It's the "Never Befores," Stupid

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"Macroeconomic policies to support strong global growth"
Remarks at the Stronger Global Economic Growth Conference
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I extend a hearty thanks to the conference organizers. The China MOF Think Tank on International Economics, the Shanghai Development Research Foundation, the Reinventing Bretton Woods Committee, and the Shanghai Center for International Economic Exchange are to be congratulated for hosting today's conference at a time of great stress in financial markets and the global economy.

In our session, the conference organizers asked us to consider:

- What are the fundamental reasons for the global economy sliding into mediocrity?
- What policies are needed to support a stronger global economy?
- How should these policies be coordinated?

James Carville and the Economy Today

In considering the first two questions, I am reminded of the 1992 Presidential campaign in the United States. At the time, **Bill Clinton's campaign advisor – James Carville – coined a powerful and memorable phrase "It's the Economy, Stupid."**[1] The success of the campaign, the simplicity of the idea, and the audacity of the words led to the incorporation of this phrase into everyday language in the U.S. today – at least for policy experts, journalists, and economists. In other words, Carville was saying that the economy was the only real issue and force affecting the election.

Today, it still is the economy. Yet, the drivers are far more complex. So to me, Caville's famous phrase must extend well beyond the economy into financial markets.

One of the most important lessons from the global financial crisis is that markets can overwhelmingly influence our economic future. Thus, my remarks today will center on the vital – yet poorly understood – space at the intersection financial markets and global economy.

So, now … It's the "never befores," stupid. For example, **"never before" has there been such:**

[1] Michael Kelly, "The Democrats -- Clinton and Bush Compete to Be Champion of Change; Democrat Fights Perceptions of Bush Gain," The New York Times, October 31, 1992.

- **Large scale intervention by central banks and governments,**
- **Growth in the financial regulatory apparatus and labyrinth of rules governing markets,**
- **Distortions across a wide range of financial markets.**

I first highlighted these three "never befores" last March in remarks titled "The Unwind: What's Next for Global Markets?"[2] In analyzing these "never befores," in a keynote address at an annual dinner meeting for analysts, the conclusion was clear. Based upon the most likely path forward, I noted that "market participants will lose patience with the potential for the fundamentals to improve sufficiently to eliminate the present price distortions. Markets [will] correct." I stated that this unwind would occur within 12 to 18 months.

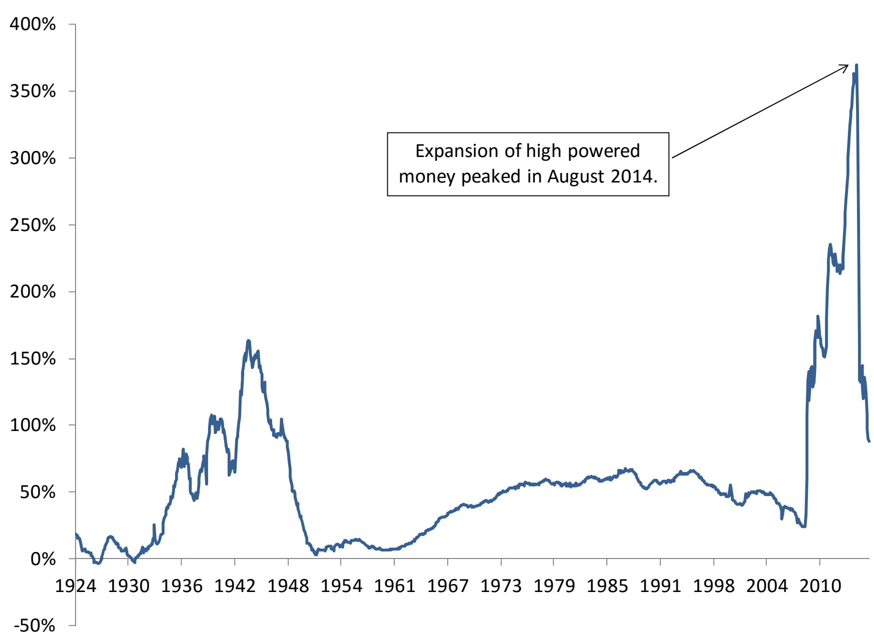
Since then, my premonition has been correct for the right reasons.

So, today, **assessment of the 'never befores' holds the answers to the thoughtful questions posed by our conference organizers.**

Large Scale Intervention by Central Banks and Governments

In the U.S., never before has such a monetary experiment been conducted.

Figure 1. Largest surge of money in the history of the Fed



Source: Federal Reserve Bank of St. Louis and Center for Financial Stability.

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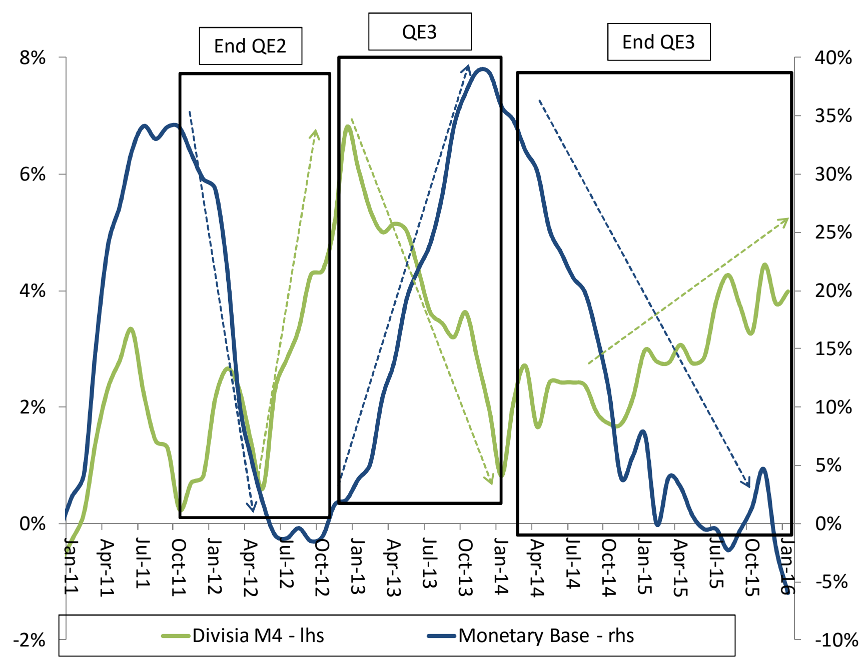
[2] Lawrence Goodman, "The Unwind: What's Next for Global Markets," Remarks at the Capital Markets Credit Analysts Society: Twenty-Sixth Annual Dinner Meeting, May 27, 2015 - http://www.centerforfinancialstability.org/speeches/unwind_052715.pdf.

In response to the financial crisis, the Federal Reserve engineered the largest surge of its balance sheet since the founding of the Fed in 1913. For instance, the Fed's high powered money or monetary base expanded by nearly 400% from the peak-to-trough over a period of six years. When evaluated over time, this is the by far largest cumulative six-year expansion in history (see Figure 1).

In fact, the second largest six-year cumulative expansion was less than half of the recent swell in the size of the Fed's balance sheet. This expansion – ending in 1944 – was arguably much more beneficial. It helped the U.S. exit from the Great Depression and a World War.

Thus, **there are legitimate questions regarding the cost / benefit calculus today from such recently deployed extraordinary policy measures.**

Figure 2. Limited QE benefit – CFS Divisia M4 and monetary base move oppositely



Source: Federal Reserve, Bloomberg, and Center for Financial Stability.

Center for Financial Stability (CFS) monetary and financial data[3] vividly illustrate that benefits have been dubious.

We offer the broadest and most comprehensive measures of US monetary and financial liabilities on a monthly basis freely to the public. The data – developed under the leadership of

[3] See http://www.centerforfinancialstability.org/amfm.php.

Professor William A. Barnett[4] – are the cornerstone of our Advances in Monetary and Financial Measurement (AMFM) project.

Since 2012, our monetary data reveal counter-intuitive and surprising trends.

- First, when QE2 ended, money and liquidity created by the private sector improved. This is measured by CFS Divisia M4 (the green line in Figure 2).
- Second, when extraordinary monetary policy resumed with QE3 (the blue line), private sector liquidity plunged.
- Third, with the cessation of QE3, liquidity created by the private sector began to improve again (the green line).

Finally, monetary liquidity – as measured by CFS Divisia M4 – is crucial for economic growth. **Recent research by Johns Hopkins professor and CFS special counselor Steve Hanke, shows how CFS DM4 leads forward looking domestic economic activity by three months.**[5]

Restrained Growth from the new Financial Regulator Apparatus

Second, rapid development of the financial regulatory apparatus and labyrinth of rules governing markets represents a major structural shift.

To be sure, the financial system is better insulated to withstand reoccurrence of the last crisis. However, well intended financial regulations appear to have been either ill-targeted or have gone too far.

In a recent survey by Broadridge,[6,7] nearly 150 buy and sell side bank analysts from around the world believe that the return generated by capital market banks is expected to fall short of their cost of equity over the next five years. In other words, even after de-risking their business models and tenaciously cutting expenses – these institutions are not expected to generate acceptable returns through 2020!

US analysts are the most optimistic with their European and Asian counterparts progressively more pessimistic.

[4] William A. Barnett, "Getting It Wrong: How Faulty Monetary Statistics Undermine the Fed, the Financial System, and the Economy," MIT Press, 2012.
[5] Steve Hanke, "Biggest danger is bank bashing: Solid money growth shows US can withstand Fed tightening," The Bulletin of the Official Monetary and Financial Institutions, January 2016, Vol. 7 Ed. 1.
[6] With thanks to Brad Hintz, New York University.
[7] "Restructuring for Profitability: Analysts Predict Opportunities and Challenges for Global Capital Markets Institutions through 2020," Broadridge, 2015.

One needs to look no further than bank stocks around the world to witness an ailing industry.

Yes, of course, there was excessive growth in the financial system prior to the financial crisis. Yet, this is now a very old story.

CFS monetary and financial data corroborate the results from the Broadridge survey. At a macro level, market finance[8] in the US is now about 30% below where it should be to foster growth above 2.5% on a sustained basis.

Distortions across a Wide Range of Financial Markets

Third, distortions exist across a wide range of financial markets. For instance,

- Financial market valuations are stretched and pulled to extremes.
- Currencies remain under pressure.
- Adjustments occur more rapidly and less predictably than ever before – witness EUR/CHF, USD/CNY, equity markets, etc.
- Financial market liquidity – as opposed to central bank liquidity – is limited. In other words, smaller trade sizes result in larger swings.[9]

These are but a few of the costs from the never befores due to the unprecedented monetary and macro policies. In many cases, **financial markets needed to correct …and they did. Yet many problems persist.**

But why should we care if a few speculators lose? Well, one of the lessons from the recent crisis is how deeply financial markets are now intertwined with the real economy.

An analysis of oil prices vividly illustrates this point.

At the end of 2008 – before the start of QE, oil prices peaked at roughly 140 dollars / barrel. This was largely demand driven. Demand from emerging economies – such as China – was strong. While, new sources of supply were stagnant. In this environment, speculative activity was limited (see Figure 3). The net positions of speculators or noncommercial oil market players were net long, but they were small and close to equilibrium (dark blue line in Figure 3).

With the start of the global financial crisis, demand plunged. Prices followed retreating to roughly 40 dollars / barrel in early 2009.

However, **with the advent of QE and free money, prices and speculative positions were quick to respond.** Global demand for oil remained weak, yet oil prices headed higher.

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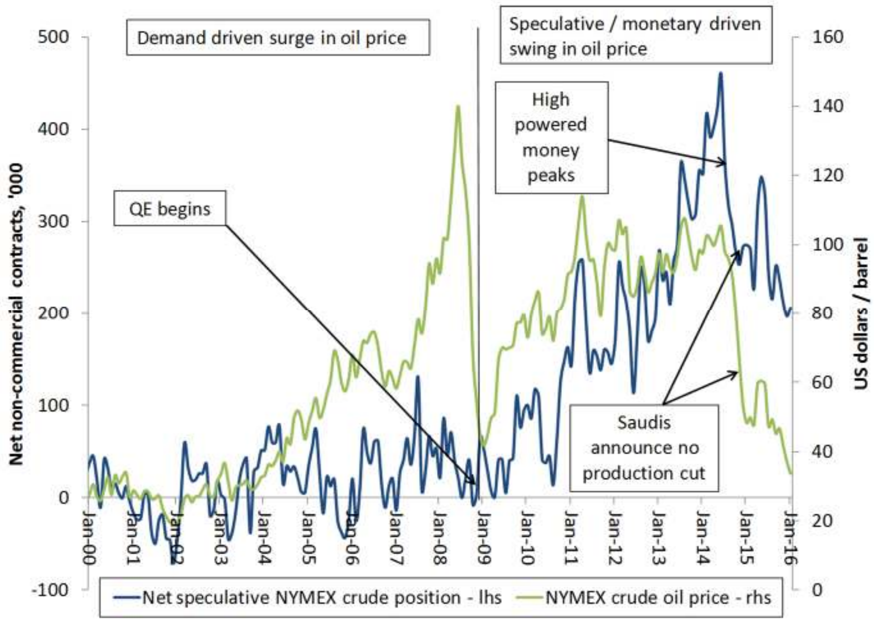
[8] CFS market finance includes: money market funds, repurchase agreements, and commercial paper.
[9] Lawrence Goodman and Stephen Dizard, "Fixing the Fed's Liquidity Mess," *The Wall Street Journal*, July 21, 2015.

Figure 3. Long speculative crude oil positions hit historic high before collapse



Source: CFTC, Bloomberg, and Center for Financial Stability.

The rise in speculative net long positions – fueled by inexpensive money and the idea of new production technology frontiers[10, 11] – propelled prices back to over 100 dollars / barrel. In fact, **net speculative positions long positions or bets in futures markets reached all time highs** (see blue line in Figure 3).

However, as easy money was tapered back and inventories became excessive, oil prices and speculative positions crashed…unleashing a supersized downward price spiral.

Why should we care? We should care, because "never before" have we witnessed such a rapid crash in oil prices – at least dating back to the 1970s…and before then oil prices were essentially stagnant at least dating back to the early days of John D. Rockefeller.

These swings skew incentives and damage growth prospects.

Coordination and Concluding Thoughts

Geographically, the Fed is at the epicenter of this issue. The reason is twofold. First, the Fed's balance sheet is the largest in the world. Second, the Fed was the first central bank to meaningfully intervene in response to the financial crisis. Many nations followed – at varying rates and depths. With each move, more unpredictability and new distortions were created.

[10] Robert Shiller refers to "new era economic thinking".
[11] Robert Shiller, "Irrational Exuberance," Princeton University Press, 2000.

This phenomenon naturally raises issues surrounding the last question posed by our conference organizers … coordination.

In reality, policy coordination is the topic of a separate presentation. Yet – as you can see by my remarks, **restoration of monetary stability – with a keen focus on resolving constraints from the three never befores would help.**[12, 13]

Today, China stands at the heart of the international monetary system. China has a major role to play – as the Nation did in 1944. At that time, China had the second largest delegation to Bretton Woods conference with more than 30 members.[14]

So, today, many nations must work together. **Nations must focus on the elimination of the three never befores by:**

- **Stopping large scale central bank and government interventions. They have reached their limits.** The poor response to the recent Bank of Japan policy to move toward negative rate should be no surprise.[15]

- Taking stock of the recent expansion in the size of the financial regulatory apparatus and labyrinth of regulations. For instance, **efforts must be deepened to better measure the impact of Dodd Frank and regulatory measures on the evolution of the financial system.**

- **Allowing markets – even though they are imperfect – to function.** Distortions – whether here in Shanghai, New York or London – are the outgrowth of investors racing into risky assets following central bank stimulus or even simply talk. After busts, investors seek security in safe assets. This unwinding of crowded trades unleashes sharp swings in asset prices. This is no recipe for global growth.

So, yes, coordination is a noteworthy goal. But, perhaps a new consensus is needed. The new consensus would rest on policies to promote stability and promote growth both in individual nations and secondarily on a global basis. **A good start would be to reduce the drain on growth by eliminating the three never befores.**

So, let us be smart. Today, it is the never befores!

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[12] John B. Taylor, Stanford University – has developed a "Near an Internationally Cooperative Equilibrium."
[13] John B. Taylor, "Nice Squared," Remarks at Bretton Woods: The Founders and the Future, Center for Financial Stability, September 3, 2014 - http://www.centerforfinancialstability.org/bw2014/bw_taylor_remarks.pdf.
[14] "The Bretton Woods Transcripts," edited by Kurt Schuler and Andrew Rosenberg, Center for Financial Stability, 2013.
[15] Takashi Nakamichi, "Bank of Japan Faces a New Opponent on Negative Rates: Main Street," The Wall Street Journal, February 18, 2016.