The Global Financial System and Rules of the Game

There are few areas of robust growth around the world, with the IMF repeatedly reducing its growth forecasts in recent quarters. This period of slow growth is particularly dangerous because both industrial countries and emerging markets need high growth to quell rising domestic political tensions. Policies that attempt to divert growth from others rather than create new growth are more likely under these circumstances. Even as we create conditions for sustainable growth, we need new rules of the game, enforced impartially by multilateral organizations, to ensure countries adhere to international responsibilities.

The conventional diagnosis and remedy

Why is the world finding it so hard to restore pre-Great Recession growth rates? The obvious answer is that the financial boom preceding the Great Recession left industrial countries with an overhang of debt, and debt, whether on governments, households, or banks, is holding back growth. While the remedy may be to write down debt so as to revive demand from the indebted, it is debatable whether additional debt fuelled demand is sustainable. At any rate, large-scale debt write-offs seem politically difficult even if they are economically warranted.

How does one offset weak household and government demand if debt write-downs are off the table? Ideally, the response would be to incentivize investment and job creation through low interest rates and tax incentives. But if final demand from consumers is likely to be very weak for a considerable period of time because of debt overhang, the real return on new investment may collapse. The Wicksellian neutral real rate — loosely speaking the interest rate required to bring the economy back to full employment with stable inflation — may even be strongly negative. This typically has been taken as grounds for aggressive monetary policy. Because policy rates cannot be reduced significantly below zero (though a number of European countries are testing these limits), equilibrium long term interest rates may stay higher than levels necessary to incentivize investment. Hence, central banks have embarked on unconventional monetary policy (UMP), which would directly lower long rates.

Another way to stimulate demand is for governments that still have the ability to borrow to increase spending. Since this will increase already-high levels of government debt, proponents suggest investing in infrastructure, which may have high returns today when construction costs and interest rates are low. However, high-return infrastructure investment is harder to identify and implement in developed countries where most obvious investments

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1 Governor Rajan delivered remarks at a talk organized by the Central Bank of Sri Lanka on 5th October 2015 based on this written text. Rajan thanks Dr. Prachi Mishra of the Reserve Bank for very useful comments and research support.


3 Though see a thoughtful piece by Claudio Borio and Piti Disyatat at http://www.voxeu.org/article/low-interest-rates-secular-stagnation-and-debt suggesting that the real neutral interest rate may be influenced by low policy rates.
have already been made. Also, while everyone can see the need for repair and renovation of existing infrastructure, this requires far more decentralized spending and may be harder to initiate and finance from the centre.

Put differently, high-return infrastructure investment is a good idea but may be hard to implement on a large scale for most advanced country governments. To the extent that such debt fuelled spending creates a self-fulfilling virtuous cycle of confidence and activity, it can be a bridge to sustainable growth. But to the extent that it misallocates capital, it can worsen public anxieties about the future, reducing corporate investment and increasing household savings.

All this highlights another concern. Even if stimulus works in raising growth temporarily -- and the above discussion suggests it may not – this growth has to be a bridge to sustained aggregate demand. But what if it isn’t?

The Productivity Puzzle, Secular Stagnation, and other concerns.

The arguments I have just enunciated for action apply to an economy where nothing fundamentally is wrong except perhaps excessive debt – what is needed is a cyclical return of growth to potential growth. Yet a number of economists such as Tyler Cowen, Robert Gordon, and Larry Summers have raised the possibility that potential growth in industrial countries had fallen even before the Great Recession. Perhaps then the growth that we are trying to return to is unachievable without serious distortions.

The term “secular stagnation” used by Larry Summers to describe the current persistent economic malaise has caught on. But different economists focus on different aspects and causes of the stagnation. Summers emphasizes the inadequacy of aggregate demand, and the fact that the zero lower bound as well as the potential for financial instability prevents monetary policy from being more active. Among the reasons for weak aggregate demand include ageing populations that want to consume less and the increasing income share of the very rich, whose marginal propensity to consume is small.

Tyler Cowen and Robert Gordon on the other hand, emphasize a weak supply potential. They argue that the post-World War II years were an aberration because growth was helped in industrial countries by reconstruction, the spread of technologies such as electricity, telephones, and automobiles, rising educational attainment, higher labour participation rates as women entered the work force, a restoration of global trade, and increasing investments of capital. However, post-war total factor productivity growth – the part of growth stemming from new ideas and methods of production – was lower than its 1920-50 high. More recently, not only has productivity growth fallen further (with a temporary positive uptick towards the

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end of the 1990s because of the IT revolution), but growth has been held back by the headwinds of plateauing education levels and labour participation rates, as well as a shrinking labour force. It is obvious from these lists of factors that it is hard to disentangle the effects of weak aggregate demand from slow growth in potential supply.

Structural reforms, typically ones that increase competition, foster innovation, and drive institutional change, are the way to raise potential growth. But these hurt protected constituencies that have become accustomed to the rents they get from the status quo. Moreover, the gains to constituencies that are benefited are typically later and uncertain. No wonder Jean-Claude Juncker, then Luxembourg’s prime minister, said at the height of the Euro crisis, “We all know what to do, we just don't know how to get re-elected after we've done it!”

**The Growth Imperative**

If indeed fundamentals are such that the industrial world has, and will, grow slowly for a while before new technologies and new markets come to the rescue, would it be politically easy to settle for slower growth? After all, per capita income is high in industrial countries, and a few years of slow growth would not be devastating at the aggregate level. Why is there so much of a political need for growth?

One reason is the need to fulfil government commitments. As sociologist Wolfgang Streeck writes, in the strong growth years of the 1960s when visions of a “Great Society” seemed attainable, industrial economies made enormous promises of social security to the wider public. Promises have been augmented since then in some countries by politically convenient (because hidden from budgets) but fiscally unsound increases in pension and old age healthcare commitments to public sector workers. Without the immediate promise of growth, all these commitments could soon be seen as unsustainable.

Another reason is that growth is necessary for inter-generational equity, especially because these are the generations that will be working to pay off commitments to older generations. Given these are also the cohorts that can take to the streets, growth is essential for social harmony.

Not only are the benefits of growth unequally distributed across generations, they are also very unequally distributed within generation. Because of changes in technology and the expansion of global competition, routine repetitive jobs, whether done by the skilled or the unskilled, have diminished greatly in industrial countries. With every percentage point of growth creating fewer “good” jobs for the unskilled or moderately skilled, more growth is needed to keep them happily employed. Equally, the rapid deterioration in skills for the unemployed is an additional reason to push for growth.

**The Deflation Fear**

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Finally, a big factor persuading authorities in industrial countries to push for higher growth is the fear of deflation. The canonical example here is Japan, where many are persuaded that the key mistake it made was to slip into deflation, which has persisted and held back growth.

A closer look at the Japanese experience suggests that it is by no means clear that its growth has been slower than warranted let alone that deflation caused slow growth. It is true that after its devastating crisis in the early 1990s, Japan may have prolonged the slowdown by not taking early action to clean up its banking system or restructure over-indebted corporations. But once it took decisive action in the late 1990s and early 2000s, Japanese growth per capita or per worker looks comparable with other industrial countries (Table 1).\(^8\)

<table>
<thead>
<tr>
<th></th>
<th>Japan</th>
<th>United States</th>
<th>Euro area</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996-2000</td>
<td>0.63</td>
<td>3.10</td>
<td>2.41</td>
</tr>
<tr>
<td>2001-2005</td>
<td>1.05</td>
<td>1.56</td>
<td>0.99</td>
</tr>
<tr>
<td>2006-2010</td>
<td>0.35</td>
<td>-0.12</td>
<td>0.41</td>
</tr>
<tr>
<td>2011-2014</td>
<td>0.91</td>
<td>1.38</td>
<td>0.13</td>
</tr>
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Source. World Economic Outlook Database, IMF.

What about the deleterious effects of deflation? One worrisome effect of deflation is that if wages are downwardly-sticky, real wages rise and cause unemployment. Yet Japanese unemployment has averaged 4.5% between 2000-2014, compared to 6.4% in the US and 9.4% in the Euro area during the same period.\(^9\) In part, the Japanese have obtained wage flexibility by moving away from the old lifetime unemployment contracts for new hires to short term contracts. While not without social costs, such flexibility allows an economy to cope with sustained deflation.

Another concern has been that moderately low inflation spirals down into seriously large deflation, where the zero lower bound on nominal interest rates keeps real interest rates unconscionably high. Once again, it is not clear this happened in Japan (Figure 1).

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\(^8\) I first learnt of these facts from Jean Claude Trichet. For a more comprehensive look at deflation, see Claudio Borio, Magdalena Erdem, Andrew Filardo and Boris Hofmann, “The costs of deflations: a historical perspective”, BIS Quarterly Review March 2015.

\(^9\) Source. World Economic Outlook Database, IMF.
Even if deflation is moderate, it may cause customers to increase savings in anticipation of a lower price in the future, especially if the zero lower bound raises real interest rates above their desired value. In Fig 2, we plot household savings as a share of GDP in Japan against the deflation rate. Again, it is hard to see a sustained pattern of higher savings with higher deflation.

Finally, it is true that deflation increases the real burden of existing debt, thus exacerbating debt overhang. But if debt is excessive, a targeted restructuring is better than inflating it away across the board.
Regardless of all these arguments, the spectre of deflation haunts central bankers. When coupled with the other concerns raised above, it is no wonder that the authorities in developed countries do not want to settle for low growth, even if that is indeed their economy’s potential.

So the central dilemma in industrial economies has been how to reconcile the political imperative for strong growth with the reality that cyclical stimulus measures have proved ineffective in restoring high growth, debt write-offs are politically unacceptable, and structural reforms have the wrong timing, politically speaking, of pain versus gain. There is, however, one other channel for growth – exports.

Emerging Market Response

If industrial countries are stuck in low growth, can emerging markets (I use the term broadly to also stand for developing or frontier markets) take up the global slack in demand? After all, emerging markets have a clear need for infrastructure investment, as well as growing populations that can be a source of final demand. Emerging markets have no less of an imperative for growth than industrial countries. While many do not have past entitlement promises to deliver on, some have ageing populations that have to be provided for, and many have young, poor, populations with sky-high expectations of growth. Ideally, emerging markets would invest for the future, funded by the rich world, thus bolstering aggregate world demand.

The 1990s were indeed a period when emerging markets borrowed from the rest of the world in attempting to finance infrastructure and development. It did not end well. The lesson from the 1990s crises was that emerging market reliance on foreign capital for growth was dangerous.
Source: World Economic Outlook Database, April 2015. Emerging economies include “emerging and developing” countries.

Following the 1990s crises, as the dotted line in Figure 3 indicates, a number of emerging markets went further to run current account surpluses after cutting investment sharply, and started accumulating foreign exchange reserves to preserve exchange competitiveness. Rather than generating excess demand for the world’s goods, they became suppliers, searching for demand elsewhere.

In 2005, Ben Bernanke, then a governor at the Federal Reserve, coined the term “Global Savings Glut” to describe the current account surpluses, especially of emerging markets, that were finding their way into the United States. Bernanke pointed to a number of adverse consequences to the United States from these flows including the misallocation of resources to non-traded goods like housing away from tradable manufacturing. He suggested that it would be good if United States’ current account deficit shrank, but that primarily required emerging markets to reduce their exchange rate intervention rather than actions on the part of the United States.

So pre-global financial crisis, emerging markets and industrial countries were locked in a dangerous relationship of capital flows and demand that reversed the equally dangerous pattern before the emerging market crises in the late 1990s. Sustained exchange rate

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intervention by emerging market central banks, as well as an excessive tolerance for leverage in industrial countries contributed to the eventual global disaster. But post-financial crisis, the pattern is reversing once again.

Industrial countries have curtailed their investment without increasing their consumption (as a fraction of GDP), thus reducing their demand for foreign goods and their reliance on foreign finance. The counterpart of this shift of advanced economies from current account deficit (demand creating) to surplus (supply creating) has been a substantial fall in current account surpluses in emerging markets. This relative increase in demand for foreign goods from emerging markets has come about through a ramp up in investment from 2008, rather than a fall in savings. Facilitating or causing this shift has been a broad appreciation of real effective exchange rates in emerging markets and a depreciation in industrial country rates between 2006-2014.

Figure 4: Real Effective Exchange Rate Movements 2006-2014

![Figure 4: Real Effective Exchange Rate Movements 2006-2014](source. IMF)

Have industrial country central banks policies, similar to the sustained exchange rate intervention by emerging market central banks in the early 2000s, accelerated this current account adjustment? Possibly, and likely candidates would be what are broadly called unconventional monetary policies (UMP).

**Unconventional Monetary Policy**

Unconventional monetary policies include both policies where the central bank attempts to commit to hold interest rates at near zero for long, as well as policies that affect central bank balance sheets such as buying assets in certain markets, including exchange markets, in order to affect market prices.\(^\text{11}\)

There clearly is a role for unconventional policies – when markets are broken or grossly dysfunctional, central bankers may step in with their balance sheets to mend markets. The

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\(^{11}\) For an excellent overview, see Claudio Borio and P. Disyatat, "Unconventional monetary policies: An appraisal", The Manchester School; Vol. 78, Issue s1, pp. 53-89, September 2010