"Ultra-low interest rates– causes, policies, effects"

Daniel Daianu, **ASF International Conference**, Bucharest, 2 June 2016

Contents

1. Context

- **Economic slowdown; low inflation**
- **High connectivity, high volatility**
- “New” **systemic risks…high fragility**
- **Disruptions,** *sudden stops* ***(liquidity traps)***
- **New technologies** and financial markets
- **Cyber attacks: huge risk (***Swift***, bank robberies…)**
- Change in business models

1.1 Macroeconomic context

- **Insufficient demand/ *"the new normal"***
- **Low inflation/deflation; *liquidity traps***
- ***Hysteresis*** (labor, potential GDP-- Summers)
- **Legacy of resource misallocation** (Borio)
- ***Debt-overhang*** (Rogoff), **deleveraging** (Koo)
- ***Uncertainty***; impact on **investment and saving**
- **Ultra-low interest rates**
- **Unconventional policies**

1.2 Macroprudential context

- **Unfinished regulatory reform** (ex: capital and liquidity requirements –Banks'models, BIS/VAR rules to be standardized…)
- **Complexity**: a challenge for both regulators/supervisors and CEOs (*conformity*)
- **Large entities** and systemic risks
- **Migration of risks** (capital markets)
- **Fintech** and new risks; **parallel currencies**?

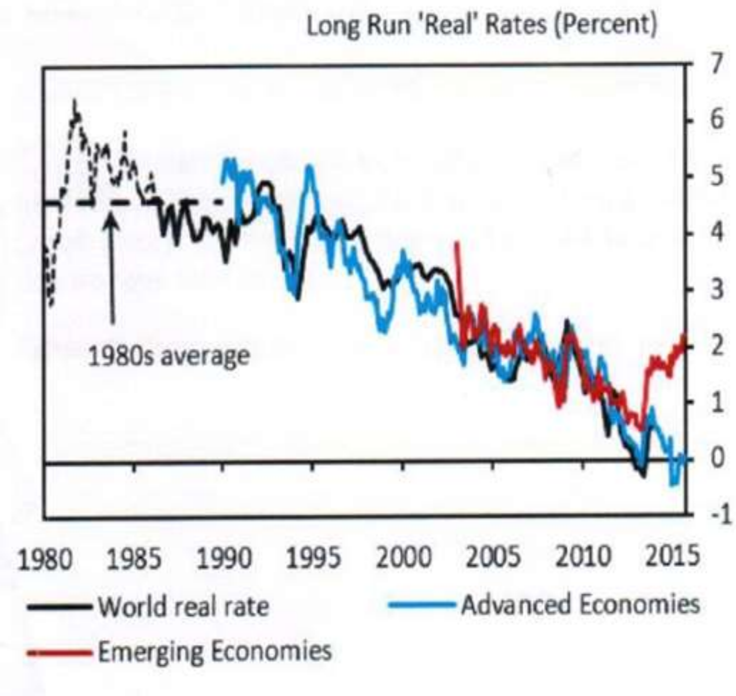
2. Why ultra-low interest rates matter

- They mirror **large dysfunctions in economies**
- **Side effects**: bubbles, distributional impact, instability in EMs, high volatility, perpetuation of resource misallocation (BIS)
- Banks' and non-banks' **balance-sheets** (PPFs,insurance companies -- *the double hit*)
- **Forced change in business models**
- **Policies confounded** – unconventional tools

3. What drives real interest rates: ***structural/secular trends***

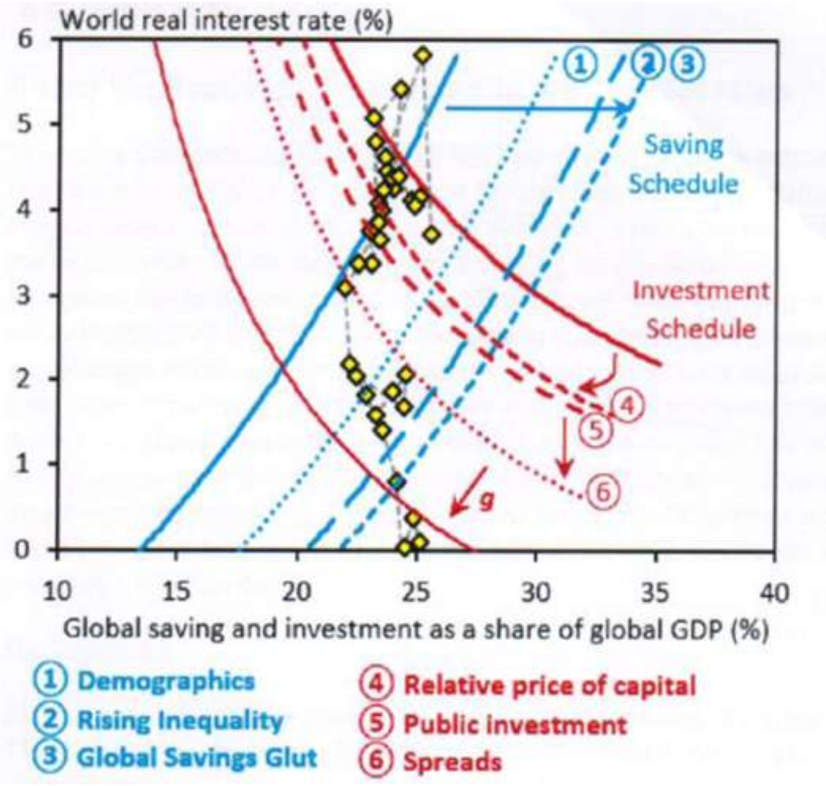
- **Demographics (dependency, aging)**
- **Income distribution/inequality** (OECD, IMF)
- **Productivity gains** slowdown (OECD, EC)
- An "**educational plateau"** (Gordon)?
- **Global competition** (*savings glut*/Bernanke)
- Cost of capital
- **The Crisis: growth prospects are dimmer**
- Saving and investment propensities shift

Long run real interest rates: years of high borrowing fueled growth hid structural trends (- 450bps)



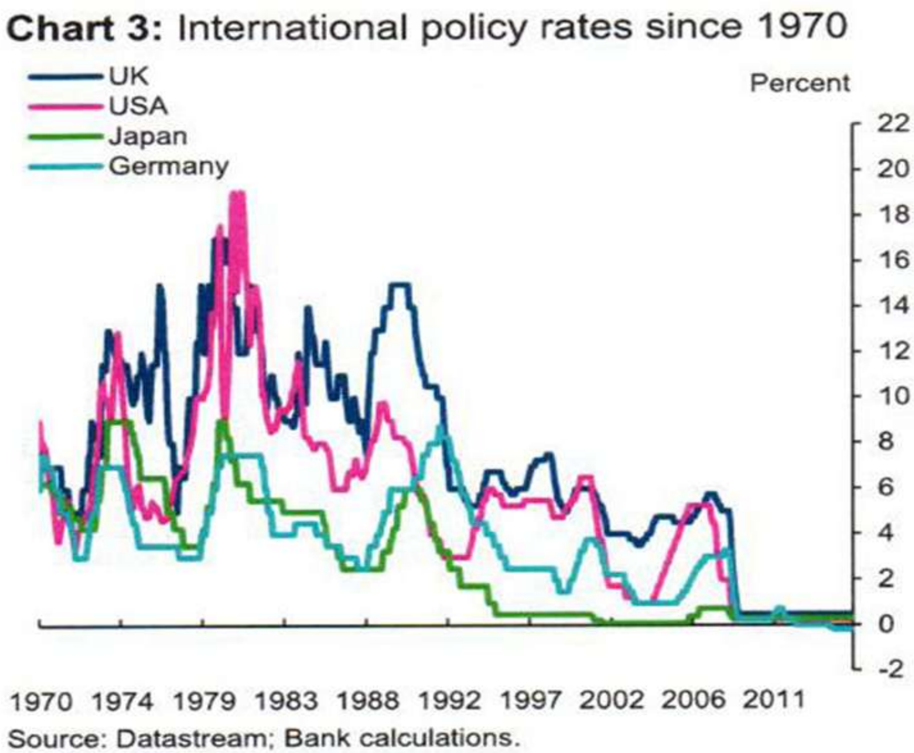
The real rates show the average 10-year yield of inflation-linked bonds in the G7 during 1980-2013 (King and Low, 2014). Other sources: Rachel and Smith, Haldane, Laubach and Williams, IMF….

Shifts in desired savings and investment



Sources: Rachel and Smith, 2015

Policy rates since 1970 (Haldane)



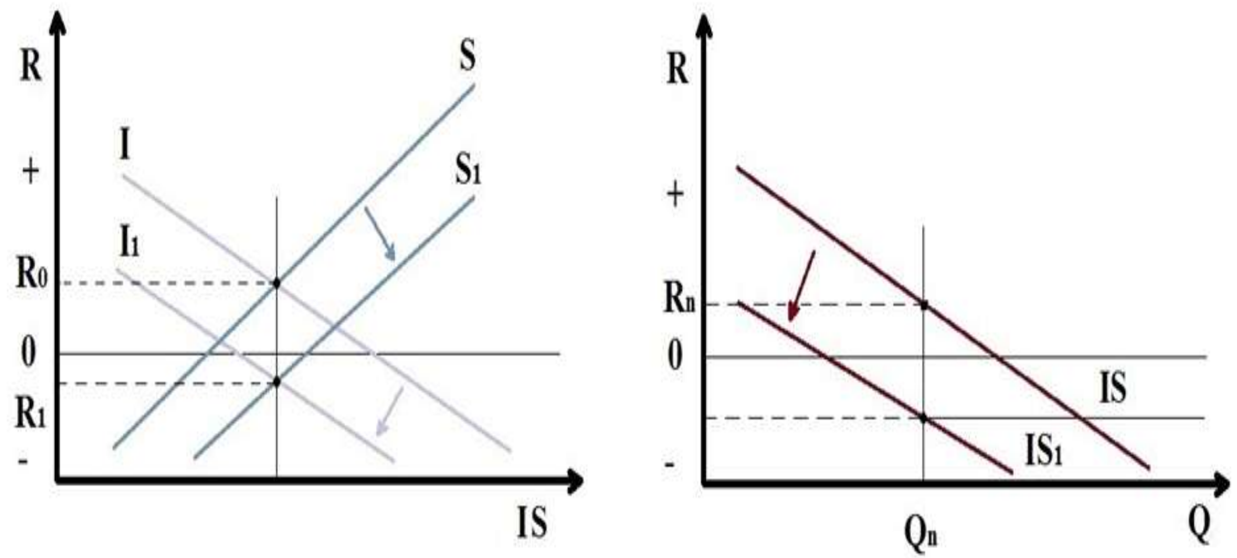
3.1 What central banks do?

- **CBs are hardly behind the fall of long term real interest rates**
- However, a role in **amplifying the *global financial cycle*** –*easy money*(resource misallocation…***financialization***….over-debt)
- **2 key questions**: a/ do negative natural interest rates (Wicksell) make sense?; b/ can nominal policy rates be negative (and can they be effective?

3.2 Do negative natural interest rates make sense?

- **In a frictionless environment they do not make sense**; natural rates should be positive and balance S and I at full employment of resources (*time preference*)
- **With large resource underuse, after a big crisis, rates can be significantly negative**
- **When inflation is very low, the ZLB bites** and policies can turn unconventional(QE)

Negative real interest rates as I and S curves shift



3.3 Are negative nominal policy rates feasible, are they effective?

- Bank of Japan, BoE, ECB, Danish CB, etc
- **Effectiveness in debate due to side effects (***a big trade-off/*Summers**) and bad transmission**
- **Proxy for "competitive devaluation**"?
- Low rates and un-conventional measures have **diminishing returns**
- **Fiscal policy activism** (Summers,de Long, IMF), **structural reforms**, **policy coordination**

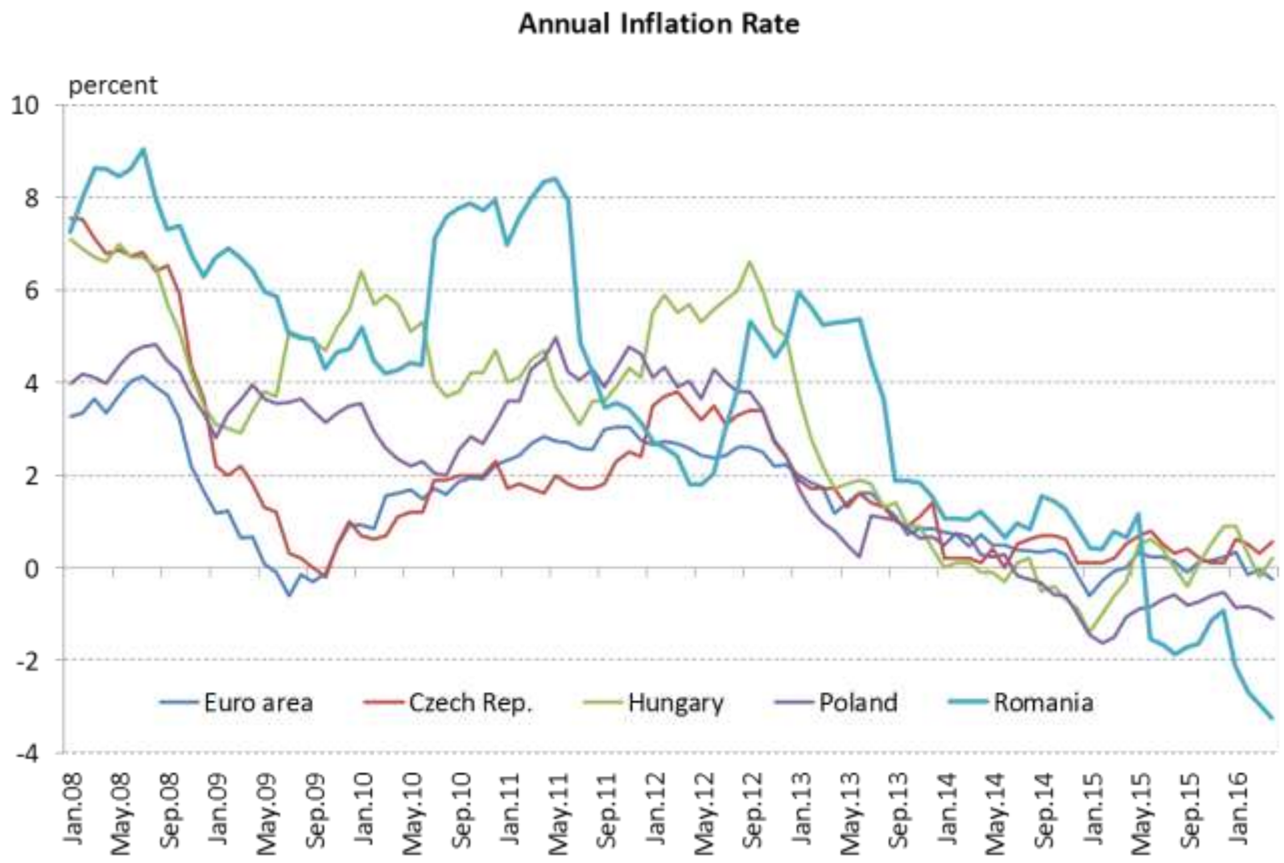
3.4 Could CBs engineer rises in real rates?

- **In the short run yes** -via massive sterilization
- **But that would quite likely trigger a new** big recession, chain defaults, another banking crisis, etc
- Economic conditions remain fragile; **a new recession could happen be IRs pretty low**
- **Policy rates should be raised carefully provided circumstances justify it**…(Fed's intentions are critical)

3.5 Policy rates in Romania

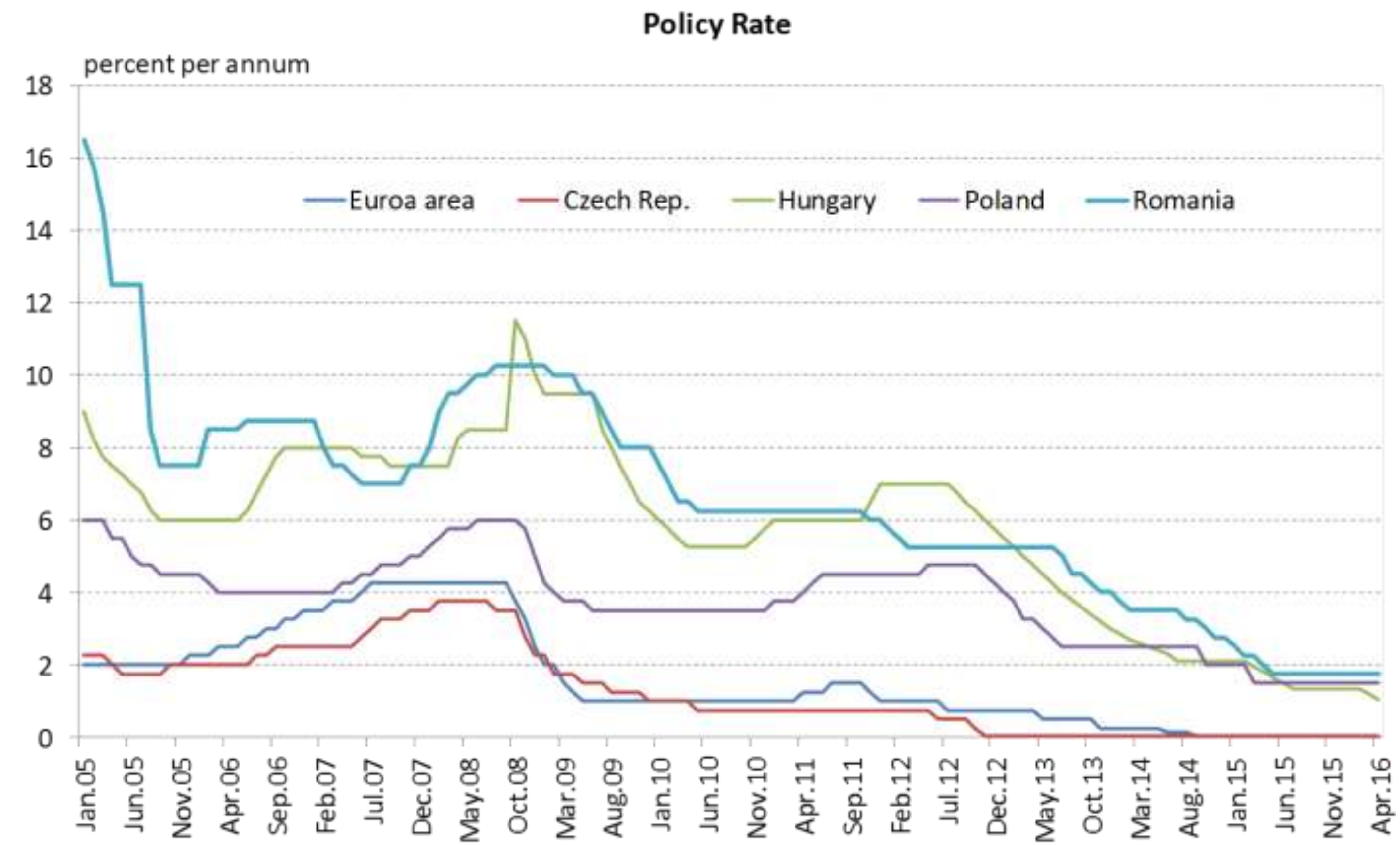
- **Conventional policies still available**
- Negative inflation: massive tax cuts (figure)
- Underlying inflationary pressures
- **Policy rates in neighboring economies constrain Romanian monetary policy/MP** (a high policy rate differential is unworkable)
- Local money market rates reflect excess liquidity

Inflation



Source: central banks' websites

Policy rate



Source: central banks' websites

3.5 Policy rates in Romania (ii)

- **MP can try to contain inflationary pressures, but can hardly offset budget policy slippages**
- **It would be good to have *fiscal space* when a major slowdown sets in (structural budget deficit has jumped to cca.3% of GDP from about 1% in 2015)**
- **Fiscal revenues at 28% of GDP --lowest in EU**

4. Banks under siege

- More severe **capital and liquidity requirements** (credit supply)
- **Less credit demand** (*debt-overhang*)
- Ongoing **balance-sheet repair (**FS ECB report**)**
- **Reputational damage** (business conduct)
- **Competition** from *shadow banking*
- **Capital markets as alternative funding**
- Technological innovation; **fintech**

4.1 Risks abound

- **Capital markets are not devoid of systemic risks** (“too big to fail”, ***sudden stops/***remember money markets tremors)
- “Credit cycle” in *shadow banking* too
- ***Lending Club***”s case…
- **CCPs as purveyors of systemic risks** (capital and liquidity requirements needed)
- **Do capital markets need a LoLR?**
- What kind of securitization….

5. Finance in Romania

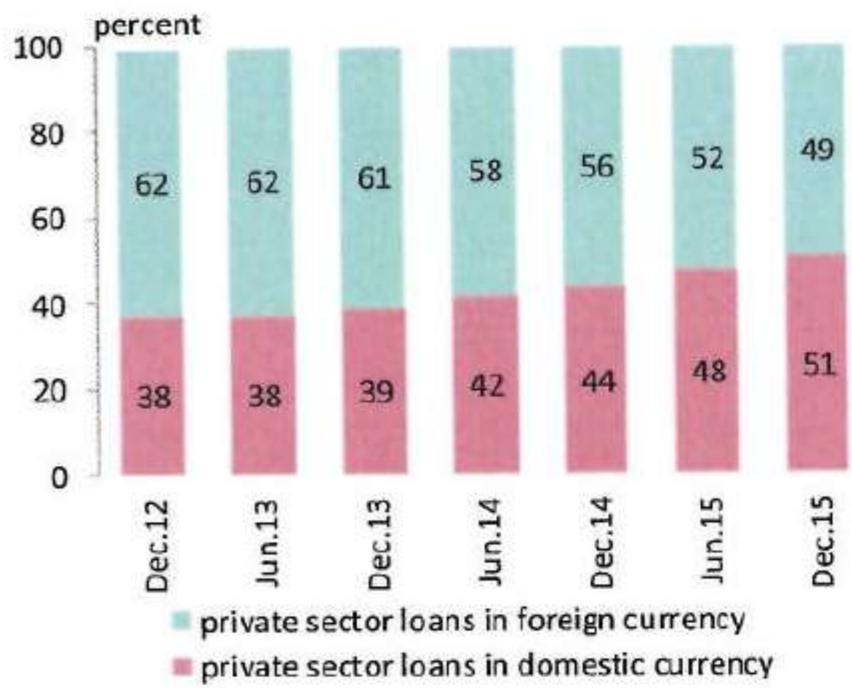
- **Oversize finance** in developed economies (Pagano et.al); **undersize in Romania**
- **Private credit is about 31% of GDP** in Romania (from about 40% in 2009) –lowest in EU28
- **Less sophisticated finance is not inherently bad!**
- Capital markets play a small role (below 10%)
- **Private companies’ listing is badly needed**

5. Romania’s finance

Profitability of banks restored in 2015

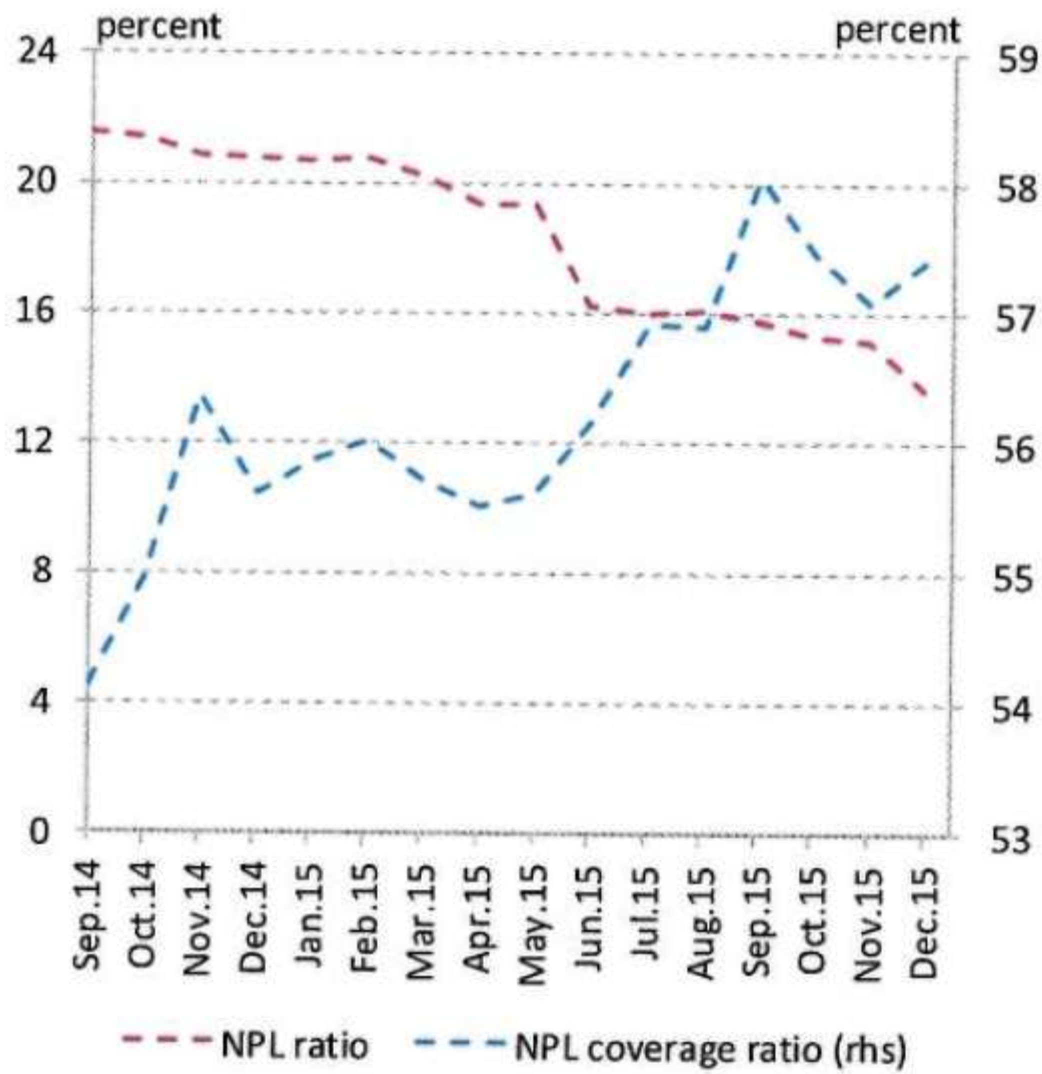
- **Banks well capitalized**; NPLs, write-offs
- Business conduct and the “walk away law”’
- **Banks heavily present on capital markets**
- PPFs: **do not search yield at any price, protect the principal**
- Short-selling: benefits vs. speculative trading
- ***(De)euroization*** is a big policy issue (fig)

Structure of credit to the private sector by currency



Source: NBR

NPL ratio and NPL coverage ratio (EBA definition)



Source: NBR

Capital buffers implemented by the NBR in 2016

Buffer	Objective	Level established in Romania	Deadline for implementation
Capital conservation buffer	Increase the loss-absorbing capacity	2.5 percent of total risk exposure amount of the institution by 2019	Gradual phasing-in, i.e. 0.625 percent per annum during 2016-2019. The first rate of 0.625 percent has been activated as of 1 January 2016.
Countercyclical capital buffer	Limit excessive credit growth	0%	The buffer has been applied since 1 January 2016.
O-SII buffer	Mitigate the systemic risk generated by the size of institutions	1 percent of total risk exposure amount of the institution, solely for systemically important banks	The buffer has been activated as of 1 January 2016.
Systemic risk buffer	Prevent or mitigate long-term non-cyclical systemic or macroprudential risks	1 percent of total exposure amount to which it applies, solely for selected banks; it does not add to the O-SII buffer	The buffer has been activated as of 31 March 2016.

6. Fintech

- Supply creates its own demand
- It is still small scale; it can help SMEs
- **Banks will continue to dominate funding in Europe**
- Attention to frauds, illicit operations…
- Parallel currencies (bitcoin) and "parallel banking"? Low interest rates favor it.
- **Fintech be regulated (John Williams, San Francisco Fed)**

6.1 Fintech: major risks (WEF and Wyman Report)

- Ultimate lenders’ losses (*Lending Club*…)
- Market electrification (HFT, dark pools, trading platforms)…escape scrutiny
- Data security
- Misconduct; amplifier of illicit operations
- Payment effectiveness of MP transmission mechanism
- Regulatory arbitrage

7. The Capital Markets Union and finance

- **It is proceeding slowly**
- CMU: **for EU28 or the euroarea?**
- CMU and the banking union
- **Local capital markets (bourses) and SMEs**
- **Listing state companies only does not make an "emerging market"** –private companies?

8. Challenges

- **Highly uncertain global environment**
- **Cognitive models** under question
- **Low economic growth** and **low inflation**
- **Disruptions** (*sudden stops*); **social strain**
- **Systemic risks**
- New technologies and “parallel markets”
- ***Complexity*** and ***fragility*** an issue for regulators/supervisors, CEOs (*compliance*)

- **Thank you**