

CENTRAL BANKS AND FINANCIAL MARKETS. ADJUSTMENTS TO A NEW REALITY

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Abstract

Following the recent financial turmoil, the theories and paradigms based on the efficiency and capacity of self-regulation of markets, have been much discussed. In the new created context, economies depend on central banks that by their power to print money provide a quick response to crises. Increasing dominance of the monetary policy and the transformation of more and more central banks into institutions with very wide scope open new debates on the authority, prudence and independence of central banks. Monetary policy has supported the financial markets for the past 8-9 years, but the direction has gradually begun to change. However, there are different trends and actions at the level of the globally representative central banks. Financial markets have become more and more dependent on central bank support, and their room for manoeuvre has diminished. Continuing this situation as public confidence in central banks is called into question may have serious consequences for the financial markets and the economy in general.

Keywords: central banks, financial markets, monetary policy

JEL classification: E52, E58, G19

Introduction

Following the recent financial turmoil, the theories and paradigms based on the efficiency and capacity of self-regulation of markets, that have influenced economic developments so far, have been discussed. The economic, financial, and political global context is in a continuous change, some adjustments are short-lived and others are noticeable after more time. The recent evolution of the global economy is a reflection of changes in production, commerce or the financial sector, and the understanding of certain economic relationships is becoming more and more difficult. Increasing financial integration has augmented the influence of the exchange rates of the major currencies used for financing on global financial conditions, with significant effects especially on emerging markets.

New debates arise in the economic literature regarding the link between financial structure and economic growth, reiterating that "too much" funding can damage sound economic growth or that permanent innovation of forms and funding instruments can change the financial structure. At the same time, the challenge for regulators and supervisors is to contribute to sound risk management and at the same time allow for the emergence of favourable innovations for the economy and society.

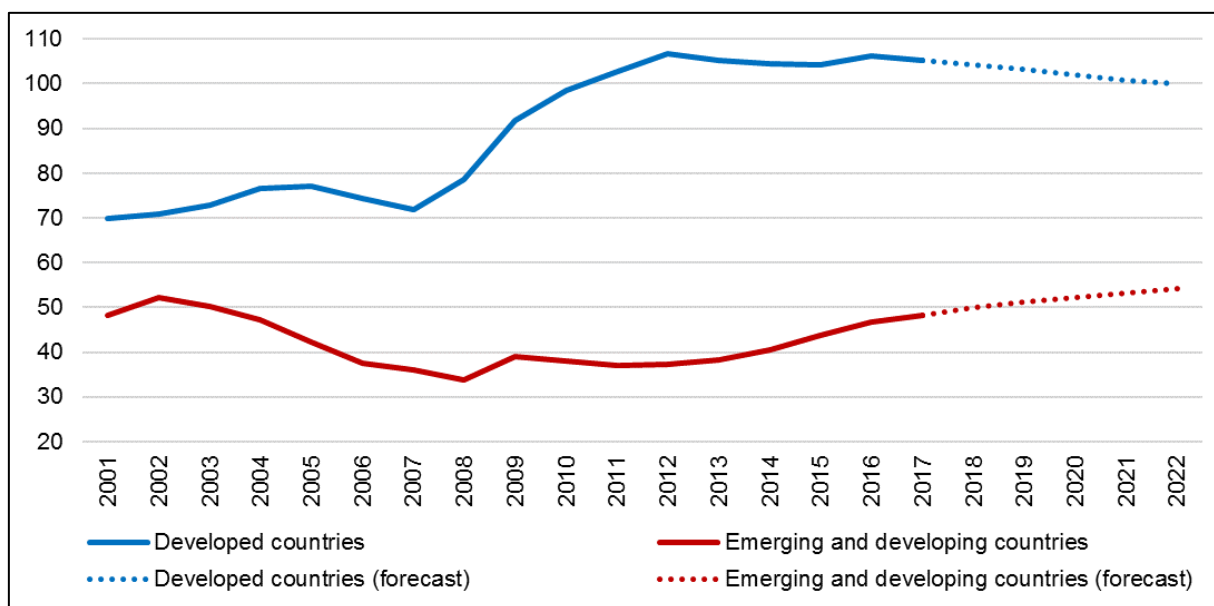
In the new created context, economies depend on central banks that by their power to print money provide a quick response to crises. Increasing the dominance of monetary policy and the transformation of more and more central banks into institutions with very wide scope open new debates on the authority, prudence and independence of central banks.

Characteristics of the New Economic and Financial Conditions at Global Level

Among the main features of the new global economic and financial conditions is a larger global debt ratio compared with the value recorded before the financial crisis in 2007 (Figure 1).

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Figure 1 – Evolution of global debt as a share of GDP (2001 –2022)



Source: Author's processing using IMF statistical data (2017)

However, there is a difference between developed countries⁹⁰, where the growth rate was much faster, and emerging and developing countries, the gap between the two categories of countries rising until 2012, after which it was maintained or even started to decrease slightly.

Moreover, the International Monetary Fund (IMF) forecast for the next five years shows a slight fall in debt-to-GDP ratios for developed countries, which will reach 99.9% of GDP in 2022 and an increase in the debt ratio in GDP for emerging and developing countries, with an estimated value of 54.1% in 2022.

The United States of America (US) has the largest government debt measured as a share of global debt (31.8%), followed by Japan with a share of 18.8%, China (7.9%), Italy (9%) and France (3.8%) (details in table 1).

Although it holds a significant share of the global debt, China has a reduced debt share in national GDP compared to most countries in the world, currently only 47.6%. The other four countries have a government debt over (or very close to, in the case of France) the national GDP.

Together, these countries hold over 66% of the global public debt. According to estimates, private debt is still significantly below government debt, accounting for only two-thirds of it in 2015.

Table 1

Ranking of the world's first countries according to the debt ratio in global debt

Position	Country	Debt (\$ billions)	Debt (% of global debt)	Debt (% of national GDP)
1	US	19.947	31.8%	108.1%
2	Japan	11.813	18.8%	240.3%
3	China	4976	7.9%	47.6%
4	Italy	2454	3.9%	133.0%
5	France	2375	3.8%	96.8%

Source: Visual capitalist and IMF (2017)

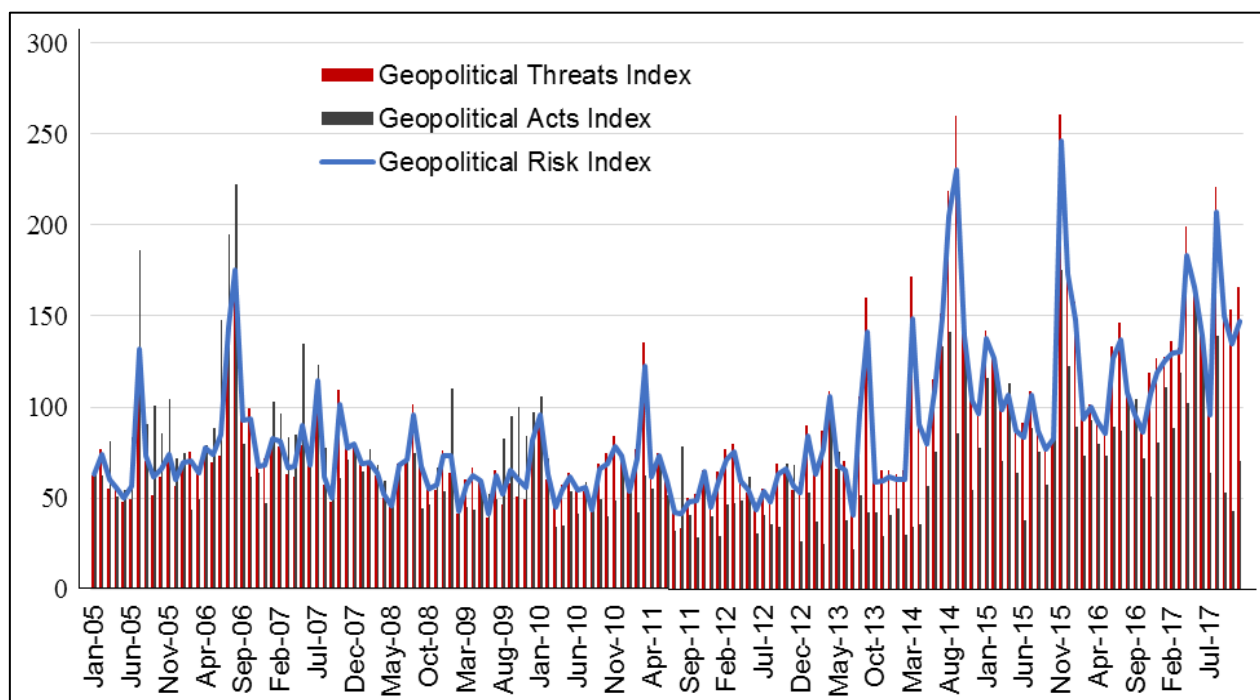
⁹⁰ Government debt has increased substantially in developed countries (on average by 22.2% between 2008 and 2011). In some countries (Greece, Portugal, Spain, Japan, Slovenia, Ireland), government debt as a share of GDP increased by over 50% between 2006 and 2016. Germany is the only G7 country in which public debt is currently 65% of GDP, below the level registered in 2006 (67%). There is also a group of countries in which the share of government debt in GDP declined over the same period (Norway, Israel, Turkey, Saudi Arabia, Indonesia, India, Argentina, Switzerland and Sweden), but the decrease is much lower compared to the increase in the other countries (the largest decrease in Norway, - 19.1%).

Trends on Financial Markets

The presence of very low interest rates has made lending possible, but has encouraged companies and consumers to accumulate even more debt. The Bank of International Settlements (2017) Annual Report highlighted increased credit risk in several emerging countries but also in smaller developed countries as well as a possible resurgence of trade protectionism that could weaken the strength of the global economy.

At international level, efforts are being made to preserve regulatory reforms in recent years, while increasing political uncertainty in developed countries has increased the volatility and unpredictability of the macroeconomic environment. Geopolitical risk indexes⁹¹ (the Geopolitical Risk Index, the Geopolitical Threats Index and the Geopolitical Acts Index, whose evolution is presented in Figure 2), which measured geopolitical risks, had low values and low fluctuations during the crisis and began to increase and record very high fluctuations in the post-crisis period, remaining very high towards the end of 2017.

Figure 2 – Evolution of the geopolitical risk index (January 2005 - November 2017)

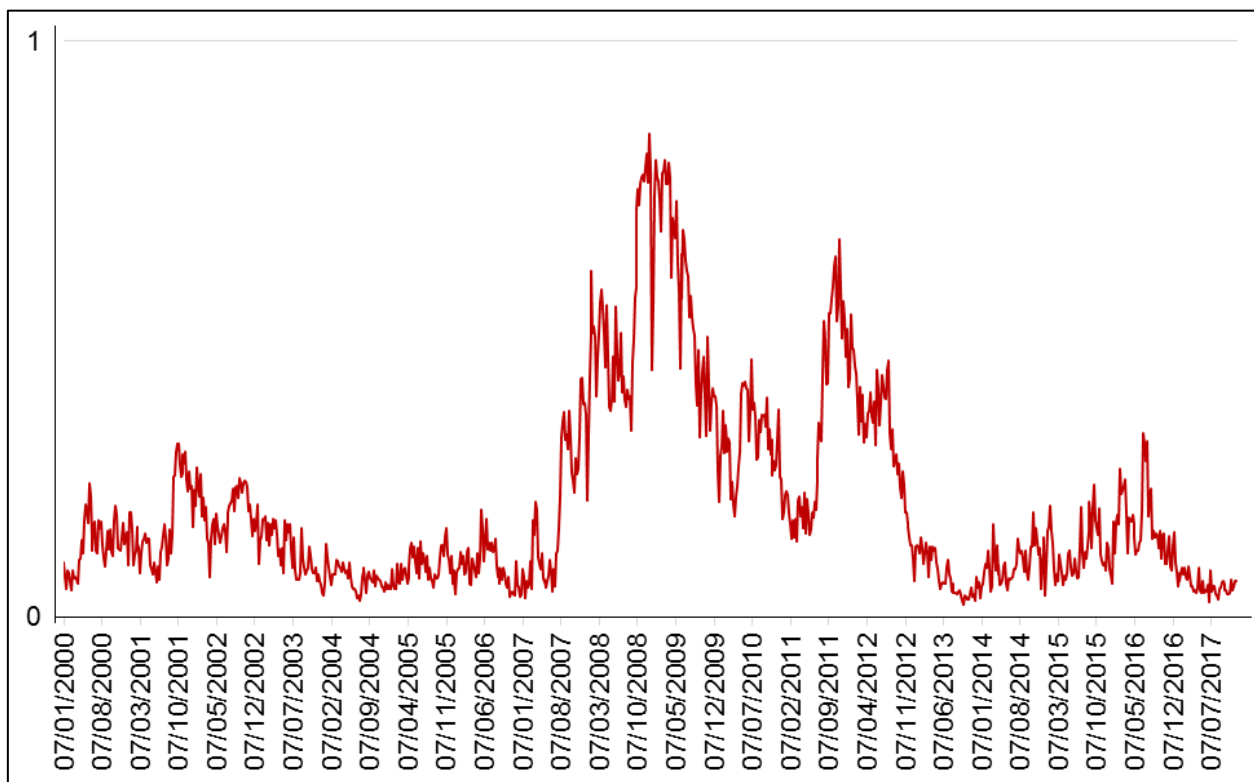


Source: Author's processing using data from Caldara and Jacobiello (2017)

If global geopolitical risk index values are rising after 2012, the composite index for systemic risks calculated by the European Central Bank (ECB) for the euro area (Composite Indicator of Systemic Stress, CISS) is considerably smaller in the same period, reaching minimum values in 2017 (Figure 3). This index includes several indicators specific to different sectors of the financial system (equity and bond markets, foreign exchange markets and money markets, etc.) and is built to show the extent to which systemic financial stress contributes to financial instability (Hollo et al. 2012). The value of this indicator may be between 0 and 1, higher values representing periods of major financial difficulties.

⁹¹ An example of such an index is that calculated by Caldara and Jacobiello (2017) who developed a monthly index (the geopolitical risk index) based on the inventory of the words on geopolitical tensions in the main international newspapers organized in six groups. Thus, Group 1 contains words associated with precise references to geopolitical risk and military tensions involving large regions in the world. Group 2 encompasses words about nuclear tensions, and groups 3 and 4 include words about war threats and terrorist threats. Unlike the previous groups where the risks were recorded, the last two groups (5 and 6) contain words that appear in the press of current unfavourable geopolitical events that could lead to the rise of geopolitical uncertainty (like terrorist acts or the onset of a war). Geopolitical Risk Index refers to all groups of words, groups 1-4 refers to Geopolitical Threat Index, and groups 5 and 6 appertain to Geopolitical Acts Index.

Figure 3 – Evolution of the composite index for systemic risks calculated by the European Central Bank for the euro area (CISS, January 2000 - November 2017)



Source: ECB (2017)

Monetary policy has supported the financial markets for the past 8-9 years, but the direction has gradually begun to change. However, there are different trends and actions at the level of the main central banks (Fed, European Central Bank, Bank of England, and Bank of Japan).

As a result of these actions, Morgan Stanley, by calculating and publishing the correlation index of financial assets, estimated a sharp fall in the correlation between different financial markets (index evolution is shown in Figure 4). This correlation index of Morgan Stanley's financial assets is a measure of how financial asset prices evolve in a similar way, both in terms of financial assets - shares, bonds, and regions of the world. The lack of a correlation between the prices of financial assets is important for investors who try to avoid the simultaneous fall of prices of all assets in the portfolio, aiming at compensating loss through gains elsewhere.

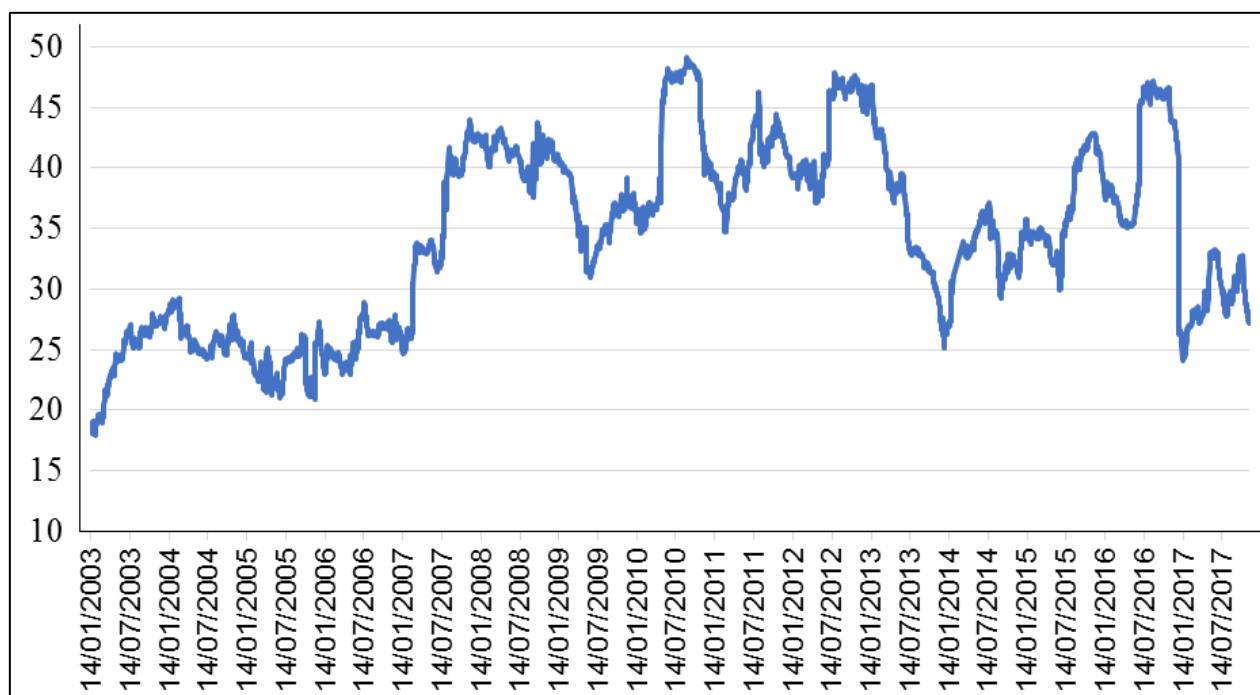
According to recent data, this correlation reached the level recorded in early 2007, in the early stages of the financial crisis that followed. At that point, the correlation in the financial markets increased sharply, then fluctuated in a high-value range until 2012-2013 when it declined steadily (the Fed has made it clear that it uses quantitative easing policies).

In 2014 and 2015, a rebound in economic growth was seen against the backdrop of the rise in oil prices and the difficult situation in China's hard-landing economy, and global financial conditions tightened. Increasing the correlation between financial assets in this period has led to doubts about the self-sustainability of the global economy. In 2016, this index of global financial asset correlation declined again as a result of Republican election winning in the US; although the economy was growing, there were doubts about its sustainability.

In January 2017, this index fell steeply, reaching a minimum of the past 11 years, highlighting the emergence of divergences in central bank shares and an increase in geopolitical risk.

Morgan Stanley identifies another factor that has led to significant changes in the evolution of correlation (from very high values in September-December 2016, to very low values in January-February 2017), namely increasing confidence in a global economic recovery reduces the chances that markets will be panic at the same time.

Figure 4 – Global correlation of financial assets (January 2003 - November 2017)



Source: Bloomberg, Morgan Stanley Research, Global Correlation Index

According to the Morgan Stanley researchers, such a sharp drop in correlations usually occurs in the final phase of an economic cycle. In the current context, asset prices are more influenced by their specific events and less general concerns about the economic downturn, factors that influence the market during this period vary and the links between different financial assets are no longer preserved.

Conclusions

The global financial crisis has triggered many changes in economic and financial policies, increasing the focus on objectives, instruments, policies, and alternative tasks for the major central banks in the world.

Financial markets have become more and more dependent on central bank support, and their room for maneuver has diminished. Continuing this situation, as public confidence in central banks is called into question, may have serious consequences for the financial markets and the economy in general.

Central banks have given full attention to the risks to financial stability by addressing this issue through new, often centralized, central bank approaches. The monetary easing policy may come at the cost of financial instability, while a stricter monetary policy could bring production losses, higher unemployment, and a failure to meet the inflation target, and the assessment of the appropriate monetary policy stance must take into account these compromises.

The results of recent academic research suggest that high increases in short-term interest rates for reasons of maintaining financial stability imply costs that can well outweigh the benefits, with interest rates being too rudimentary to deal with financial stability concerns.

In a complex economic context, instruments that are more suited to meeting the central bank's prerogatives to prevent threats to financial stability seem to be regulation, supervision and macro-prudential policy, including for example, stress tests or increasing capital requirements. Without being perfectly suited, these instruments do not carry risks to production or unemployment, as is the case for unconventional monetary policies.

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