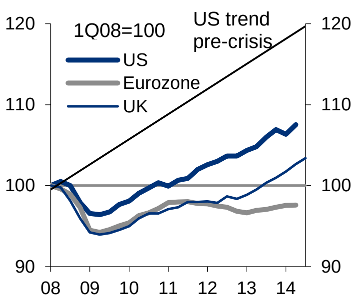
Economics
7 November 2014

The New Abnormal

…more shocks are in store

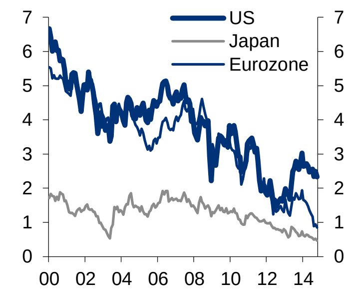
Forget normality, the global economy is likely to deliver more surprises in coming years. The exit from the massive and unconventional monetary easing may run into damaging bumps. Well-meaning efforts to achieve financial stability may be exposed by the unintended consequences of regulation. However, the New Abnormal may spring favourable surprises in the long term.

GDP



Source: EcoWin

10Y bond yields (%)



Source: EcoWin

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Over the past few years many commentators have subscribed to the view that the world is heading towards a 'New Normal'. Initially promoted by the fund managers at PIMCO, the idea of the 'New Normal' is that we face a future norm of low growth, interest rates and investment returns. This, it is argued, stems from the global financial crisis, which is compounding previously underestimated structural changes. Yet even as progress is made in addressing the crisis aftermath, talk of a gradual return to normality, albeit of a new, gloomier, variety, is misplaced. The situation is far from 'normal'. In fact, it is probably more instructive to think of a 'New Abnormal'. This may lead to fresh surprises that force policy makers and financial markets further into uncharted territory.

This report expands on work that we have done over the past two years[1]. It explains why we believe that the New Abnormal raises doubts about smooth 'normalisation' of interest rates. The exit from massive and unconventional monetary easing may run into unexpectedly damaging bumps. We argue that well-meaning efforts to achieve financial stability may be exposed by the unintended consequences of regulation. However, we conclude with the thought that the New Abnormal does not preclude favourable surprises in the long term.

Fig 1 Dictionary definition of 'normal'; hardly applies to the New World…

Normal **(n., adj.) the usual, typical, healthy, or expected state or condition, average, regular, orderly**

Although extreme events continue to occur more often than expected, economic and market risk models continue to be based on normally distributed outcomes…
"If you hear a "prominent" economist using the word 'equilibrium', or 'normal distribution', do not argue with him; just ignore him, or try to put a rat down his shirt." **Nassim Nicholas Taleb**

Source: ING

It may be new, but it's not normal…

Dictionaries typically define 'normal' as regular, usual, healthy, natural, orderly, ordinary, rational (Figure 1). It is hard to use such words to describe the current performance of the world economy and financial markets. Just think of the unprecedented and unconventional monetary measures that are being applied to the main developed economies in an effort to revive economic growth. Despite zero, or even negative, interest rates and massive infusions of liquidity into the money markets and bond purchases by central banks, growth in the developed world varies from the mediocre to the barely positive (see Figure 2). Meanwhile, while markets are partying like it's 1999 and corporate profits remain close to all-time highs, businesses are reluctant to invest and workers' pay is generally growing sluggishly.

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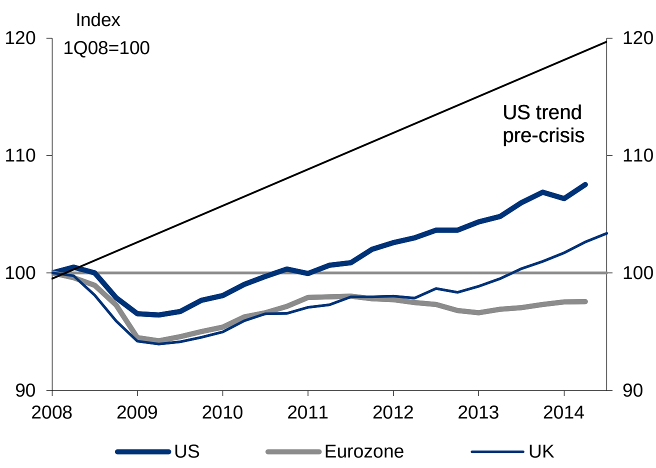
[1] Our first critique of the 'New Normal' came in our report entitled *Warped World of Bonds* (August 2012). This report is based on a presentation to the Treasury Summit in Vienna in September 2014.

The situation in Europe is particularly abnormal…

The ECB's tortuous and improvised journey continues

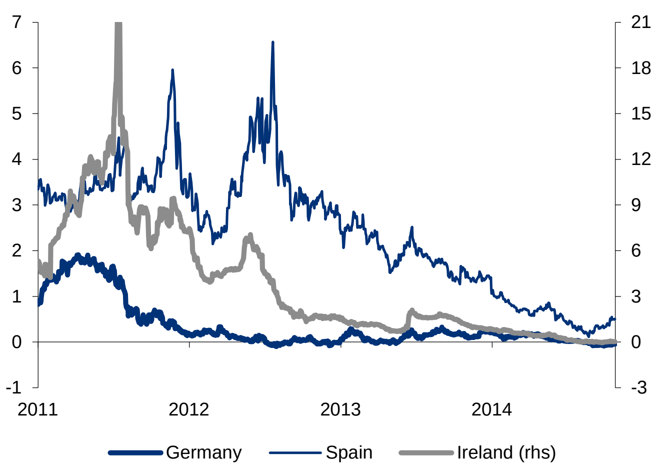
The situation in Europe is particularly abnormal. The Eurozone's periphery continues to struggle with mass unemployment, popular discontent and rising government debt. Despite this, their governments' bond yields, which only two years ago were shooting skywards, have plunged, in some cases into negative territory (see Figure 3). Meanwhile, the euro's exchange rate, which was bizarrely strong at the height of the Eurozone's economic woes, is finally falling as the European Central Bank continues on its tortuous and improvised journey of unconventional monetary easing.

Fig 2 Growth in the developed world still well below pre-crisis trend



Source: EcoWin

Fig 3 From Toxic to Core: 2 Yr Eurozone government bond yields



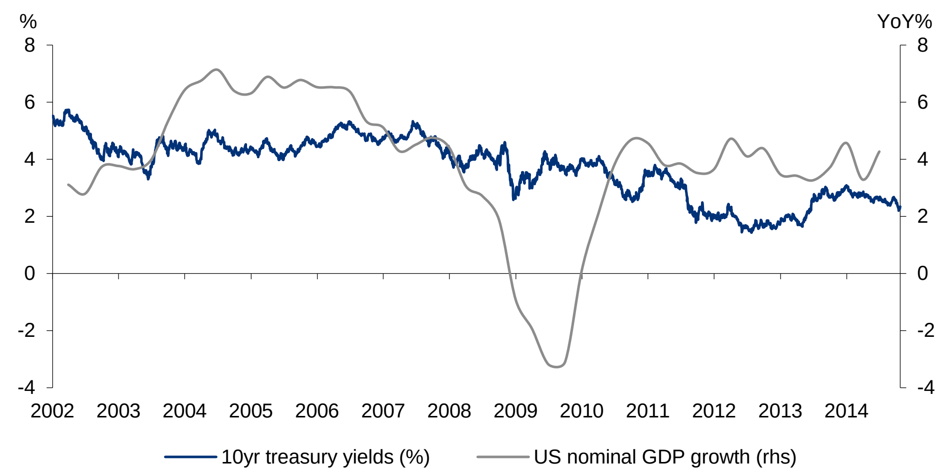
Source: EcoWin

Why bond yields may remain abnormally low

'New Normal' thinking continues despite fresh surprises

'New Normal' thinking remains pervasive among economists and financial market practitioners. This is despite repeated surprises and policy shifts. Expectations for government bond yields provide a prime example of this. At the start of the year, the near universal expectation (which we shared!) was that yields would rise. Instead, they have fallen further, even in the US, where growth and inflation have largely performed as expected (see Figure 4). Once again, after-the-fact rationalisations have been found, such as geo-political shocks and fresh disappointments from the Eurozone economy.

Fig 4 US 10yr Treasury bond yields vs US nominal GDP growth



Source: EcoWin

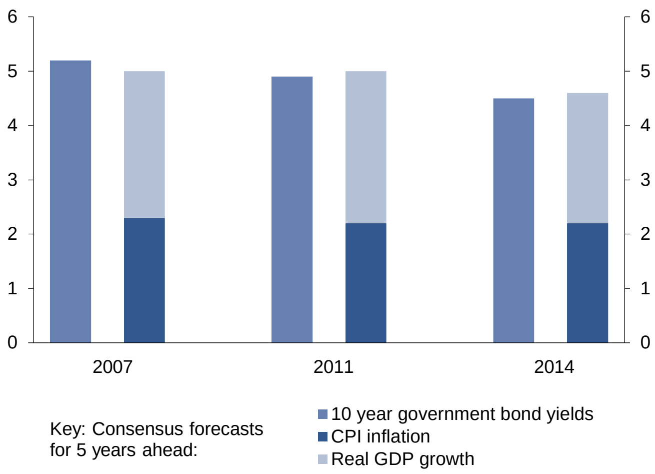
Interest rates are expected to rise gradually…

The widespread expectation, displayed both in economists' forecasts and market forward rates, continues to be that yields will rise gradually over the next few years, albeit to 'new normal' levels below the trend levels that prevailed before the global financial crisis (see the blue bars in Figures 5 and 6). In the case of the US, the consensus forecast among economists (according to the October survey by Consensus Economics) is that 10 year yields will rise by around 220 basis points to 4.50% over the next four years, and then level out, while in Germany, the expectation is for a more leisurely rise, over the next five years, of 240bp, to 3.20%.

…in line with trend growth and inflation

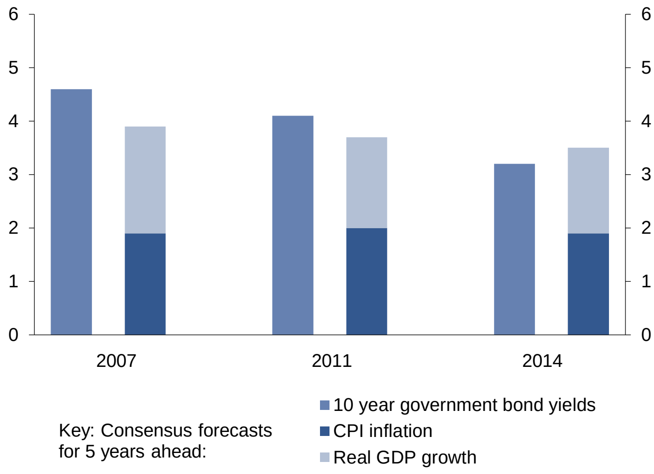
At the heart of the pervasive 'new normal' forecast for bond yields is a gradual convergence interest rates towards trend rates of economic growth and inflation. Thus, on a five year horizon, the US 10 year yield expectation of 4.5% almost matches the sum of the expected real GDP growth rate of 2.4% and CPI inflation of 2.2%, while the German 10 year yield expectation of 3.3% is similarly close to the sum of real GDP growth of 1.5% and inflation at 1.9% (Figures 5 and 6).

Fig 5 US long-term expectations for bond yields, growth and inflation



Source: Consensus Economics

Fig 6 Eurozone long-term expectations for bond yields, growth and inflation



Source: Consensus Economics

Structural forces holding down rates may be more persistent and volatile than expected

Despite this, it should be obvious that the evolution of government bond yields is being driven by more than just the state of the real economy. In the next section, we discuss how the path that yields follow is unlikely to be as smooth as generally expected. But this will also depend on the evolution of the structural forces that are currently depressing yields to abnormally low levels. In our view, these structural forces may be both more persistent and volatile than the consensus expects.

The factors behind the current low level of government bond yields in the advanced markets can be summarised under four headings:

1) **Secular stagnation.** Many economists argue that economic growth will be structurally weaker

2) **Low inflation.** Deflation risks still predominate, especially in Europe

3) **Tightening regulation.** Reinforcing structural reappraisal of risk and demand for 'safe assets'

4) **Unconventional monetary policy.** Central banks have been forced to step in with huge bond buying (quantitative easing) and generous liquidity infusions to banks.

Growth expectations have been marked down only modestly…

Regarding the first two, we saw the consensus forecasts among economic forecasters earlier. The picture that they paint is that there has been a downshift in growth expectations, although perhaps not as dramatic as the gloomy commentary around the idea that the world, or at least the developed world, is suffering from a 'secular stagnation'.

…despite talk of secular stagnation

In brief, the secular stagnation thesis, which was revived last year by Professor Larry Summers[2], suggests that trend growth is weakening not just because of the hangover of deleveraging from the financial crisis but also because of underlying structural shifts stemming from slower growth in the labour force and productivity. The fact that long-term growth expectations have not been marked down more suggests that at least some economists expect policy-makers to have some success in offsetting these forces. Indeed, as we note later, we have our own reservations about 'secular stagnation', which is unduly pessimistic about the potential for positive policy changes and technological progress.

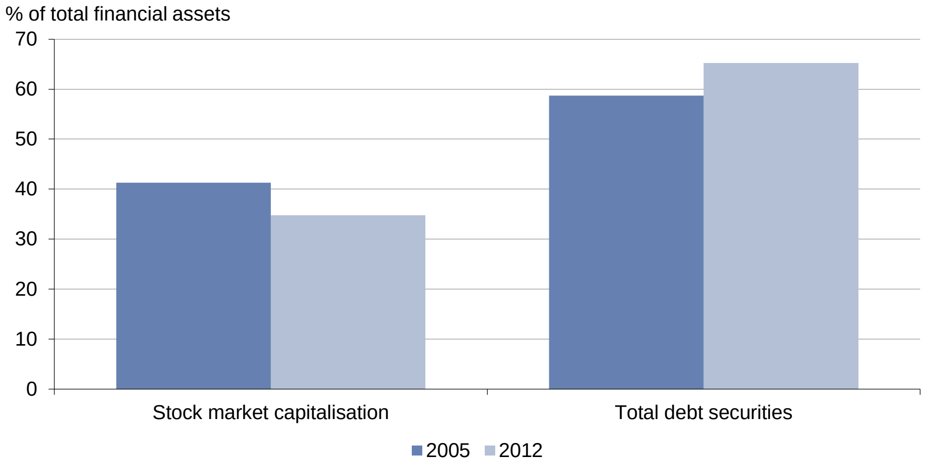
Meanwhile, inflation is expected to move back to targeted levels

Likewise, the fact that inflation expectations continue to suggest that central banks will meet their targets of around 2% in the longer term, suggests that near term fears of deflation will prove to be temporary.

Structural factors are lifting the demand for bonds

The impact of tighter regulation, in combination with other structural factors lifting the demand for high quality bonds, has perhaps received less attention than it deserves. We summarise these factors in the Box below (*Structural Forces Prompting Portfolio Shifts Towards High Quality Bonds*). Remarkably, despite the dramatic rally in the stock markets from the lows of 2009, investors' portfolios have shifted towards bonds and away from equities (see Figure 7).

Fig 7 Investors shift from stocks to bonds



Source: World Bank

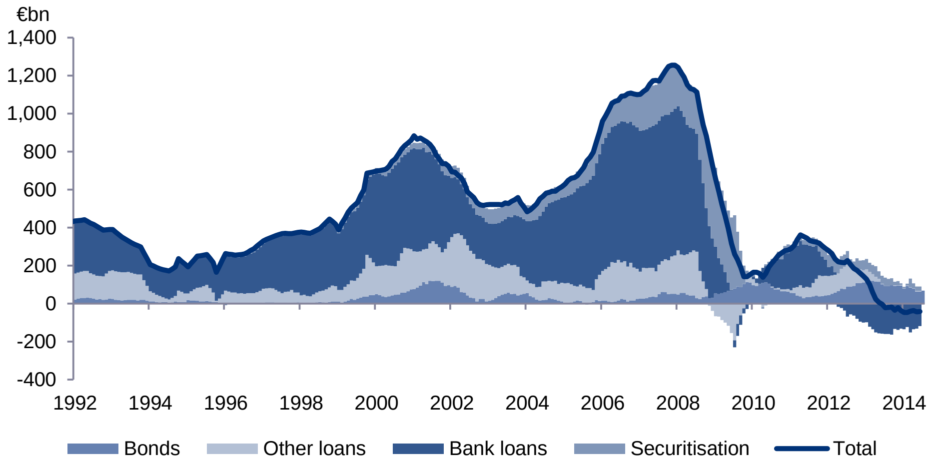
Regulation has stimulated the banks' demand for government bonds and reduced their appetite to lend

Moreover, although policy-makers have been reluctant to admit it, the fact that banks and other financial institutions have been incentivised to deleverage and de-risk has stimulated their demand for 'safe' government bonds[3] and reduced their appetite to lend. This in turn has been a headwind for economic growth. This is especially true in the Eurozone (see Figure 8), where bank lending has continued to contract, although this is partly due to weak demand for loans as well as the banks' reduced appetite for lending.

[2] See http://larrysummers.com/commentary/financial-times-columns/why-stagnation-might-prove-to-be-the-new-normal/

[3] Italian banks, for example, have record exposure to Italian government bonds (BTPs), partly stemming from the Bank of Italy encouraging them to participate in the ECB's long-term refinancing operations. With the public debt to GDP ratio continuing to rise, this would leave them acutely vulnerable, *in extremis*, in the event of a renewal of concerns about Italy's position in EMU.

Fig 8 Eurozone credit growth: Net lending to the non-financial private sector



Source: Bloomberg

Structural demand for bonds may, if anything, intensify

Reviewing the list of the structural factors driving the demand for bonds, if anything, most are likely to intensify. In particular, the toughening of regulation, although now well advanced, may have further to go, and the demographic force of ageing is only partly been partly offset by rising retirement ages.

Structural Forces Prompting Portfolio Shifts Towards High Quality Bonds

1) **Tightening regulation** – new regulations on banks and other financial institutions, including much higher capital and liquidity requirements and tougher risk weightings on assets, have reinforced a structural reappraisal of risk and demand for 'safe assets'[4].
2) **Post-crisis loss aversion** – despite the stock market rally since 2009, many investors are wary of equities after two major bear markets in the previous decade. There is widespread 'bubble-phobia', with investors on the look-out for further crises (reflecting what behavioural economists call 'salience bias').
3) **Safe asset shortage** – the financial crisis exposed many "AAA"-rated assets, including asset backed securities (ABS) and even government bonds. Demands for higher quality collateral, partly driven by regulation, have reinforced concerns about the supply of safer assets.
4) **Ageing, rising longevity** – ageing investors, seeking stable retirement incomes are progressively adding to the demand for bonds, in place of the more volatile returns offered by equities and other asset classes.
5) **Switch from Defined Benefit (DB) to Defined Contribution (DC) pensions** – pension funds, challenged by low returns and tougher regulations, are shifting risk to individuals. Lacking the benefit of risk-pooling in DB schemes, individuals in DC schemes may be more conservative in their portfolio allocations.

Loss aversion may fade…

Arguably, the only one of the five structural factors supporting the demand for bonds that may fade is the post-crisis atmosphere of loss aversion. While no-one in finance will forget the losses and bankruptcies at the height of the global financial crisis, memories will fade.

[4] Tougher regulations in the shape of the Basel III liquidity coverage ratio have reinforced the attractions of government debt as one of the few qualifying assets. Meanwhile, the new capital requirements for insurance companies (Solvency II) are also incentivising them to sell riskier bonds in favour of government debt. There are concerns that the regulations are encouraging pro-cyclical investment behaviour, see: http://www.ecb.europa.eu/pub/pdf/scpops/ecbop154.pdf

…partly because of monetary policy support…

…QE has changed the investment landscape dramatically

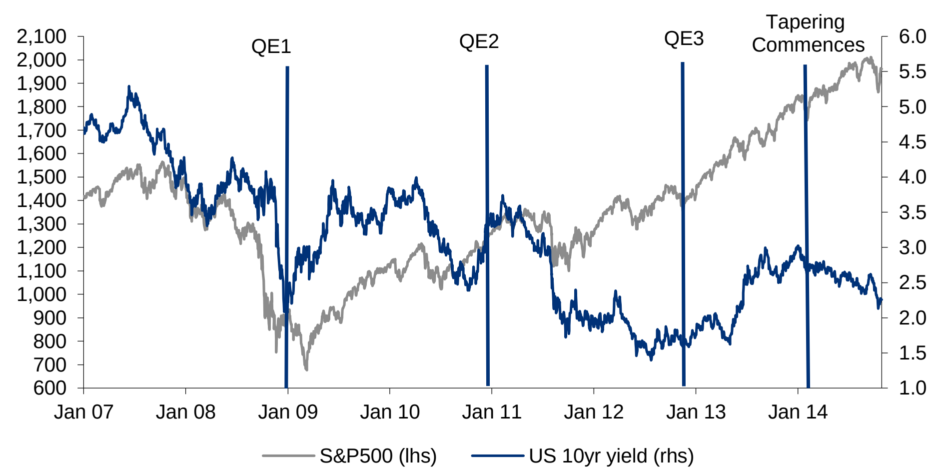
However, a more important factor driving risk appetite in the financial markets is monetary policy, the final of our four factors behind the current low level of yields. Central banks have transformed the investment landscape with their unconventional policies, with huge infusions of liquidity into the banking system and heavy purchases (actual or expected) of government and other bonds. Such quantitative easing (QE) has led to a dramatic restructuring of portfolios as investors have been driven to buy riskier assets in a 'search for yield'.

The impact of QE is controversial, but unmistakeable…

…risk assets have surged

While the precise impact of QE is, and will continue to be, hotly debated, a straight-forward comparison of the performance of the US 10 year Treasury yield and the S&P500 stock market index should suffice to make the point (see Figure 9). While Treasury yields remain some 250-plus basis points below their pre-crisis levels, stock markets have reached new highs this year. Likewise, riskier segments of the bond market, including high yield and emerging markets debt, have soared as investors seek to meet minimum returns. In the case of euro-denominated high yield bonds, yields now average 3.9% on an average life of five years, a yield that was not so long ago regarded as an attractive yield level for 30-year German government bonds.

Fig 9 US Treasury yield versus equities: QE transforms the relationship



Source: EcoWin

Normalisation? Why the QE exit may be bumpy

'Normalisation' – a smooth rise in interest rates – is expected to start in the UK and US next year

An important element of 'New Normal' thinking is that the leading central banks will eventually unwind their unconventional monetary policies, and do so gradually. The US Federal Reserve and the Bank of England are expected to lead a process of 'normalisation', ending quantitative easing and beginning to raise official interest rates from their current near-zero levels at some point next year. The consensus is that they will raise interest rates gracefully and gradually to a 'new normal' level of 3% or so over the next three years. The judgement is that the US and the UK economies are healthy enough to withstand this.

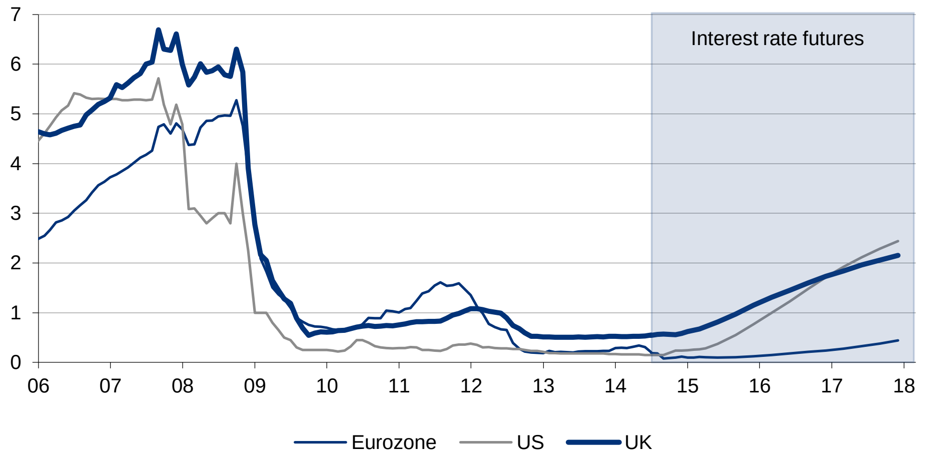
The ECB and the BOJ are still 'abnormalising'…

By contrast, the Eurozone and Japanese economies are not ready for interest rate 'normalisation'. Indeed, the European Central Bank (ECB) and the Bank of Japan (BOJ) are still 'abnormalising'. The BOJ has just announced an expansion of its QE programme, increasing its annual purchases of Japanese government bonds (JGBs) to JPY80 trillion (US$712 billion), up from JPY60-70tn. Meanwhile, the pressure is still mounting on the ECB to engage in what is generally termed 'full-blown' QE, in other words the purchase of government bonds. Nevertheless, even in the cases of Japan and the Eurozone, the markets are still expecting them to go into reverse and be 'normalising' on a three-to-five-year horizon.

The process may not proceed smoothly

The sudden sharp correction in the markets in mid-October underlines our concern that this 'normalisation' may not proceed as smoothly as suggested by the forward interest rate curves (see Figure 10). The sudden fall in a broad range of asset classes, which also featured an alarming intra-day plunge in US Treasury yields on 15 October (which saw the 10-year US Treasury yield drop by 34bp to 1.84%, before bouncing back to 2.15%), was a vivid illustration of how hyper-sensitive markets may be as the Fed moves towards the QE exit.

Fig 10 3 month interest rates – a smooth 'normalisation' ahead?



Source: Bloomberg

Monetary policy decisions may be as much 'market dependent' as 'data dependent'

Although central bankers are keen to emphasise that their decisions on monetary policy will be 'data dependent' – ie, reflect the evolving outlook for the real economy – it will surely also be 'market dependent'. The fact that October's market dive was immediately followed by a queue of central bankers reassuring the markets that they are not in a hurry to start tightening policy underlined this point. They are clearly concerned that a sharp fall in asset prices might derail their efforts to foster economic growth.

Unprecedented nature and scale of central bank intervention leaves huge scope for surprises…

Even if we leave aside the capacity of the real economy data to spring surprises, the unprecedented nature and scale of seven years' worth of monetary interventions in the financial markets should give pause for thought about the potential volatility that lies ahead. Policy-makers, let alone the market practitioners, have no prior experience on which to judge the so-called 'normalisation' of policy.

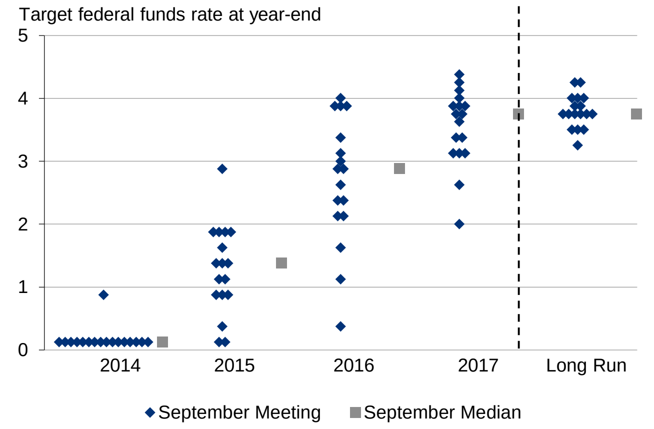
…including policy errors, and sudden investor panics…

This leaves ample scope for policy errors and sudden investor panics. It is not reassuring that policy-makers are making it up as they go along. This improvisation is evident from the changing rationalisations of the need for QE, and the wide range of views being expressed by individual policy-makers (witness the Fed's 'dot diagram' of their interest rate expectations, see Figure 11).

…which could be compounded by international policy conflicts

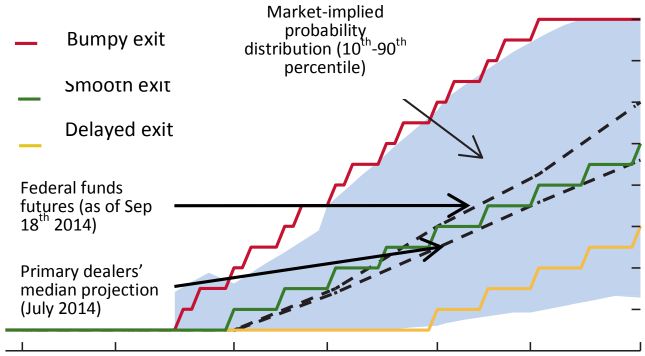
Moreover, it also leaves scope for international policy conflicts. The reaction to higher US rates is complicated by the current policy divergence with the Eurozone and Japan, given that they are still in 'abnormalising' mode. If the latter leads to a sharper than expected appreciation in the US dollar, this may lead to further financial market instability and slow or even reverse the upturn in US interest rates.

Fig 11 Overview of FOMC participants' assessments of appropriate monetary policy



Source: Federal Reserve

Fig 12 How far along the exit process?



Note: Market implied probability distribution derived from Eurodollar options as of 18 September 2014 and both market- and survey-based expectations of the lift-off date still centre around the middle of 2015.

Source: IMF, based on data from Bloomberg, Federal Reserve Bank of New York, IMF staff calculations

Current pricing will make markets hypersensitive, with rates and spreads so low

In any case, current pricing will make markets hypersensitive to policy tightening. Given the starting point of ultra-low interest rates and compressed risk spreads, even small rises in interest rates will lead to large capital losses. Market practitioners are also concerned about the fact that many investors are holding similar investments, so-called ‘crowded trades’, which could lead to bigger falls in prices when they try to sell (this is a point to which we return).

Sharp falls in asset prices, would provide a severe test of the financial system’s resilience

A sharp fall in asset prices, whether triggered by policy tightening or some other shock, would provide a severe test of the resilience of the financial system, which is still recuperating from the global financial crisis. Regulators have moved to strengthen financial institutions by stiffening rules on risk-taking and increasing capital and liquidity buffers. But in our New Abnormal world it is far from clear that future crises will be less frequent or even less damaging.

Weak growth is also a source of volatility

Policy-makers typically argue lower growth may be ‘a price worth paying’ if it is more stable…

To the extent that policy-makers acknowledge that tougher regulation may be curbing economic growth, they typically argue that ‘it’s a price worth paying’: better slower, but more sustainable growth, than a repeat of the boom and bust of the previous decade. We shall leave aside the now-fashionable debate about *who* is ‘paying the price’ (passing clue: it’s not the beneficiaries from the QE-stimulus to asset prices). Later, we discuss how the micro-prudential bias of new regulations may contribute to the New Abnormal. But first, we note how weak growth is also a potential source of volatility.

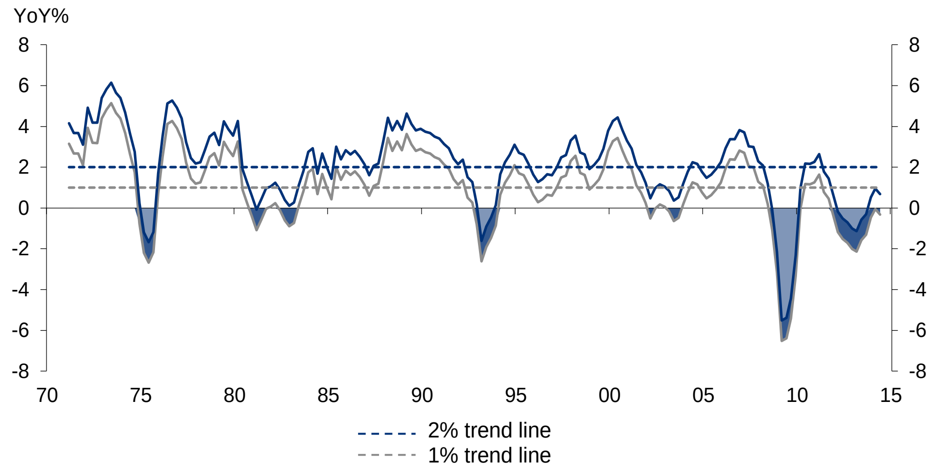
BUT downturns may become more frequent and prolonged

If indeed growth is trending lower, then this implies that downturns will be more frequent and prolonged. For that not to be case, policy-makers would need to succeed in reducing the variability around the trend, or, in other words, smooth out the economic cycle. After the dramatic collapse in the ‘Great Recession’ in 2008-09 and the subsequent lacklustre recovery in the developed world, it is perhaps harder to think in terms of regular economic cycles. Nevertheless, it is also hard to imagine that the raft of policy innovations that the crisis has sparked will lead to a sudden move towards more stable economic growth.

Lowering trend growth from 2% to 1% would have doubled the number and length of recessions since 1970

To illustrate the potential effect of lower trend growth, consider Figure 13, which shows the average real GDP growth in the Eurozone economies since 1970. The trend growth rate over the whole period was close to 2%. It featured four recessions, defined as periods of negative year-on-year growth: 1974-75, 1993-94, 2008-09, and 2012-13. But notice how growth was trending lower over the period. If we look at the period since 1995, the trend has fallen to around 1%. If we lower the trend from 2% to 1% for the whole period since 1970, then with the same cyclical pattern, there would have been not four, but eight recessions, adding two back-to-back recessions in the early 1980s and early 2000s. Moreover, the overall length of time spent in recession would also have been doubled. Correspondingly, there would have been more unemployment, more bankruptcies, and more frequent falls in asset prices.

Fig 13 Eurozone real GDP the impact of 1% lower trend growth



Source: EcoWin

Worse still, the cyclicality of the economy could intensify

To make the picture worse, it could easily be argued that the cyclicality of the economy could intensify from here. The first problem is the perception that there is little room for renewed macroeconomic policy stimulus in the event of another downturn. A recession in the next year or two would certainly be challenging for a counter-cyclical response.

A renewed recession would itself undermine the credibility of fresh rounds of quantitative easing…

…and public debt

On the monetary policy front, the starting point is that official interest rates in the developed world are close to zero, and the scope to go negative is severely limited. Meanwhile, the potential effectiveness of even bigger doses of QE is controversial: would asset prices benefit to the same degree in an environment of weak growth? Since the impact of QE appears to depend heavily on its impact on investor expectations, the very fact that the previous rounds of QE might have been seen to fail would damage the policy's credibility and hence effectiveness. As for fiscal policy, the still-high levels of government debt means that there could (perhaps wrongly[5]) be less appetite to engage in the 'pump-priming' than we saw in 2009. And as for structural reform, even its greatest fans would have to concede that it is not a quick fix for growth.

Recessions can cause more permanent damage to trend growth

The second problem is that weak growth can also cause more permanent damage, lowering trend growth, as capacity and labour that is left idle becomes less competitive and risks falling out of use permanently (a process known as 'hysteresis' in economics). Although old school 'Austrian' economists talked of recessions leading to a positive process of 'creative destruction' to reallocate resources to more productive uses, more recent research has suggested that recessions tend to slow down such a reallocation[6].

Weak growth tends to create political problems too

The third problem with weak growth is that it tends to create political problems, which can have a negative feedback effect on growth and the financial markets. As growth weakens, domestic and international political tensions tend to rise, making it harder to agree on suitable or co-ordinated policy responses and exposing the financial markets to increased geo-political shocks.

[5] Exponents of fiscal activism have struggled to make an impact, not least in the core Eurozone countries, which have typically remained sceptical of such 'Keynesian' remedies to weak growth.

[6] See Ricardo J. Caballero: http://economics.mit.edu/files/1785

A safer financial system? The unintended effects of regulation

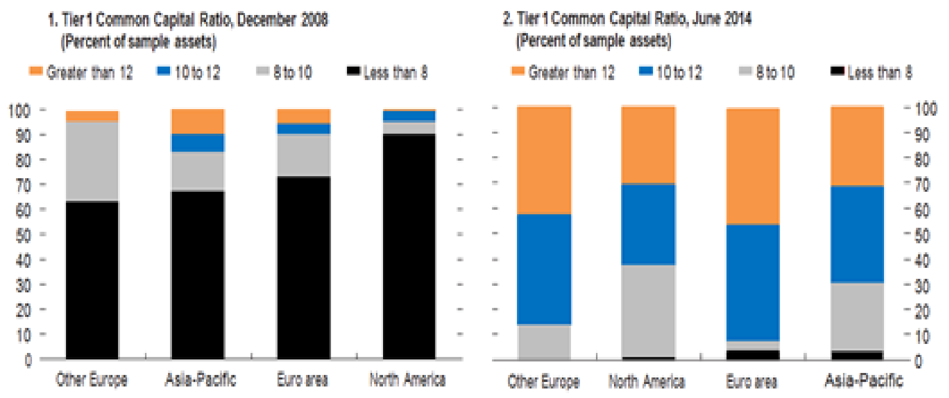
Central banks efforts to ‘normalise’ policy could easily create abnormal shocks for financial markets

It is clear policy-makers have their work cut out if they are to succeed in promoting greater financial stability. This is true even if monetary policy succeeds in offsetting the headwinds of ‘secular stagnation’ and keeps economic growth on track. As we have seen, the central banks efforts to ‘normalise’ policy could easily create abnormal shocks for financial markets.

Many leading financial institutions greatly improved the health of their balance sheets…

The good news is that many leading financial institutions have made good progress in improving the health of their balance sheets, and would be in a better position to withstand another shock (see Figure 14). The latest evidence for this is the announcement of the results of the European Central Bank’s review of the European banks’ asset quality and the associated stress tests. The capital shortfalls exposed in this process were comparatively minor, and most larger banks were convincingly robust.

Fig 14 Bank core Tier 1 ratios have improved substantially since the global financial crisis…



Based on a sample of more than 1,500 advanced economy banks. 2014 data are for 2014:2Q or latest available. Other Europe = Denmark, Sweden, Switzerland and United Kingdom. Asia-Pacific = Australia, Japan, and Singapore. North America = Canada and United States.

Source: IMF based on data from SNL Financial and IMF staff calculations

…but doubts remain about the resilience of the financial system as a whole

Nevertheless, doubts must remain about the resilience of the financial system as a whole. The growing tower of regulation has been principally focused on the health of individual financial institutions (micro-prudential), rather than the financial system as whole (macro-prudential). Indeed, the political imperative to avoid burdening taxpayers again is transferring risks back to the markets, including less tightly regulated institutions.

In transferring risk away from taxpayers to the markets, market panics could be accelerated…

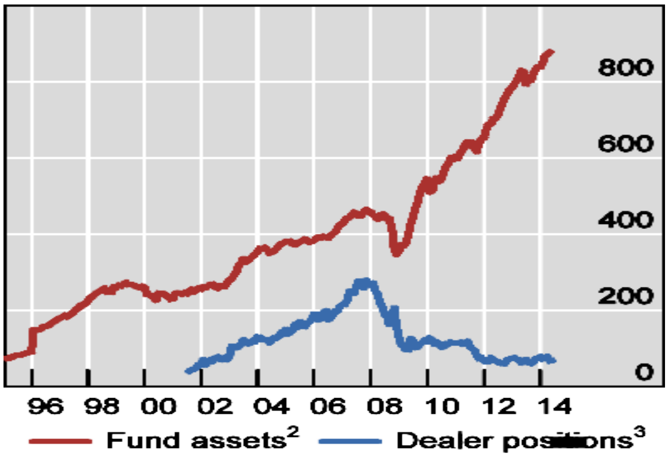
The Box below (*New regulations may threaten the system by transferring risk from taxpayers to markets*) highlights a number of unintended or underappreciated risks arising from the micro-prudential focus of the regulatory drive so far. One aim of the toughening of regulation has been to reduce moral hazard on the part of financial institutions by reducing the reliance on a taxpayer-financed safety net. But in trying to transfer the risk to the industry and its creditors, there is a danger that market panics could be accelerated when trouble starts to surface.

…‘Bail-in’-able bonds and lower dealer inventories could magnify falls in prices in a crisis

Two examples serve to illustrate the potential systemic vulnerability inspired by new regulations. One is the ‘bail-in’-able debt that the regulators are encouraging the banks to issue to boost their capital bases. One form of such ‘bail-in’-able debt is contingent convertibles (‘co-cos’), which convert into equity at the discretion of the regulator. While investors are have been snapping them up eagerly for their extra yield, they may rush for the exit at the first sign of trouble, fearing the forced conversion into plunging equity, thereby exacerbating any future setback.

A second example is the substantial reduction in dealers' inventories of bonds (see Figure 15), partly due to higher capital requirements on riskier bonds, which would make them harder to sell in the event of a crisis, forcing an even bigger drop in their prices. We had a foretaste of this in the recent market setback.

Fig 15 Bond fund assets and dealer inventory (USDbn)



[2] Corporate and high-yield ICI bond fund net assets, [3] All maturities

Source: BIS based on data from Citigroup, EPFR, ICI, BIS calculations

New regulations may threaten the system by transferring risk from taxpayers to markets

1) **'Bail-in'-able debt.** Investors may rush for the exit at the first sign of trouble.
2) **Lower dealer inventories** of bonds (partly due to capital requirements), which may mean that liquidity dries up in crises, leading to sharper falls in asset prices.
3) **Disintermediation.** Would asset managers be able/willing to bear the risk in crises? Rapid growth in ETF bond funds appears to have increased 'herding' of investment, as funds follow each other in and out of the same assets[7].
4) **Derisking.** Regulations aimed at curbing financial institution's risk-taking, are encouraging 'de-equitisation', which reduces systemic loss-absorption capacity, and reducing the willingness of banks and insurers to fund long-term investment.[8]
5) **Central clearing platforms for derivatives** may pose concentration risks and lead more risks to be left unhedged as non-standard derivatives become more expensive.[9]
6) **Bank rescues.** Banks will be more reluctant to rescue ailing competitors in future crises after costly errors last time.[10]
7) **Lender of last resort.** Restrictions on Federal Reserve's emergency lending to financial institutions in the Dodd Frank Act may be tightened further, increasing the risk that they fail in the event of a crisis.

[7] For an extended discussion of this see the IMF's latest Global Financial Stability Report, page 45 https://www.imf.org/external/pubs/ft/gfsr/2014/02/pdf/text.pdf

[8] There are also concerns that binding risk constraints and mark-to-market accounting will cause more procyclical investment behaviour: http://www.ecb.europa.eu/pub/pdf/scpops/ecbop154.pdf

[9] This was recently acknowledged the ECB: http://www.bis.org/review/r140127c.htm and slides http://www.ecb.europa.eu/press/key/date/2014/html/sp140123_1.en.pdf

[10] See the provocative article "Financial reforms will make the next crisis even messier" by John Plender in the Financial Times: http://www.ft.com/cms/s/0/25d98538-2fa6-11e4-83e4-00144feabdc0.html#axzz3HWk2RPm0

The upside of volatility – waiting for the next boom

Incomplete efforts to secure financial stability threaten economic stability

This critique of the 'New Normal' has so far emphasised volatility in the form of downside risks. A key theme here is that efforts to secure financial stability are as yet incomplete, which ultimately could threaten economic stability. In particular, aggressively expansionary monetary policy to support economic activity has depended heavily on boosting asset prices to levels that may not be sustainable. Premature reversal of quantitative easing might therefore lead to damaging falls and volatility in asset prices.

Recent experience makes it easier to think of downside risks…

Recent experience certainly makes it easier to think of downside risks. Moreover, for now, there is little sign that policy-makers are prepared to abandon the current policy consensus and adopt pro-growth alternatives. Couple this with the fact that regulators are changing the rules of the game while it is still being played; they are fuelling an uncertainty that weighs on investment.

…but the fashion for miserablism overlooks the potential for good news

However, while financial market volatility typically accompanies bear markets, there is an upside to volatility. Indeed, we have repeatedly argued against the fashion for miserablism[11]. Good news also catches out forecasters: economists are as bad at forecasting booms as recessions. This is hardly surprising given that most use models that are founded on the belief that the economy is self-equilibrating[12]. In other words, they tend to head towards 'normality'.

There are long-term sources of optimism…

Looking beyond the near-term gloom, we would summarise the potential sources of optimism as follows:

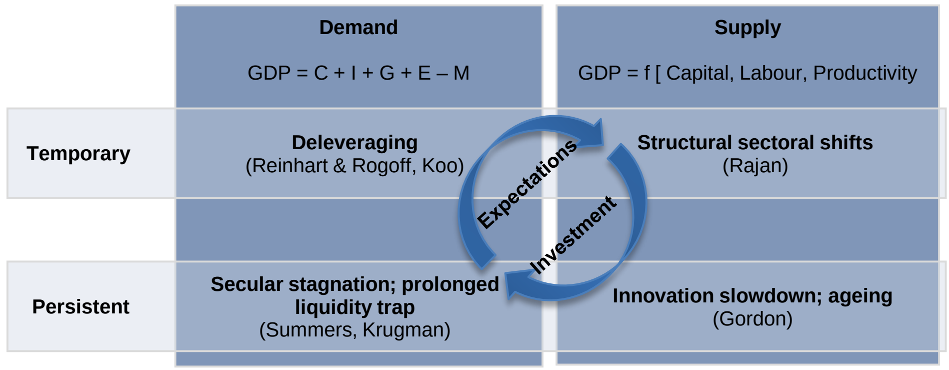
The policy consensus is learning and evolving

1) **Constructive policy changes.** While policy-making is still in uncharted territory, progress is being made as research and 'learning by doing' deepens our collective knowledge of what does and does not work. Hopefully, future setbacks in the global economy and financial markets will be minor wobbles, from which policy-makers will learn and then deliver pragmatic responses that put us on a more positive path. Over time, the political consensus over the need for structural reform and investment is evolving.

Economists offer demand-side and supply-side explanations for low growth

The matrix below (see Figure 16) summarises the debate among economists about the reasons for slow growth. Broadly, we can divide them into demand-side and supply-side perspectives. Within these, we can further sub-divide the analyses into temporary, short- to medium-term, problems, and persistent problems. As described earlier, volatility, not least emanating from the financial markets, can turn temporary problems into persistent ones. Pessimistic expectations, by undermining investment, can become self-fulfilling.

Fig 16 Why is Growth Low? The Economists' Debate



Source: ING. References to the cited economists' articles are available upon request.

[11] See for example "By Accident or Design - Optimism from a Dismal Scientist" June 2013 http://markcliffe.wordpress.com/2013/06/24/by-accident-or-design-optimism-from-a-dismal-scientist/

[12] Among numerous references on this topic see for example: http://ineteconomics.org/financial-crisis-blinders

Demand stimulus could be complementary to supply-side reforms

The next matrix (see Figure 17) addresses the potential policy prescriptions based on these analyses. We discussed earlier the widespread perception that the scope for further demand stimulus from either monetary or fiscal policy is widely seen as being constrained. Keynesian economists doubt this, or argue that there should be more emphasis on fiscal stimulus and less on monetary. Others argue that the demand stimulus is complementary to supply-side reforms to improve the structural performance of economies[13]. A key component here could be the growing recognition that fiscal consolidation needs to take account not just of the *level* of government spending, but its *mix*. There is a growing consensus on the need to step up public investment, notably on infrastructure, to act as a catalyst for long-term growth. The fact that financing costs are currently so low makes the case even more compelling.

Fig 17 Policy Prescriptions to Stimulate Growth: A Menu of Options

	Demand The expenditure focus: GDP = C + I + G + E – M	Supply The output focus: GDP = f [Capital, Labour, Productivity]
Temporary	**Monetary and fiscal stimulus**	**Retraining; financial sector restructuring; labour market reforms**
Persistent	**Radical stimulus; public investment**	**Structural reforms; deregulation; encouraging risk-taking**

Source: ING

Time is a great healer for the financial sector

2) **Financial sector recovery.** Although incomplete, the process of repair in the banking sector is well under way. Time is a great healer, and much has happened over the past five years. As we noted earlier, the banks' profits have rebounded, so they've been able to build up their capital buffers (see Figure 14). Over time, we should see bank lending picking up as well.

Likewise, despite the risks that we described earlier, new non-bank sources of finance are opening up and regulators are busy trying to put them on a sustainable footing.

We doubt the belief in a long-term technological slowdown

3) **The Third Industrial Revolution**[14]**.** Contrary to the 'secular stagnation' thesis, we do not believe in the inevitability of a long-term technological slowdown. Indeed, a new industrial revolution may be set to gather speed, as a long list of new exciting technologies comes on stream. This includes robotics, genomics, nano- and cloud technology, new energy and agriculture.

The 'anytime anywhere' economy will have powerful, positive, network effects

A distinctive characteristic of what might be called the 'anytime anywhere' economy is the powerful network effects of the technologies. The next phase of digitisation, which some call the 'internet of things', connecting billions of devices and people, opens up the prospect of faster growth across a broad range of industries. In the process, it offers the prospect of increasing returns to scale and accelerating growth at odds with the 'New Normal'.

Pessimists point to the current lacklustre performance of business investment. Many big companies are sitting on big pots of cash that they are reluctant to spend. Yet this is due largely to the hangover from the financial crisis, which should dissipate over time as the developed economies deleverage. Predicting exactly when that might

[13] Although it should also be noted that some supply-side reforms can have negative short term consequences for demand (eg, labour market reforms may allow employers to shed workers more easily or reduce compensation).

[14] Carlota Perez argues that we are already in the fifth technological revolution and the financial crisis is a precursor of a 'golden age', 'If history is a guide' (see http://www.carlotaperez.org/downloads/media/PEREZTechnologyandbubblesforEngelsbergseminar.pdf)

happen is not easy, but as the pipeline of new technological advances continues to fill, the more likely it will arrive.

People are healthier and retiring later, and there's a pool of unemployed to be put to work

4) **Demographic adaptation.** As the population ages, so the growth in the number of workers is slowing. But there are a number of offsets to this aging effect. People are getting healthier, they are retiring later, and there's a pool of unemployed and underemployed people who could be drawn back into work. In any case, what matters is not just the overall growth in economic output, but what happens to output per head. In other words, the key is productivity.

The emerging world is catching up, and will play a growing role in driving productivity and innovation

Moreover, while many countries in the emerging world, led by China, also have aging populations, they will play a growing role in driving productivity. The emerging world still has considerable growth potential, simply from catching up. Technology will fuel an acceleration in the human and digital resources devoted to innovation. And the emerging economies are joining the leaders as they grow in size and maturity. Their companies are increasingly becoming global players, both in terms of size and innovation.

Conclusion

The idea that the world faces a 'New Normal' of low growth, interest rates and investment returns has been widely embraced. Forecasters assume that the global economy will gravitate towards low but stable growth, regulators hope to deliver a more stable financial system, and central banks aspire to 'normalise' policy after years of radical improvisation. Yet this 'New Normal' thinking is in for a few surprises. The notion of a New Normal glosses over several sources of instability. Far from being normal, it is more instructive to think of the world going through a 'New Abnormal'.

The New Abnormal is characterised by on-going structural changes that extend beyond the decade-long challenge of reforming the financial system. Economic policy is unbalanced, with monetary policy forced into the role of supporting economic growth in the face of headwinds from fiscal consolidation and tightening financial regulation. Unconventional monetary policy interventions have enjoyed more success in boosting asset prices than economic growth, which suggests that moves to 'normalise' interest rates could turn out to be much bumpier than the markets expect.

Meanwhile, the reluctance of policy-makers to embrace growth-enhancing fiscal and structural reforms is deterring the investment that could stimulate a surprisingly robust upswing in the longer term. The upside of the volatility of the New Abnormal is that a host of new technologies offer the potential for positive network effects and answers for the demographic challenges to global growth. It remains to be seen whether the shock of another recession will be required to trigger the shifts in economic policy that might give business the confidence to embrace that potential.

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