***Guest* Comment**

Return of the Great Moderation?

- *The Great Moderation was an ultimately-costly illusion*
- *Yet paradoxically, resolution of the crisis seems to be creating a second moderation*
- *But if it is doing so, it is only by virtue of economic performance that is generally sub-par*
- *The previous Great Moderation ended in great volatility: this one may well do so too*

The calm and then the storm

The "Great Moderation" lasted two decades …

In the two decades leading up to the Great Financial Crisis, economists and policymakers boasted about what came to be known as the "Great Moderation", in which the volatility of economies and markets dropped to extraordinary low levels. Given that economies were believed to be self-correcting, the thinking was that there was little that central banks and governments needed to do to keep the economy stable.

… and now it looks as if it may be back

Admittedly there were shocks, notably the Asian crisis in 1997, and the bursting of the dot com bubble in 2000, that said, the Great Moderation was a nirvana for financial institutions and investors. Until 2008, of course, when it was learned at great cost that this had been a fantasy world, nurtured by bad or negligent policies, leading to an eventually catastrophic outcome. Yet, in 2014, there are signs that the Great Moderation may be back. How worried should we be?

The question needs to be raised because it should have been learned by now that economic and financial stability, while in principle welcome, can sow the seeds of chronic instability, as the great economist Hyman Minsky laid bare over three decades ago. In a nutshell, the security of stability or, more accurately, exceptionally low volatility, is false. Today, there are two manifestations of a sharp decline in volatility, following the turbulence of the financial crisis and its aftermath.

Two manifestations of moderation

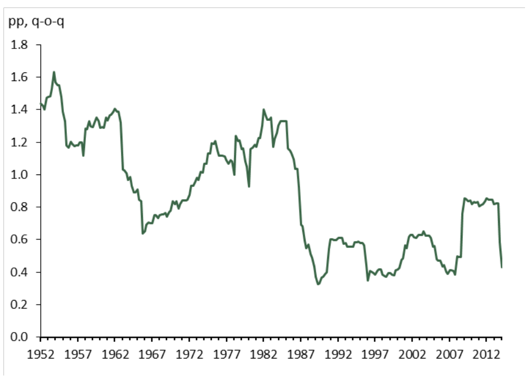
GDP volatility is falling around the world …

The first manifestation of the collapse in volatility can be seen in the figures below, which draw attention to the sharp decline in economic volatility, notably in the US.[1] Other countries show a rather different pattern, principally because of the euro area crisis from 2010-2012, and the introduction of 'Abenomics' in Japan's case. As the figures show, however, the most recent trend indicates a renewed decline in volatility.

This return of greater stability is most likely due to the exceptionally-low and predictable inflation across the entire developed world, accompanied by, and related to, the generally subdued rate of economic growth. These developments have underwritten not only an extraordinarily extended period of easy monetary policies, but also only guarded expectations of a change in interest rates – and even these have been confined to the US and UK, and then not until 2015-16.

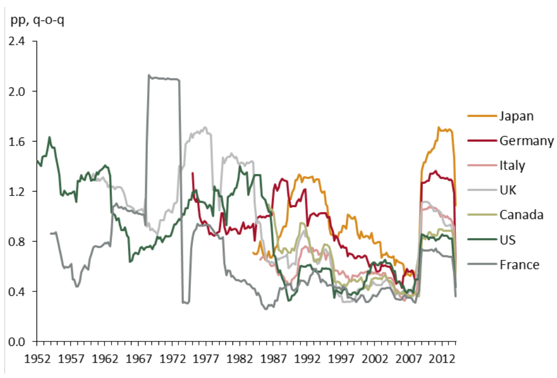
Further, most people expect the equilibrium level of policy rates to be markedly lower in the

Figure 1: Volatility of output growth, US



Source: Furman (2014); and Macrobond
Note: 20-quarter rolling standard deviation of quarter-on-quarter real GDP growth.

Figure 2: Volatility of output growth, G7 economies



Source: Furman (2014); and Macrobond
Notes: 20-quarter rolling standard deviation of quarter-on-quarter real GDP growth.[2]

future because of protracted low inflation and a decline in trend economic growth. In the euro area and Japan, the arguments for higher policy rates do not even exist yet. The European Central Bank is expected to ease policy in the near future, and could even launch its own quantitative easing later in 2014. In Japan, the Bank of Japan is expected to continue to increase asset purchases for the foreseeable future.

The second manifestation of the collapse in volatility has been in financial markets. Traders have become mesmerised by small changes in the values of major currencies and bond markets; and where there has been a more decisive trend – for example in emerging market currencies and bond markets early in 2014 – markets have quickly snapped back and re-stabilised. One of the most closely-watched instruments, the 10-year US Treasury bond, has so far this year moved within the very narrow range of 2.5% to 3%: by comparison, it traded between 1.6% and 3% in less than four months in 2013, and comparable trading ranges were registered in each of the years from 2008 to 2011.

… as is bond yield and currency volatility

European periphery government bond yields have fallen sharply as risk capital has returned to these markets, notwithstanding a plethora of observations that suggest that the economic condition of the periphery, and indeed of the euro area as a whole, remains feeble and institutionally weak. Indeed, notwithstanding continued severe economic and political dislocations in Europe, as well as also across a swathe of emerging markets, including China, Brazil, Turkey, and Thailand, low volatility has permeated all asset classes, persuading investors that it is safe to be and stay fully invested, including in the traditionally more risky financial assets.

Sober developed-world consequences

Yet the underlying risks are on the increase …

No pronounced shift in economic and market sentiment seems in prospect at the moment; but the lessons of the financial crisis should not be forgotten. The seeds of instability are certainly being sown now in high yield and sovereign bond markets, where spreads have fallen back to the lows that preceded the US tapering announcement; in elevated equity markets notwithstanding continual downward revisions to future earnings prospects, in particular markets such as London property; and in many emerging markets, including China especially, where investors are blanking out a secular deterioration in economic growth and in political order. In short, macroeconomic risks are both present and, in some cases, rising.

The US economic picture is certainly brightening again after a significant weather-related setback in the early part of the year. But the Fed's prediction of 3.9% growth this year now seems unattainable, especially as the first quarter's 0.1% is liable to be revised down. Some of the main growth propellants have run out of fuel. The household savings rate has fallen; the best of the housing market recovery is over; the rise in capital spending is tepid; and wages and salaries are not rising much even if the growth in jobs now looks fairly steady. Markets expect the Fed to have started to raise policy rates by 2015, and the mood music on the FOMC definitely suggests that the central bank considers that a change in the monetary policy regime is appropriate.

… both in the advanced economies …

The UK will likely be the fastest-growing developed economy this year, but its performance cannot be isolated from a government-nurtured housing pickup, which is widely expected to run up against stronger macro-prudential regulations, changes in government regulations, and, sooner or later, a rise in interest rates by the Bank of England. The Bank may indeed be the first major central bank to raise policy rates.

In the euro area, the good news is that competitiveness is rising, the region's external surplus will exceed that of China this year, and growth will be widespread. Strides have been made towards the co-ordination of fiscal policies and a form of banking union, where the ECB has taken on the mantle of bank supervisor, and embarked on a review of bank asset quality and capital adequacy. The bad news is that the tempo of growth seems set to remain anaemic.

In southern Europe, exceptional economic hardship and unemployment are set to persist. There are no signs that Europe is willing to embrace symmetrical economic adjustment. Creditor countries will need to make adjustments too, and the entire edifice of institutional change, including banking union, lacks commitment to joint liability and debt restructuring. Both are considered by many to be fundamental ingredients of economic healing.

Japan's consumption tax rise looks as though it has dented, not ended, the economic upswing, but Abenomics is not turning out to be as transformational as many had hoped, and structural reforms are proving to be every bit as elusive and difficult as expected. As yet there have been few or no initiatives to address deregulation of the country's service industries, changes in corporate governance to help lower high company savings, or the two major demographic agenda items of immigration and much higher labour force participation by women. It seems only a matter of time before the Bank of Japan boosts its QE to support growth later this year, most likely in vain.

Difficult developing-country prospects

… and in the emerging world

Compounding a still-sober developed world outlook, emerging markets too are facing difficult challenges. This year their contribution to global growth is expected to drop below that of their developed peers: after accounting for 75-80% of global growth in 2011-13, the contribution of emerging and developing countries is expected to slip back in 2014-2015 to around three-fifths. This slippage looks more than cyclical. Several countries, including China, Brazil, India, Russia, Turkey, and South Africa are facing slower medium-term growth prospects, and a few have tightened monetary and financial conditions as a consequence of currency market and capital flow stresses earlier this year. Although few emerging countries face external debt and payments constraints that typified instability in the 1990s, most may struggle to live up to investor expectations about growth, and many have yet to tame strong credit creation trends that were allowed to take root in recent years.

Awkward global implications

The biggest problem for emerging countries, especially commodity producers, and for the global economy is likely to be the slowdown in China's economic growth.

China is a particular concern …

China has already slowed down from 11% or 12% to about 7%, but further weakening is in prospect as the government endeavours to rebalance the economy, tame credit creation and off-budget borrowing by local governments, and implement extensive economic reforms and changes in the governance of SOEs and local governments. The biggest immediate problem is that the property sector, investment in which has topped 15% of GDP, has lapsed into a recession from which no early escape seems likely. A shakeout in the sector is likely to last well into next year, if not beyond.

A strong anti-graft campaign, high credit costs, and an undercurrent of developing cash-flow and debt-service problems are suppressing property and other investment. So far, the government has resolved not to use credit or major infrastructure spending to reverse the economic slowdown, but real estate occupies a crucial role in the economy, accounts for about a fifth of commercial bank assets, and about two fifths of the collateral used in all loans. Consequently, the implications of the evolving property downturn, not least for government policy, need to be monitored closely.

… as the country seeks to follow a new growth model

Even were the government to decide to ease monetary and other policies, including a still-weaker renminbi, any positive effects would most likely dissipate quite quickly, and the authorities would still have to manage a complicated economic transition in which economic growth would probably slow down even more. As matters stand, economic growth could drop to 6% by the end of this year, and might well settle at 4-5% over the next few years. This need not be a disaster for China, especially if rebalancing and governance reforms were to succeed, but the implications of the transition to slower growth stand to be of huge consequence not just for China, but also for the whole of Asia and indeed the global economy.

Calm before the storm

The threat is of policy error and renewed instability

Looking ahead, the key considerations will be the reaction of markets to a growing array of regulatory strategies designed to diminish pockets of excessive risk-taking, and efforts more generally to re-establish a more 'normal' interest rate and central bank balance sheet environment. In so doing, policymakers will be operating in uncharted waters, and will have no option but to rely on trial and error as they seek to calibrate their tools with the evolving business cycle. The potential for error and related financial and macroeconomic traumas in such an environment is therefore is high.

The most obvious signs of a miscalculation are likely to be the usual suspects:

- Sudden large-scale stock market corrections;
- A sharp increase in credit spreads; and
- Currency weakness for those economies with a significant external financing requirement.

The recent tranquillity may therefore merely prove to be the calm before the storm. ■

Disclaimer

[1] Taken from a presentation by President Obama's Chair of the Council of Economic Advisers, Jason Furman, to a Hyman Minsky conference on 10 April 2014.

[2] Japan and Italy: Chain-link data (from 1994 for Japan, and 1991 for Italy) were spliced to earlier-period (non-chain-linked) series. Germany: Data prior to 1991 is for 'West' Germany.