourse to a bold set of measures might have unintended consequences and that the potential repercussions for specific sectors of the financial system certainly should not be ignored. As far as the impact of low interest rates on bank profitability is concerned, low short-term interest rates can depress bank margins because, for many types of deposits, banks are reluctant to lower deposit rates, especially below zero. Moreover, since banks transform short-term liabilities into longer-term assets, a flattening of the yield curve depresses the net interest margin. This implies that banks with a higher share of retail deposits, floating rate loans and a large maturity mismatch may suffer more from low interest rates. In the current environment, this effect could be particularly problematic for those banks that are not in a sound financial position and have to manage large amounts of non-performing loans.

Our evidence suggests that the impact of monetary policy measures on bank profitability has been in general contained: they have led to higher asset valuations and, more importantly, have supported economic activity and enhanced lending. To achieve a long-lasting return to higher profitability and contribute efficiently to financing the economy, banks also need to make further progress in containing costs, upgrading technologies, and streamlining their organization and branch networks.

In evaluating the possible side effects of our unconventional monetary policy measures, we also carefully consider the risks to asset prices. To date, we do not see signs that our purchases are causing generalized imbalances. Financial assets and property prices in the area as a whole do not appear under pressure and credit growth is still weak. Furthermore, when discussing financial imbalances, I believe that it is important to bear in mind that, in the euro area, the primary objective of monetary policy is to maintain price stability and that, should any threat to financial stability materialize, macro-prudential measures should be used instead to limit the accumulation of systemic risks and to smooth the financial cycle in particular sectors or geographical areas.

While monetary policy has been successful in warding off a deflation trap and no negative side effects have emerged so far, monetary policy cannot remain 'the only game in town'. Aggregate demand in the euro area must be supported by fiscal policy, wherever and however possible. At the same time, potential growth must be reinforced through the adoption of appropriate reforms to foster technological progress and strengthen human capital.

This said, the divergence between economic policy uncertainty measures and financial market volatility is something that should not be ignored, in Europe as well as in the United States. The former indicator is high precisely because of doubts associated with factors other than the monetary policy stance, and the latter is low precisely because this stance has delivered the necessary short-term conditions for a cyclical revival of economic activity. But as rising economic policy uncertainty points towards the severe risks that the political and economic environments will face down the road, low financial volatility may suggest that markets are overly optimistic about the medium-term outlook and underestimate the risks, including political ones.

Eventually, either economic policy uncertainty will recede or an increase in financial volatility will produce (possibly very) negative headwinds for the global economy. Obviously, this will hinge on policy decisions and their crucial effects on trade, investment and growth. But we should be aware that the challenges we are facing on the domestic front are not the only ones confronting us. Indeed, as Tommaso Padoa-Schioppa observed at the height of the financial crisis, "one way in which domestic policy may lose credibility is by continuing to feed the illusion that national governments can address issues – like climate change, energy, security, immigration, finance – that are no longer national, but that increasingly have a global dimension”.

But how can countries manage to cooperate? On the one hand, we have cooperation forums like the G7 and the G20. The joint statements of these groups are highly visible and tend to have a strong impact on the media and the markets. Think, for example, of the attention paid to the communiqué of the G20 two weeks ago and, in particular, to the absence of the standard reference to the need to combat trade protectionism.

After the ‘coordination honeymoon’ that led to the Plaza and Louvre Accords in 1985-87, for reasons that would be too long to discuss here, concerted actions by governments and central banks have been rather sporadic. It is obvious that policy coordination implies facing trade-offs and accepting that we must incur some losses in exchange for well-identified and notable gains. Still, behind the losses lay real interests, with all the difficulties entailed in identifying and possibly compensating for them. Indeed I believe that much of the emphasis put on ‘cooperation’ serves to highlight the problems faced in effectively coordinating policy. Policy coordination at the G20 level, for example, temporarily garnered high visibility at the height of the global crisis, but has subsequently produced mixed results at best.

On the other hand, there are forums where cooperation occurs in a more informal setting, usually focusing on more technical matters. One example is the regular meetings of central bank governors in Basel, where a frank exchange of views takes place on issues regarding monetary policies and financial stability. Another example is the peer reviews of individual countries’ policies on the basis of comparative evidence, such as those conducted at the OECD and in G20 sub-groups. By sharing their experiences, national authorities can find better ways to deal with policy challenges, including those arising from technological, social and economic transformations.

I believe that, for the time being, as the new US administration searches for a way to interact and cooperate with other countries, this type of flexible cooperation is the only way to go. However, to cooperate effectively, we must also be wary of a long-held misconception that has appeared again in some recent public statements: that international economic relations and free trade are essentially a zero-sum game, where a country can only gain at the expense of others. The opposite view that free trade, in particular, is mutually beneficial is not a blind act of faith by economists, but is based on logic and overwhelming evidence, and has survived centuries of deep scrutiny. As a matter of fact, trade integration has been a powerful engine of economic growth at the world level over the last twenty five years or so, and I suspect that the slowdown in trade and in the development of global value chains witnessed in more recent years may be one of the causes of the concurrently slow growth in global productivity.

Eventually, all countries benefit from the effects of trade integration. It cannot be denied that freeing up trade has had its casualties, but preaching stronger trade protection would be as wrong as pushing for a retreat from the technology frontier and the spread of new technologies on the grounds that not everyone benefits equally from them. We should all work to make clear how wrong an inward-oriented policy is in response to political discontent.

Protectionism, in fact, usually serves a few interest groups at the expense of everybody else. A strong signal should instead be sent that it is in the interest of all countries to preserve the overall benefits of open markets. At the same time, managing globalization (and technology) requires that we pay much closer attention to those who are slower to adapt and most likely to be harmed. And we must recognize that this consideration has been to a large extent overlooked so far, both at the national level and in the resolutions of the G7 and the G20.

To conclude, as the global financial crisis has illustrated dramatically, in a world as economically and financially interdependent as ours right now, a failure to set the right financial regulations and economic policies can lead to very bad outcomes, with everyone paying a steep price. Such outcomes can only be prevented through open-minded cooperative confrontation. This is not an oxymoron, but instead is the basis for economic and political progress, the only way, given current conditions, to arrive at decisions that will reduce global economic uncertainty rather than cause a sharp rise in financial market volatility, with its associated sizable instability risks.