10. 9. 2024 | Frait Jan Zeisel Viktor

A “new normal”, or a continued “Great Macrofinancial Volatility”?

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Lecture for the International Conference on Finance and Economics (ICFE 2024)
Faculty of Management and Economics, Tomas Bata University
Zlín, 10 September 2024

I’d like to thank the conference organisers for inviting me to a part of our country where I spent a good part of my life – my childhood and early youth. My identity documents at the time stated that I lived in the Gottwaldov district, but at home we always said “we’re going to Zlín”. I’m glad of this opportunity to return.

I was first appointed to the Bank Board of the Czech National Bank at the beginning of this century. The deep macroeconomic and financial crisis was still being felt in the Czech Republic, and especially in its banking sector. By then, however, the CNB was one of the central banks using the relatively new system of inflation targeting. The development of the associated analytical and forecasting toolkit to support monetary policy decision-making was well underway. Like the Anglo-Saxon central banks whose example we followed, we drew on the theoretical and empirical approaches of New Keynesian Macroeconomics, which had started to gain dominance in academia and central banks through DSGE models at the start of the century. As is often the case, these approaches were a product of their time, not the other way around. It was an era characterised by optimistic expectations about long-term economic developments. In response to the favourable trends of the 1990s, macroeconomists believed in a “Great Moderation” (Great Moderation (external link)) and predicted that we would see decades of low and stable inflation amid brisk economic growth. This optimism was further fuelled by a stabilisation of public budgets and a significant reduction in public debt in advanced economies.

The belief in an ongoing and continued “Great Moderation” was reflected very strongly in the notion of optimal monetary policy, which would enable central banks to maintain macroeconomic stability through relatively subtle measures, with no significant cyclical fluctuations. It was assumed that it would be enough for monetary policy rates to move only slightly around the nominal neutral rate (external link) (the sum of the real natural rate and the inflation target rate). There was also a belief that monetary policy tools would be targeted exclusively at macroeconomic objectives. Financial stability would be the sole responsibility

of financial market regulatory and supervisory authorities. To be fair, even before the Global Financial Crisis (GFC) of 2007–2008, many economists fear d that the "Great Moderation" was being driven more by "good luck" than by the "smart policies" that central bank researchers (external link) had put their faith in.

We are now coming to the end of the first quarter of the 21st century. The contrast between what we thought lay ahead at the start of the century and what actually transpired is stark. Instead of a continued "Great Moderation", we experienced large cyclical fluctuations, waves of deflation and inflation, and turbulent cycles in credit growth and asset prices. Private and public sector debt soared. I call this period the "Great Macrofinancial Volatility". In some recent presentations, I have explored whether what we saw was merely the result of bad luck and unpredictable shocks, or whether inappropriate theories and wrong economic policies also played a significant role. Today, however, I will focus more on macroeconomic and financial variables from a historical perspective.

Are we approaching – or already in – a "new normal"?

Economists – and indeed the general public – began last year to expect the economy to return to the more favourable conditions of the 2000s and 2010s as the inflationary shock of 2021 and 2022 faded. Specifically, they expected that as inflation declined, interest rates would also drop significantly, access to credit would improve, consumption and investment would increase and buoyant growth would return amid high employment. Looking at the past two years, however, it is clear that the dream "ideal" has far from returned. Most market participants are hoping that what we are experiencing is not a "new normal". The macrofinancial situation remains highly unsettled.

The considerable uncertainty is evident in interest rates, represented here by typically relatively stable five-year interest rate swap rates (Chart 1). After having gone up in response to the inflation shock, they have been fluctuating within a fairly wide band – even in advanced economies – as market participants have reassessed the future actions of central banks. The uncertainty surrounding the real economy is also clearly visible in the behaviour of traditional energy commodity prices (Chart 2). The recent relatively low oil price can be readily interpreted as a lack of confidence in a global economic recovery. Few people now remember that the rapid rise in oil prices seen during the pre-GFC boom years was blamed on financial speculators. Serious thought was given to finding ways to curb such speculation. This was a fairly typical example of the dead ends we repeatedly find ourselves in when reacting to economic shocks. At such times, simple explanations are often sought, and even those that are clearly flawed but headline-grabbing are readily accepted.

The high level of uncertainty in recent years is perhaps best seen in exchange rates (Chart 3). In recent years, the US dollar has appreciated and at times depreciated by tens of per cent year on year against other currencies. If currencies with fixed exchange rates came under such depreciation pressure, there would be talk of a currency crisis and there would

probably be significant political repercussions. In the case of floating rates, it is merely regarded as increased volatility – an unpleasant but common enough occurrence. This is one of the few, yet very big, advantages of floating exchange rates.

Residential property prices tell a specific story (Chart 4). In advanced countries, largely due to developments in inflation-targeting countries, prices rose rapidly until 2022 and then fell back somewhat in response to monetary policy tightening. In some countries, the reversal in prices was more pronounced, while in others, it hardly occurred at all. The fact that the situation in emerging economies was noticeably calmer should be cause for deep reflection for economic policymakers in advanced countries, most of which target inflation.

Stock indices have also seen year-on-year fluctuations of tens of per cent (Chart 5). This is not historically unusual. During the recent surge in inflation, equities – like residential property and some unconventional “reserve” commodities (Chart 6) – have established themselves as assets offering some protection against inflation. However, the current surge in US shares is being driven almost exclusively by a small number of tech stocks. The lacklustre growth of the rest of the equity portfolio suggests that market participants lack confidence in stable and long-term growth across the economy. Furthermore, the greater concentration in a smaller number of large stocks is not fostering a return of the “Great Moderation.” This has been very evident in recent weeks.

Was the “Great Moderation” just an illusion?

The belief in the “Great Moderation” arose in response to the stabilisation of two closely linked variables – inflation and interest rates. While the 1970s and 1980s were characterised by large fluctuations in these variables, associated with oil shocks, the 1990s saw a marked decline and stabilisation. Today, we agree that the decline in inflation pressures (Chart 7) initially in advanced countries and then in emerging economies was primarily due to globalisation. As inflation decreased, so, naturally, did nominal interest rates (Chart 8 and Chart 9). This contributed to a significant reduction in fluctuations of economic activity. Unfortunately, the complacency about this new-found stability found its way into policy recommendations and into policies themselves. The initially unobserved tendencies that ultimately triggered the GFC started to develop.

One disappointment for not only macroeconomists is the high volatility of the nominal exchange rates of currencies that operate in the floating regime (Chart 10). This began with the collapse of the Bretton Woods system of fixed exchange rates in the early 1970s. Since then, there has been a persistent feeling that exchange rates are more volatile than would be desirable. Although histograms showing the magnitude of the changes in the two periods (Chart 11) indicate some calming since the mid-1990s (such as in the case of the key currency pair), it is not particularly significant. Large year-on-year swings are more common in the case of energy commodity prices and stock prices (Chart 12). The fact that the counterpart to the stabilisation of inflation and interest rates was increased volatility in asset

markets is clearly visible in residential property prices (Chart 13). Historical databases, which should be approached with great caution, suggest fairly convincingly that cyclical fluctuations in house prices intensified globally after the collapse of the Bretton Woods system. The histograms of residential property prices in the USA and Germany tell the same story (Chart 14). Discussing why this happened would require a separate lecture. Significant factors include the strong credit cycle in advanced countries, which was also driven by significantly relaxed banking regulation, manifested, among other things, in low capital requirements for banks (Chart 15).

With hindsight, we can safely say that the "Great Moderation" involved just a few advanced countries and didn't last long. As a central banker, I can't even recall a long period of calm. At the beginning of the century, we were struggling with the aftermath of a deep crisis in the domestic banking sector. Then came a credit boom that ended with the GFC. No sooner had we dealt with that than the euro area debt crisis began. It was followed by a long recession in our country and then by Covid-19, which significantly disrupted global supply chains. After Covid came Russia's invasion of Ukraine, an energy crisis and a wave of inflation. The GFC was undoubtedly a pivotal event that will affect Western economies for decades to come. It left a particularly harsh legacy in Europe due to the subsequent poorly managed euro area debt crisis. Many of the issues that now trouble us in Europe and cause us to fear for its economic future have their roots right there.

Following the onset of the GFC, a consensus emerged that its roots lay in poorly designed regulation of financial markets and insufficient oversight of banks. Supranational and national authorities responded forcefully to the GFC by implementing a wide range of reforms, now usually referred to in the banking sector as Basel III. When this process began in 2009–2010, we believed the proposed reforms would generate a range of substantial improvements. We expected banks to be less risky (less leveraged), as they would have to hold more and higher-quality capital in new types of buffers. We thought that the requirement to issue bail-inable near-capital would mean that shareholders, not taxpayers, would bear the losses in case of problems. We anticipated that banks would better reflect credit risk in risk weights, create forward-looking loan loss provisions through the cycle and manage liquidity risk using sophisticated quantitative methods. And we believed that large and interconnected banks would be less "too big to fail" and we would have better resolution tools. Bank shares and bonds were ultimately expected to become attractive assets for investors, maybe generating lower returns than before, but also offering much lower levels of risk.

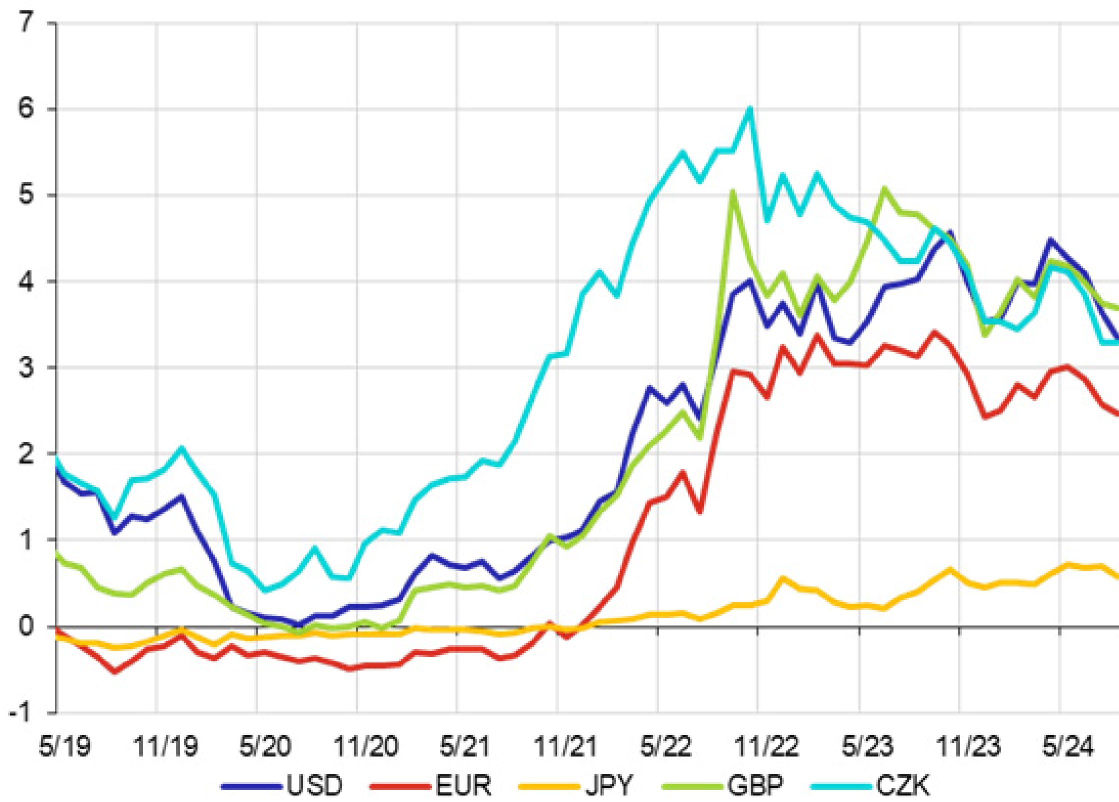
The reforms also pursued broader macroeconomic goals. The new macroprudential policy tools should protect banks from the cycle but also protect the cycle from banks. In other words, fluctuations in bank lending should cause smaller fluctuations in the business cycle and on asset markets. Banks should be more resilient to property market swings. Nearly 15 years after the reform efforts began, we can say that most of the objectives have been

achieved. However, the attempts to introduce through-the-cycle provisions have largely failed. The goal that banks should provide greater support for the development of non-financial corporations other than those active in the real estate business has not been fully achieved. In the EU, we have unsuccessfully tried – in response to the euro area debt crisis – to reduce the sovereign risk that financial markets are exposed to as a result of investing in government debt. To sum up, the system as a whole is not as countercyclical as we initially envisaged. In addition, for most of the post-GFC period, European banking stocks have not been drivers of stock index growth.

Conclusion

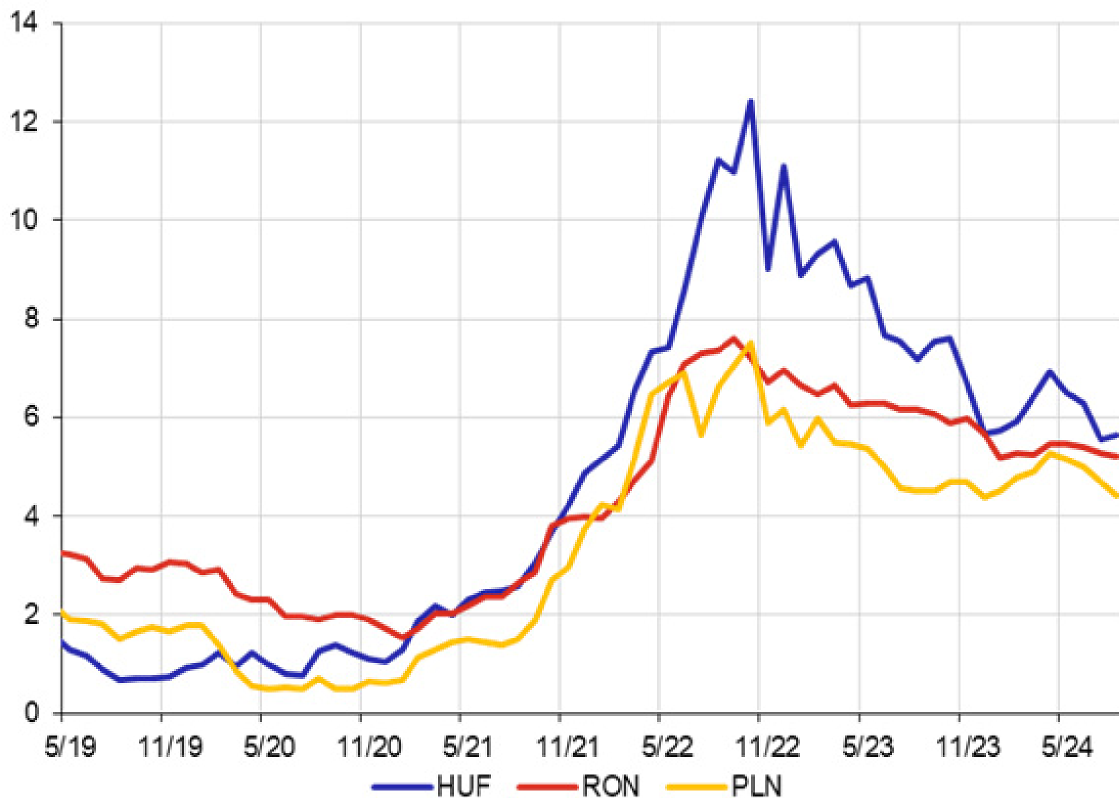
In conclusion, we have to say that we don't consider an early return of the "Great Moderation" to be the baseline scenario. This is not only because geopolitical, social, climate and cyber risks have become more pronounced in recent years, but also because modern monetary and financial systems, despite their manifold advantages, contain mechanisms that support cyclicality and volatility. We have mitigated some of these mechanisms by reforming financial regulation in response to the GFC. I expect changes to monetary policy frameworks in response to the assessments of the roots of the recent inflation wave to have a positive impact in the coming years. Many central banks, including the CNB, are now undergoing reviews of their analytical, forecasting and decision-making processes. I expect that in the end, there will be an acknowledgement that monetary policy, like in the past, is not only a science but also an art, and that monetary policy tools have big impacts on the economy, impacts that have highly variable lags and show up in very different ways over time. First and foremost, therefore, central banks as monetary policymakers should identify the significant stories unfolding in the economy and refrain from reacting to individual statistics. They should be aware that economic processes are often non-linear, discontinuous and subject to multiple equilibria (external link) – the situations when a specific monetary policy action can ultimately result in very different macroeconomic outcomes. They should therefore be holistic, non-dogmatic and flexible in conducting monetary policy. All this while being mindful of their core mandates – a sound currency, price stability and financial stability – and being aware of their shared responsibility for the internal and external balance of the economy.

Chart 1a – Selected 5Y swap rates (%)



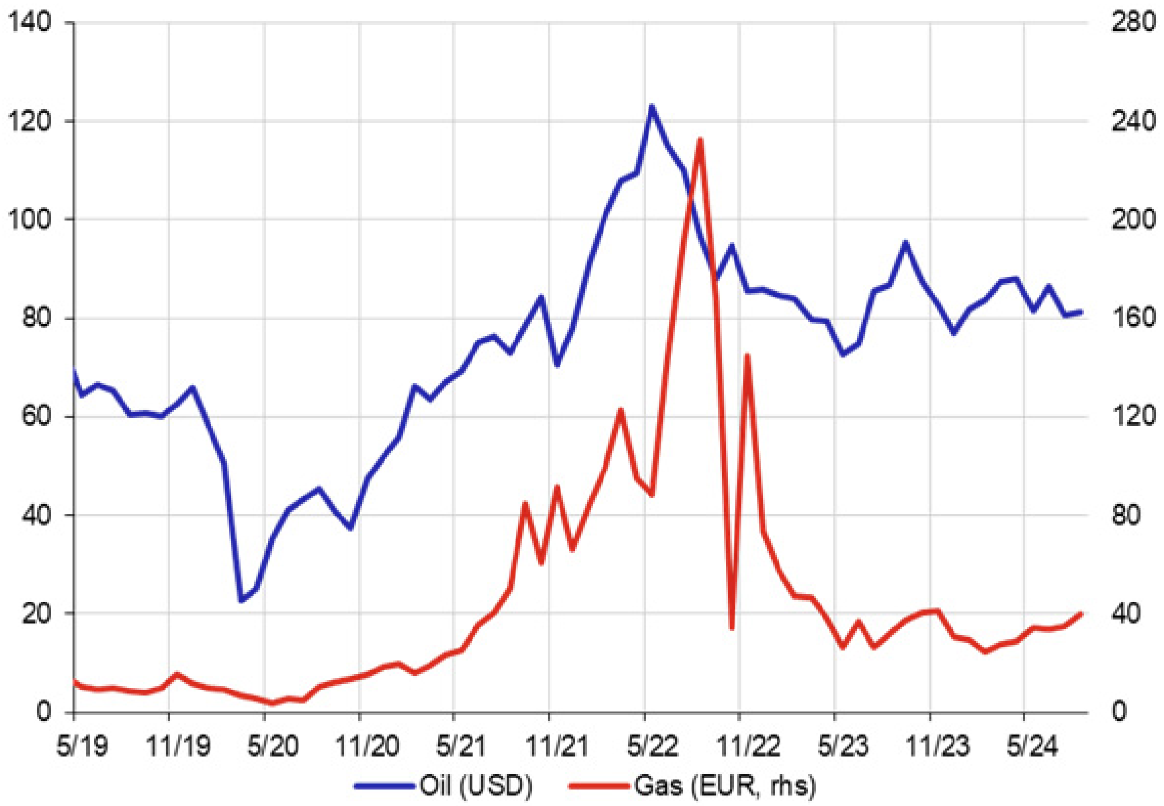
Source: Bloomberg

Chart 1b – Emerging Europe 5Y swap rates (%)



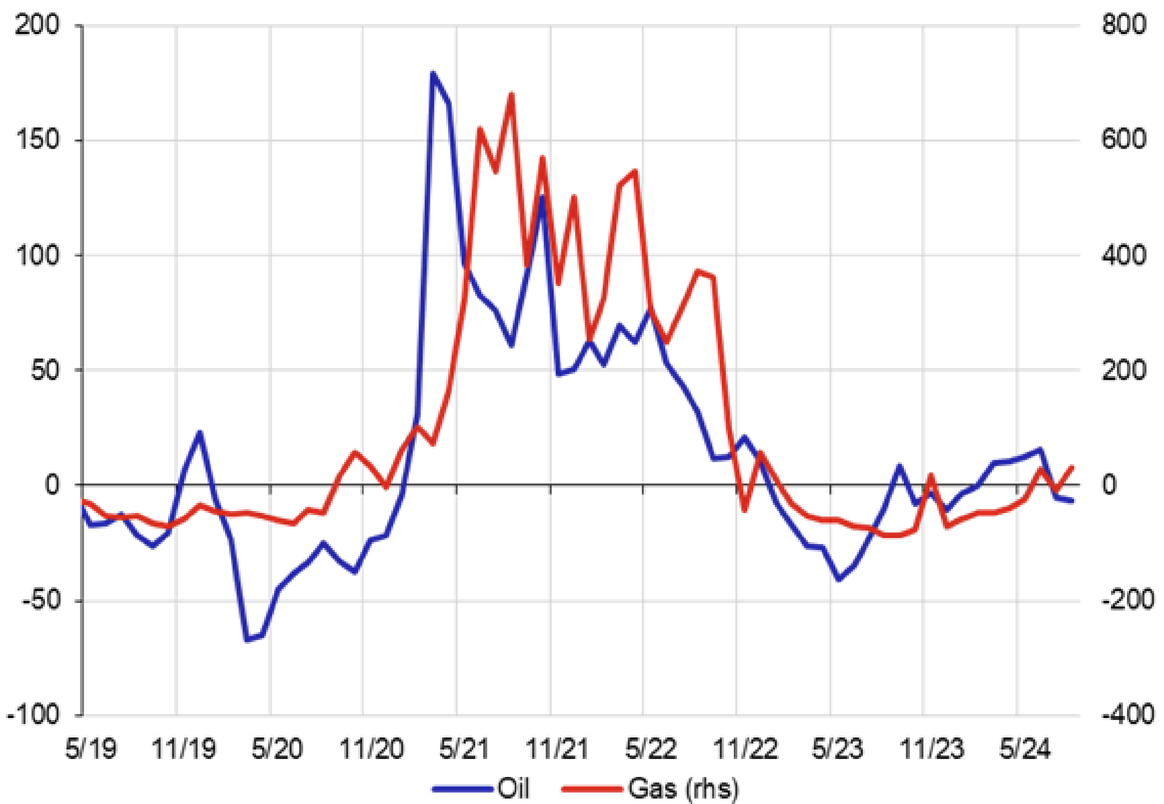
Source: Bloomberg

Chart 2a – Commodity prices



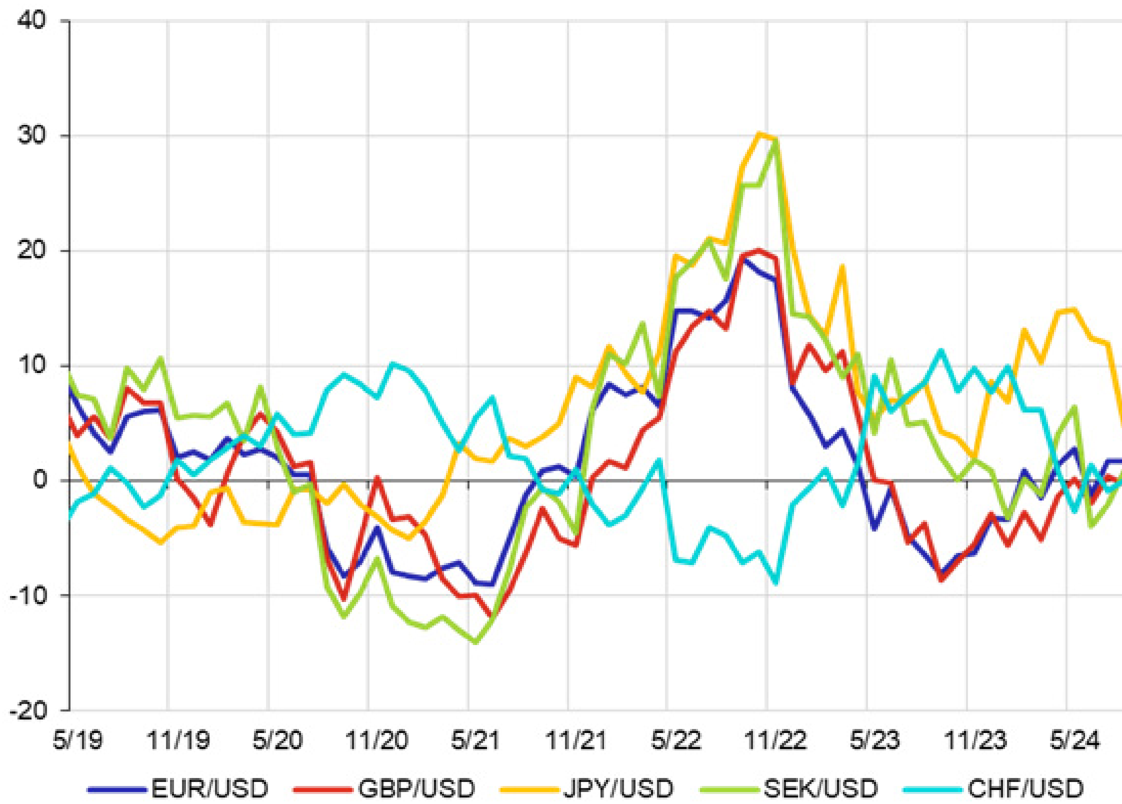
Source: Bloomberg

Chart 2b – Dynamics of commodity prices (y-o-y in %)



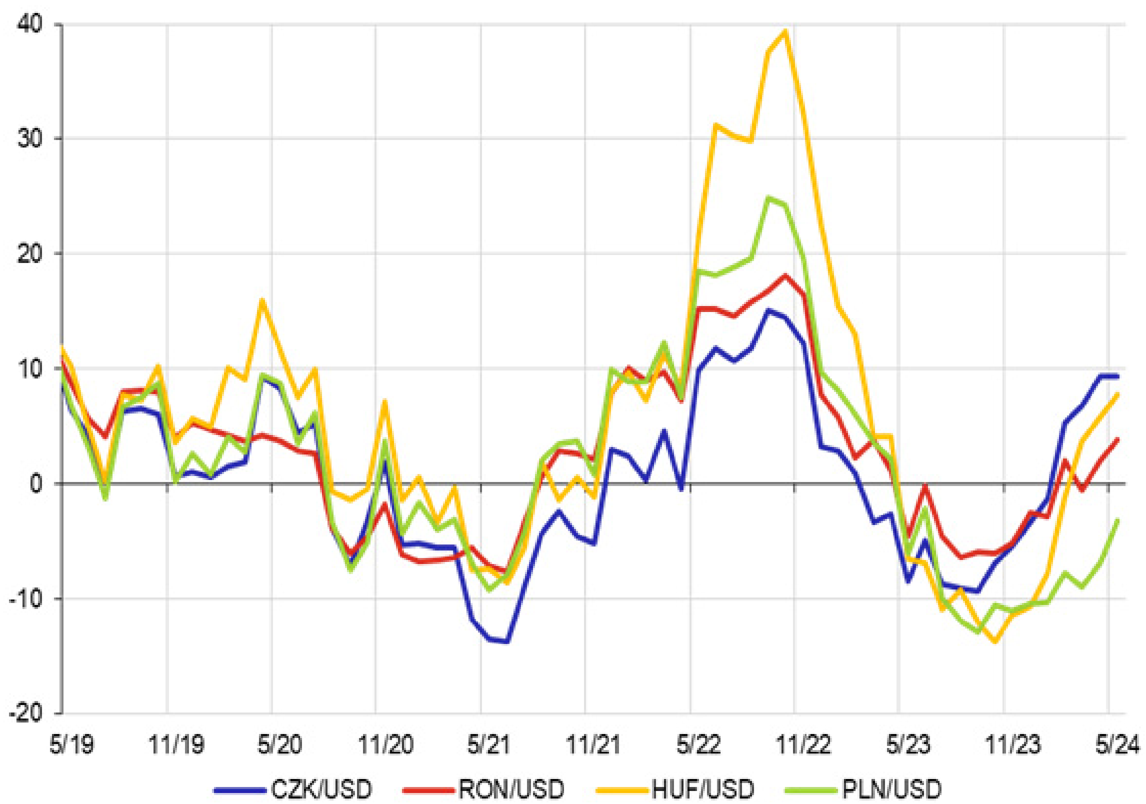
Source: Bloomberg

Chart 3a – Developed countries nominal FX rates (y-o-y in %)



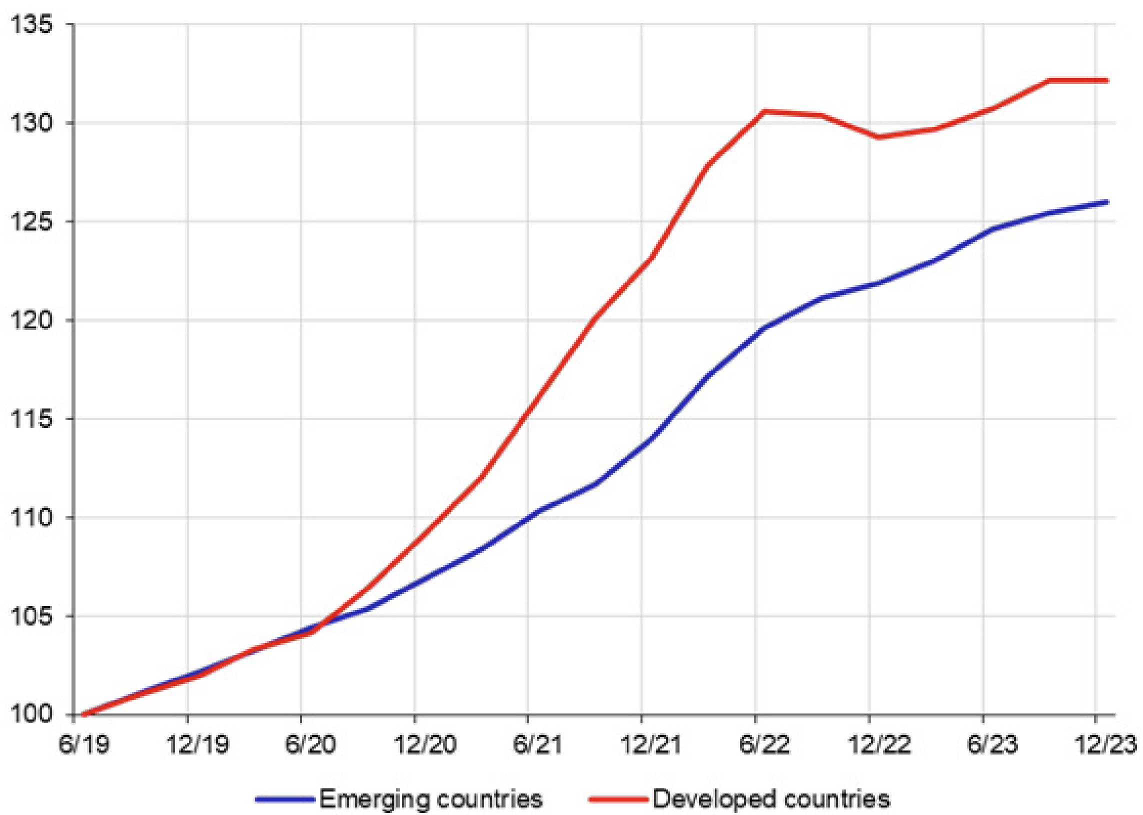
Source: Refinitiv Datastream

Chart 3b – CEE nominal FX rates (y-o-y in %)



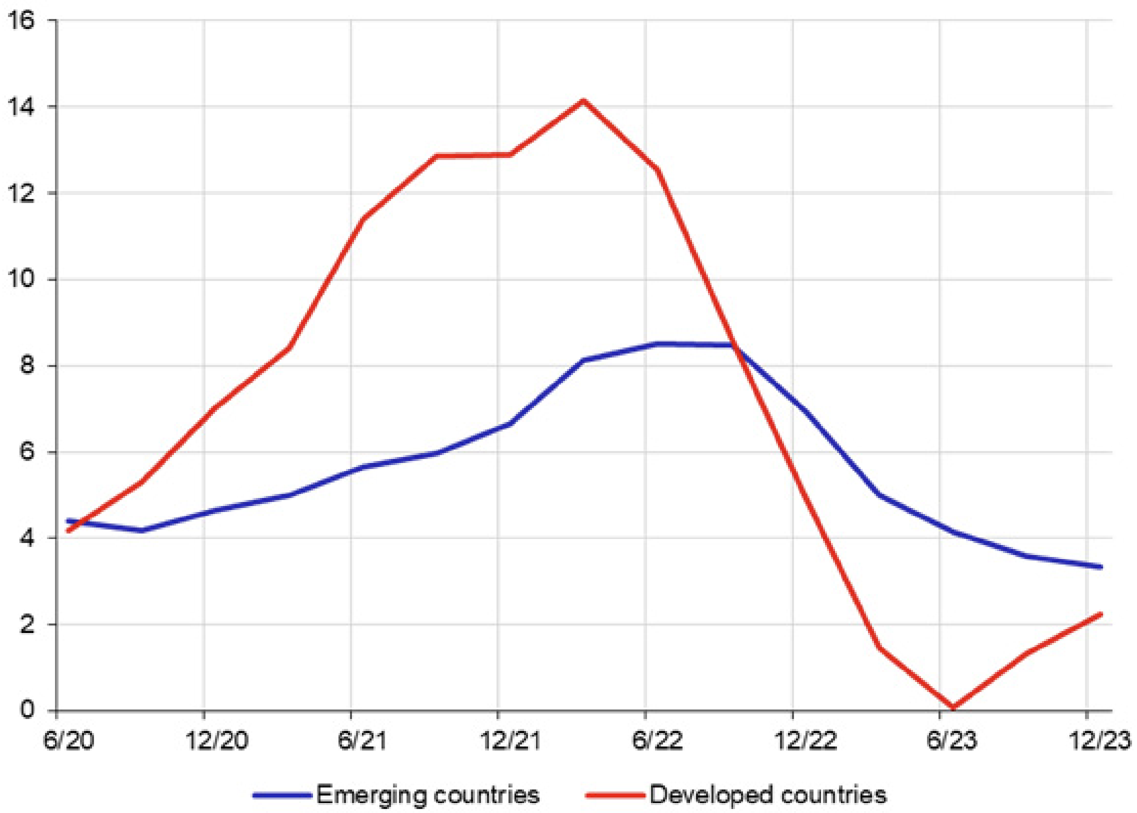
Source: Refinitiv Datastream

Chart 4a – Nominal house price index (30.6.2019 = 100)



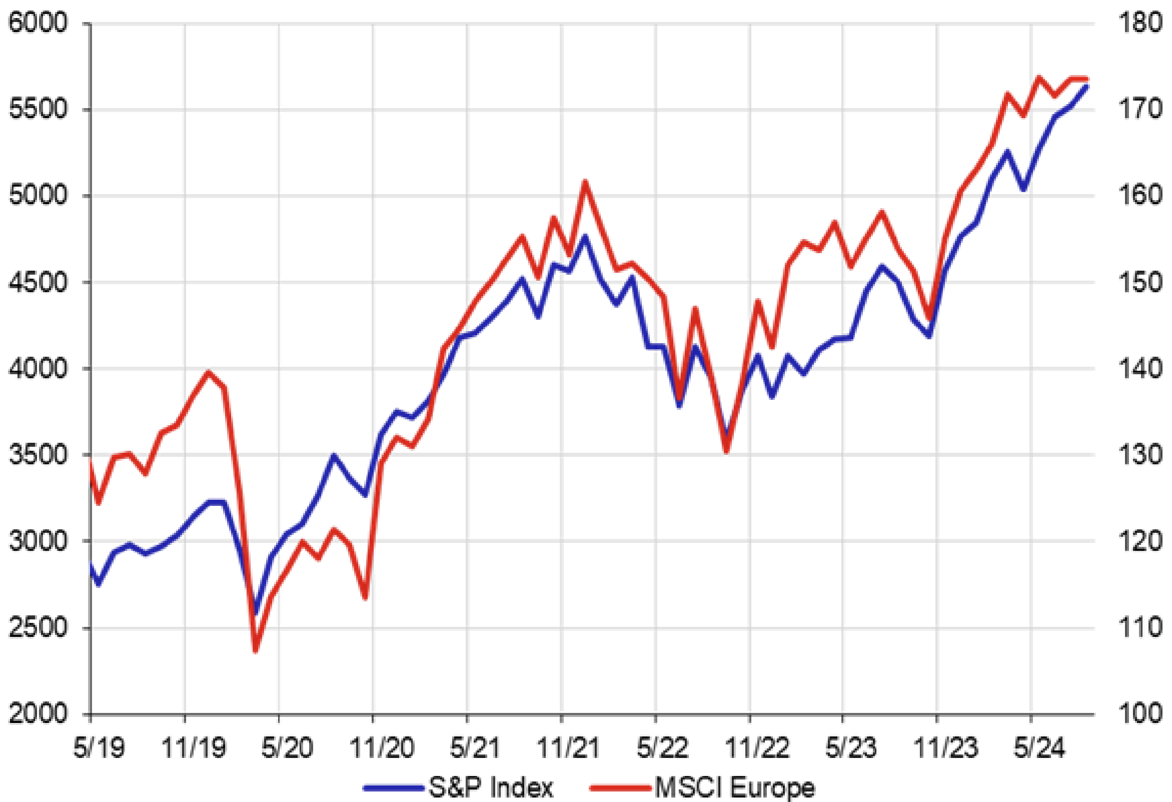
Source: BIS

Chart 4b – Dynamics of nominal house prices (y-o-y in %)



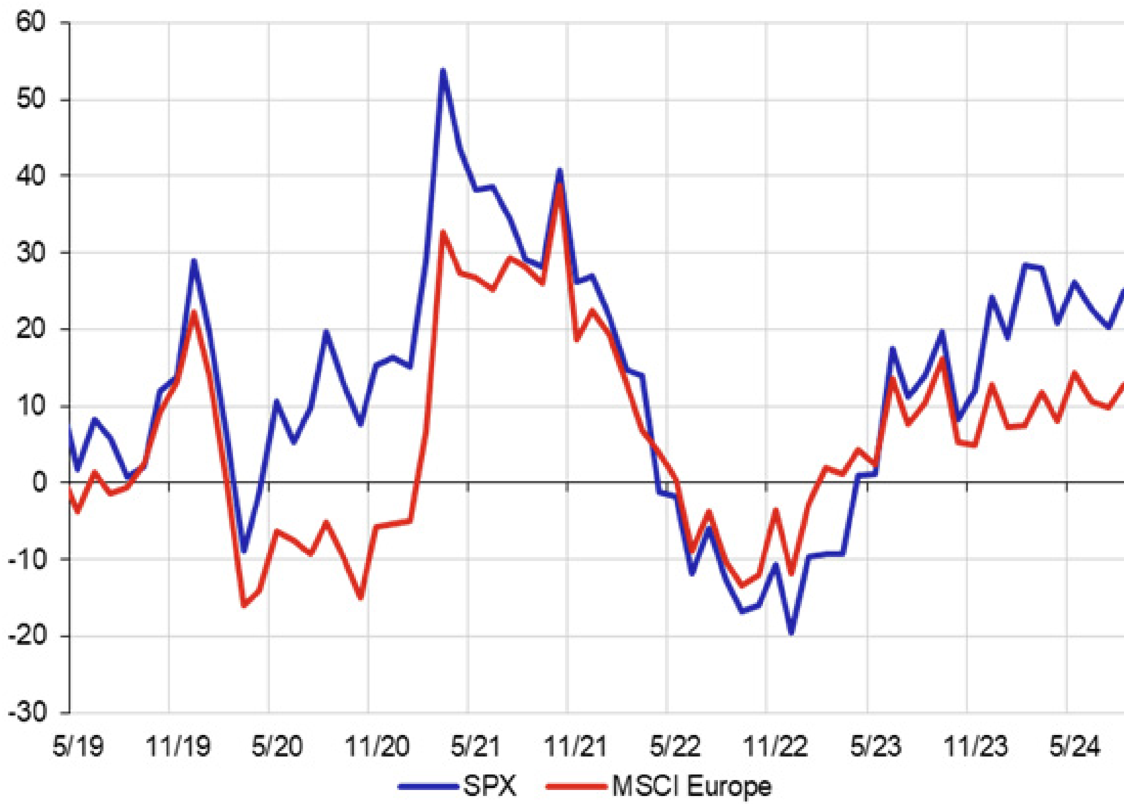
Source: BIS

Chart 5a – Equity indices (index)



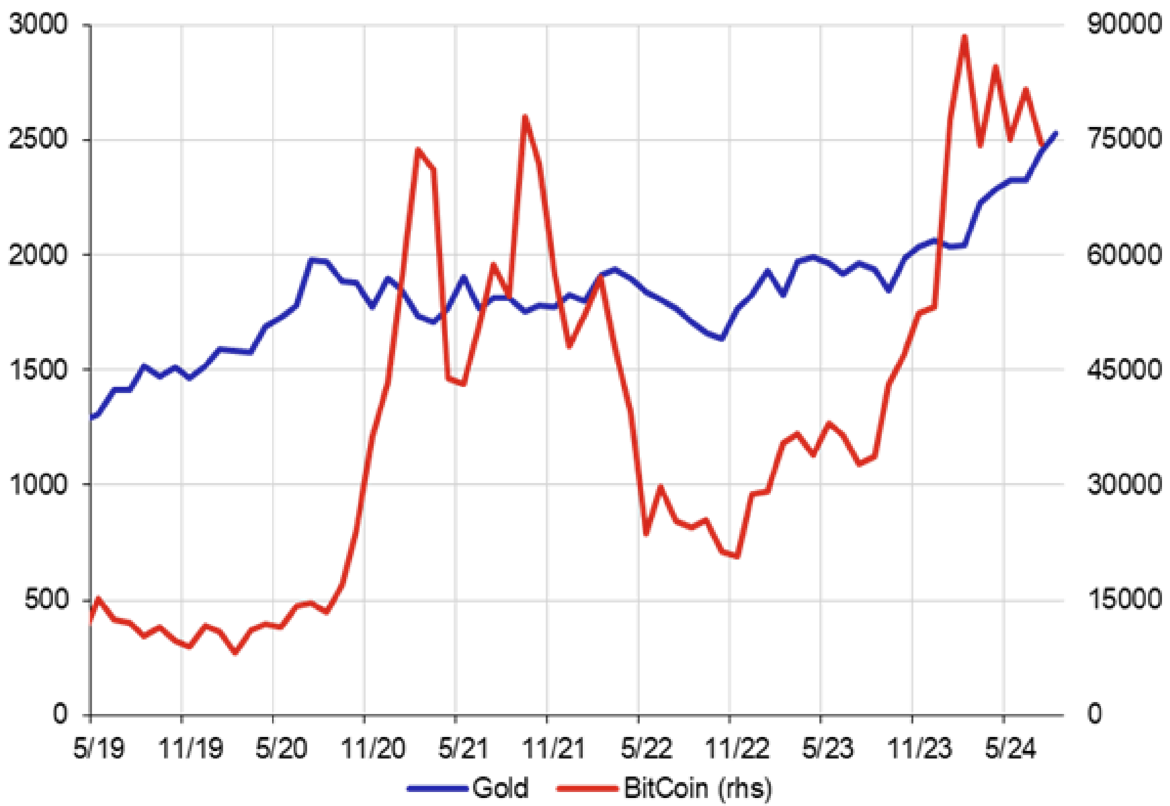
Source: Bloomberg

Chart 5b – Dynamics of equity indices (y-o-y in %)



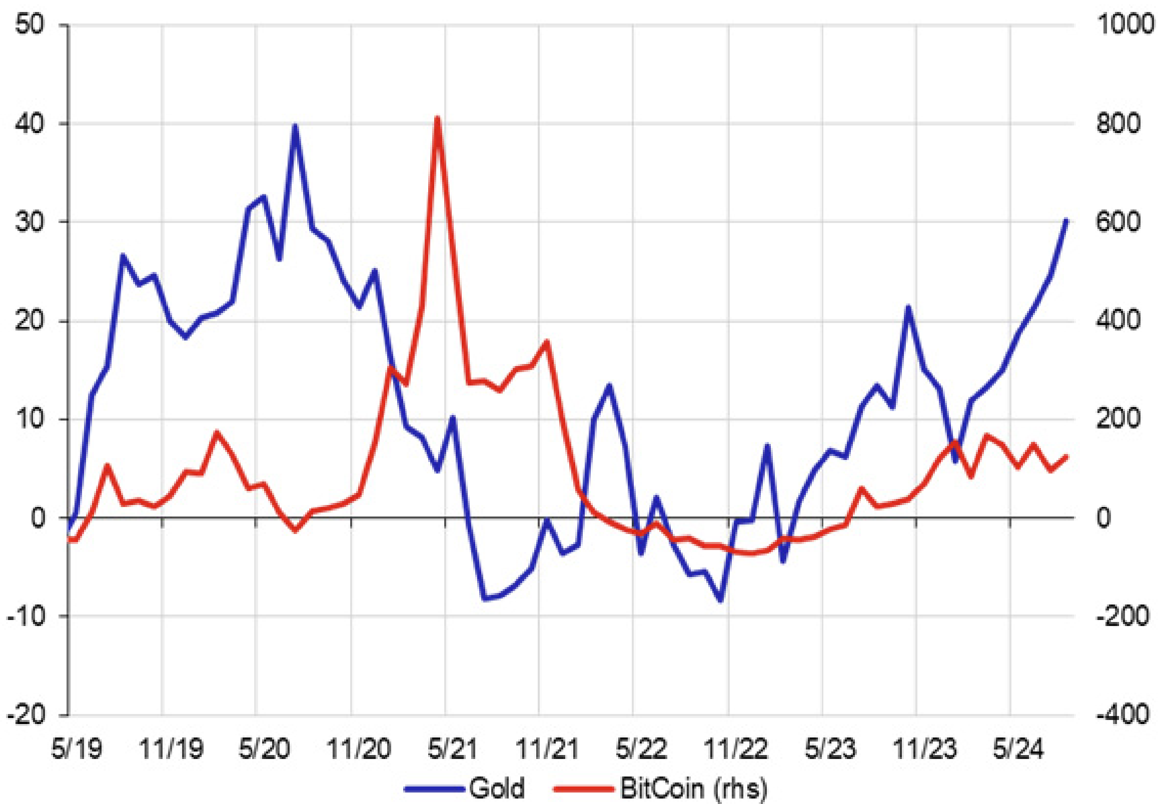
Source: Bloomberg

Chart 6a – Commodity prices (USD)



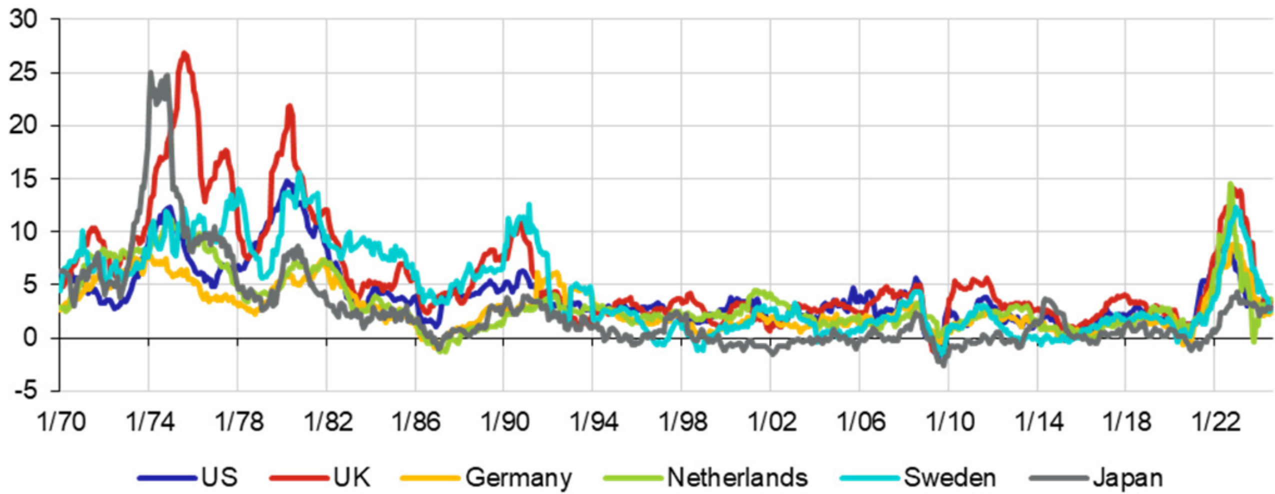
Source: Bloomberg

Chart 6b – Commodity prices (y-o-y in %)



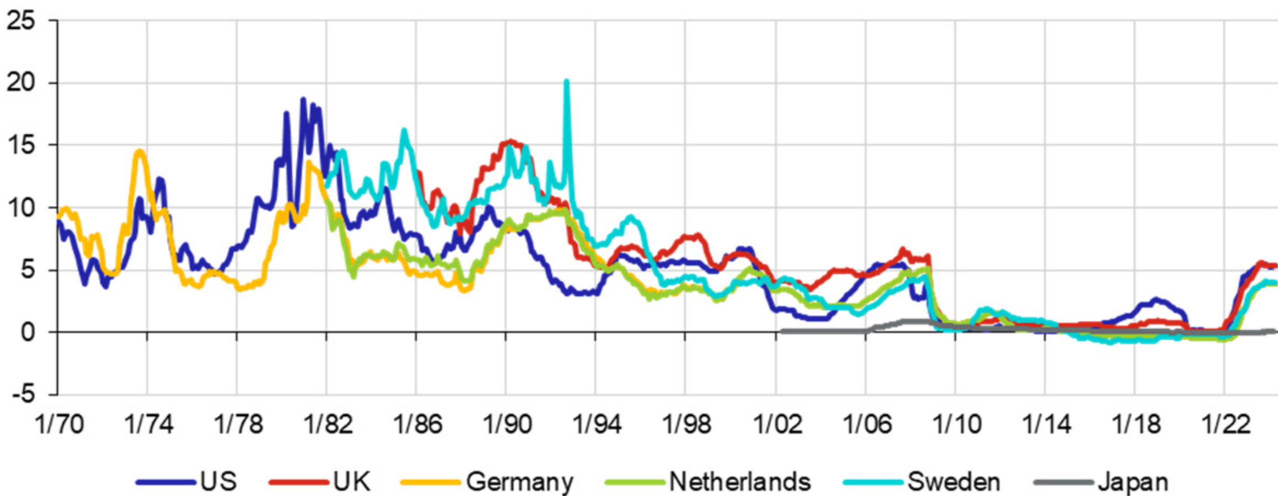
Source: Bloomberg

Chart 7 – Inflation rate in selected advanced economies (y-o-y in %)



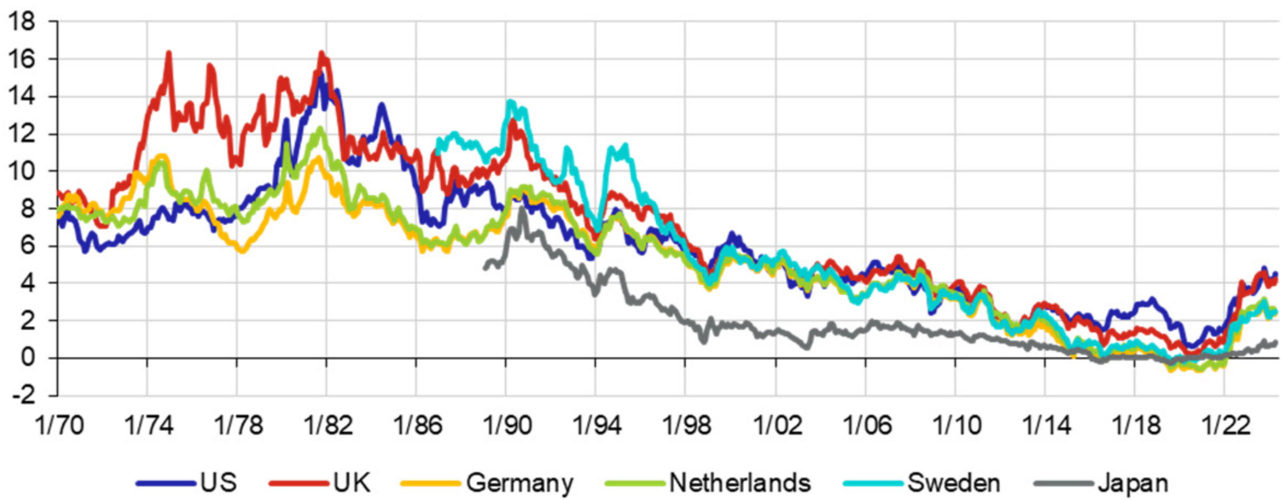
Source: Refinitiv Datastream

Chart 8 – Short-term interest rates in selected advanced economies (%)



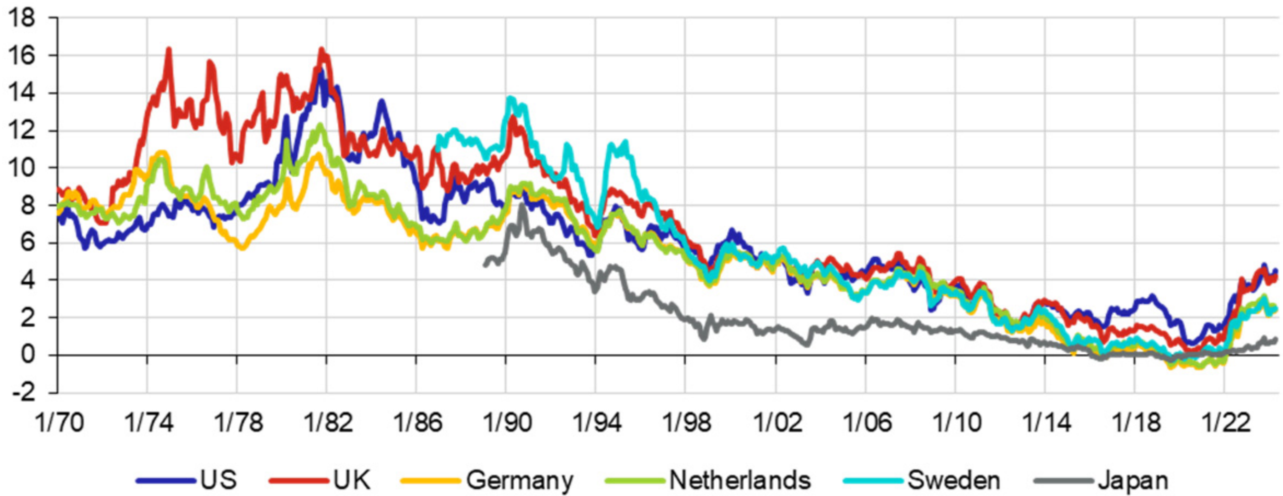
Source: FRED

Chart 9 – Long-term interest rates in selected advanced economies (%)



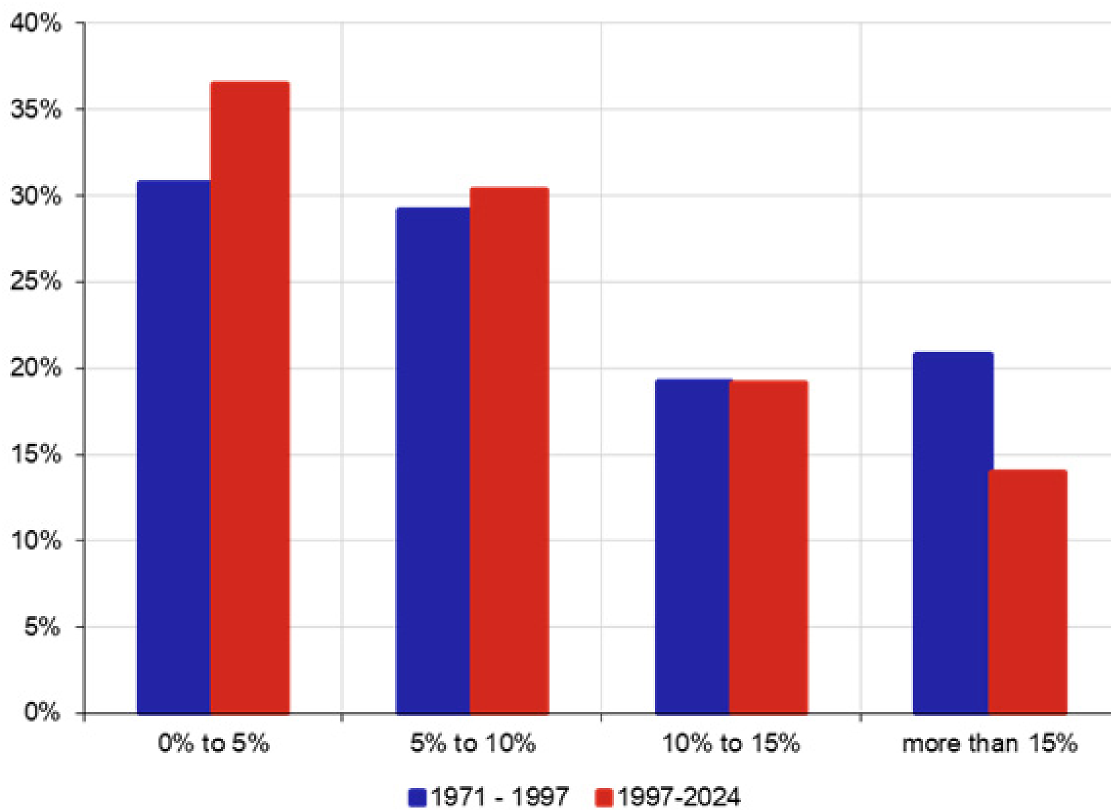
Source: FRED

Chart 10 – Selected nominal exchange rate (y-o-y in %)



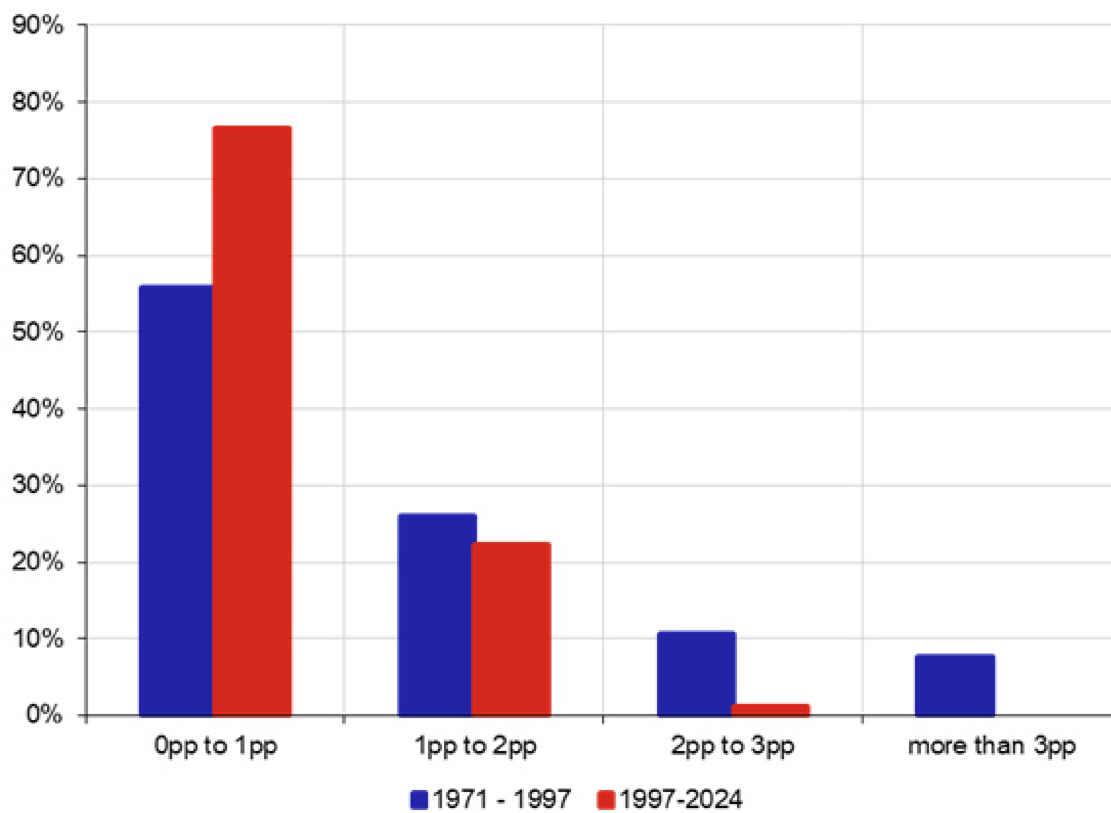
Source: Refinitiv Datastream

Chart 11a – Histogram – USD/EUR (%, y-o-y)



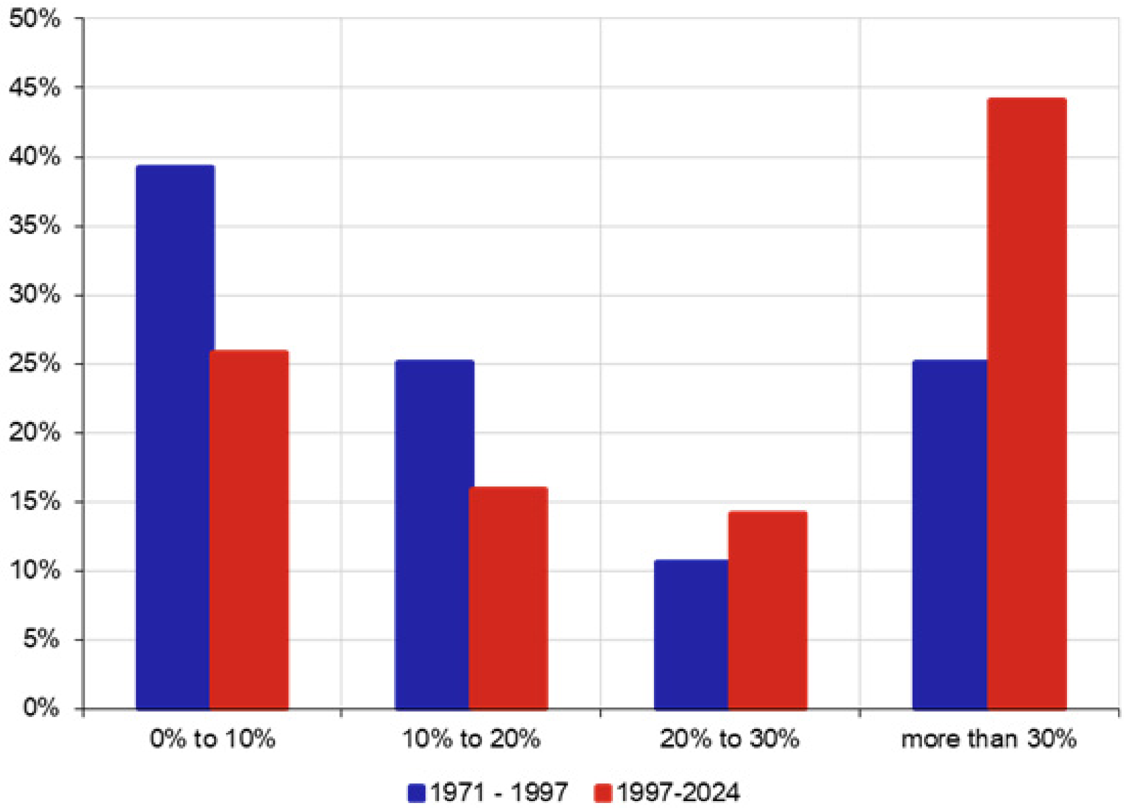
Source: Refinitiv Datastream

Chart 11b – Histogram – U.S. long-term interest rates (y-o-y in pp)



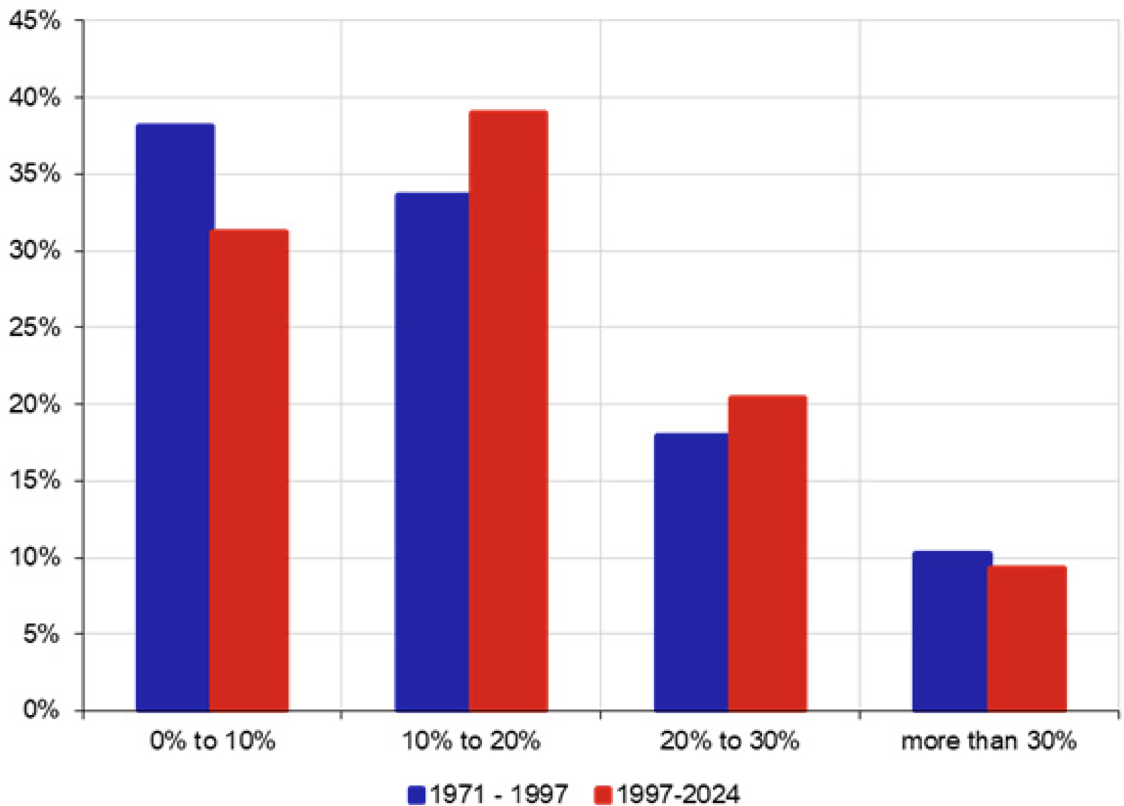
Source: Fred

Chart 12a – Histogram – Oil prices (%, y-o-y)



Source: Refinitiv Datastream

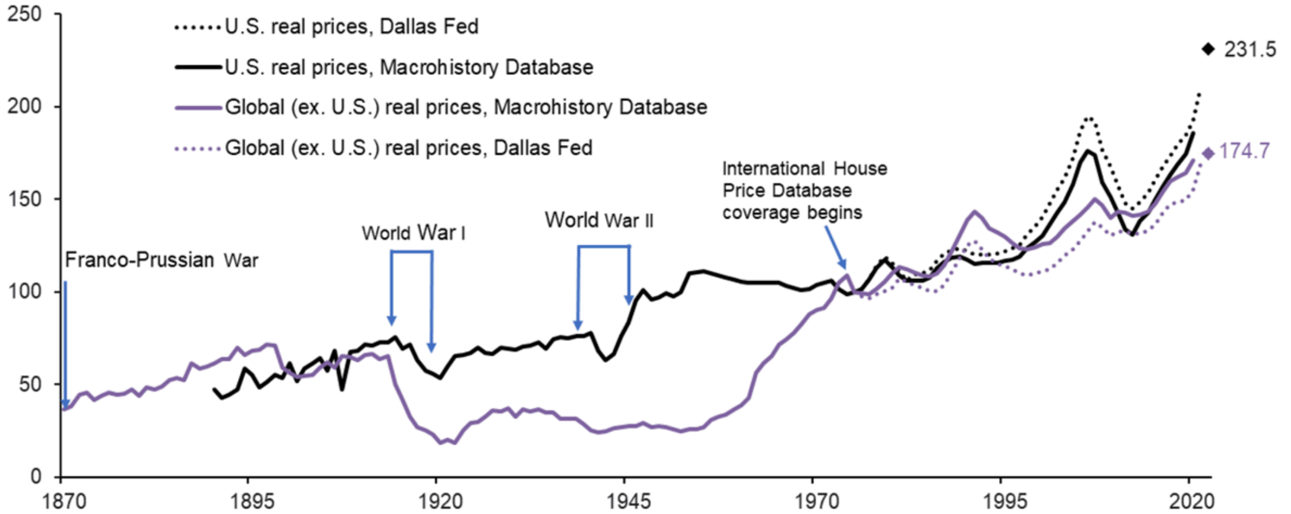
Chart 12b – Histogram – S&P Index (%, y-o-y)



Source: Refinitiv Datastream

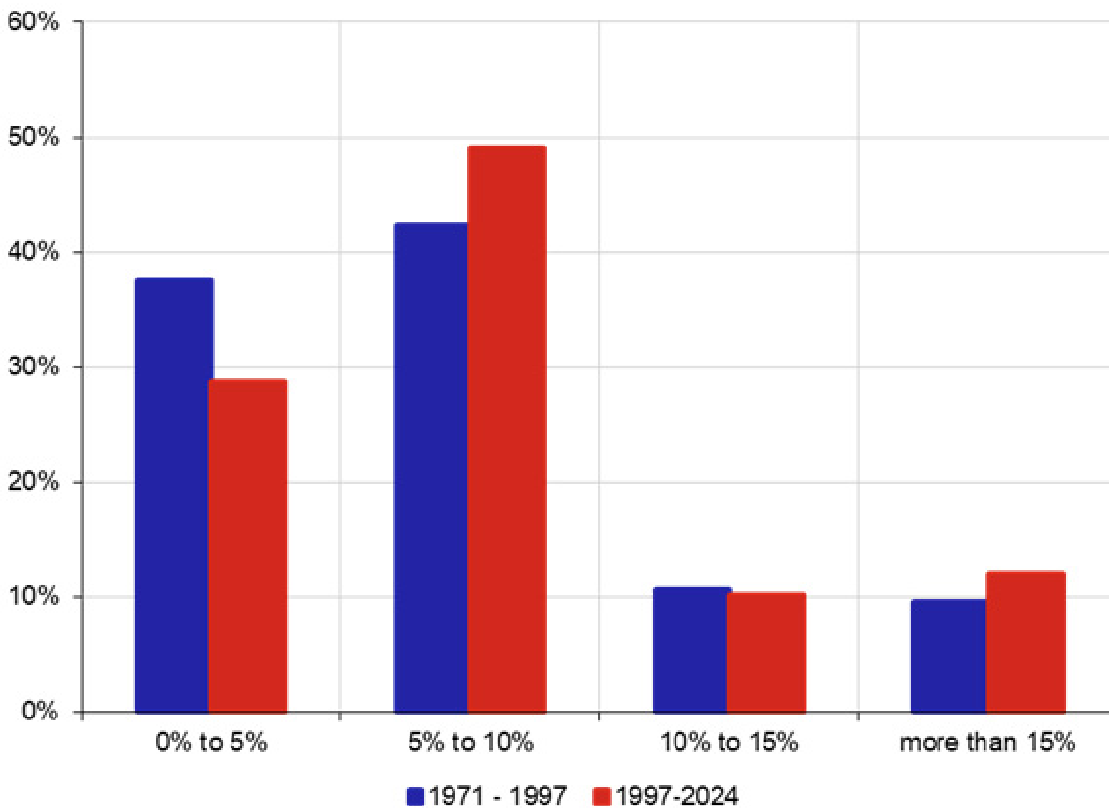
Chart 13 – House prices took off after World War II; cyclicality more pronounced since the 1970s

(Index, 1975 = 100)



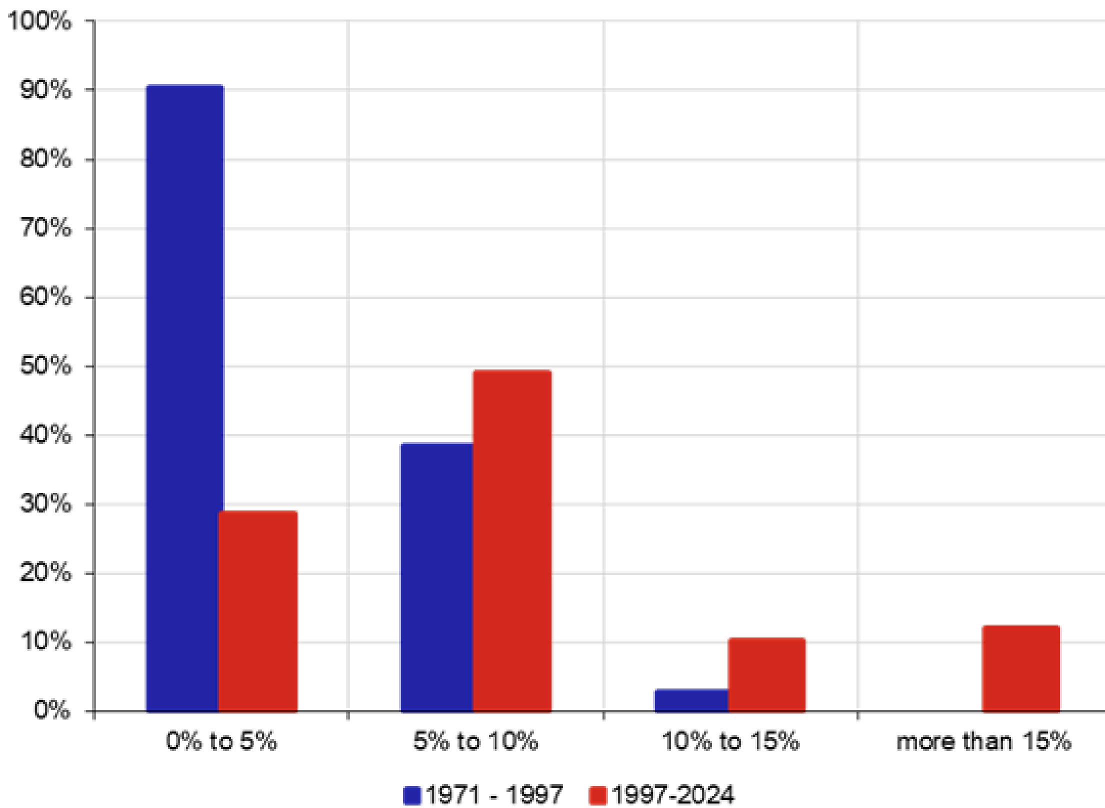
Source: Dallas Fed: Threat of global housing slide looms amid rising rates

Chart 14a – Histogram – US housing prices (y-o-y in %)



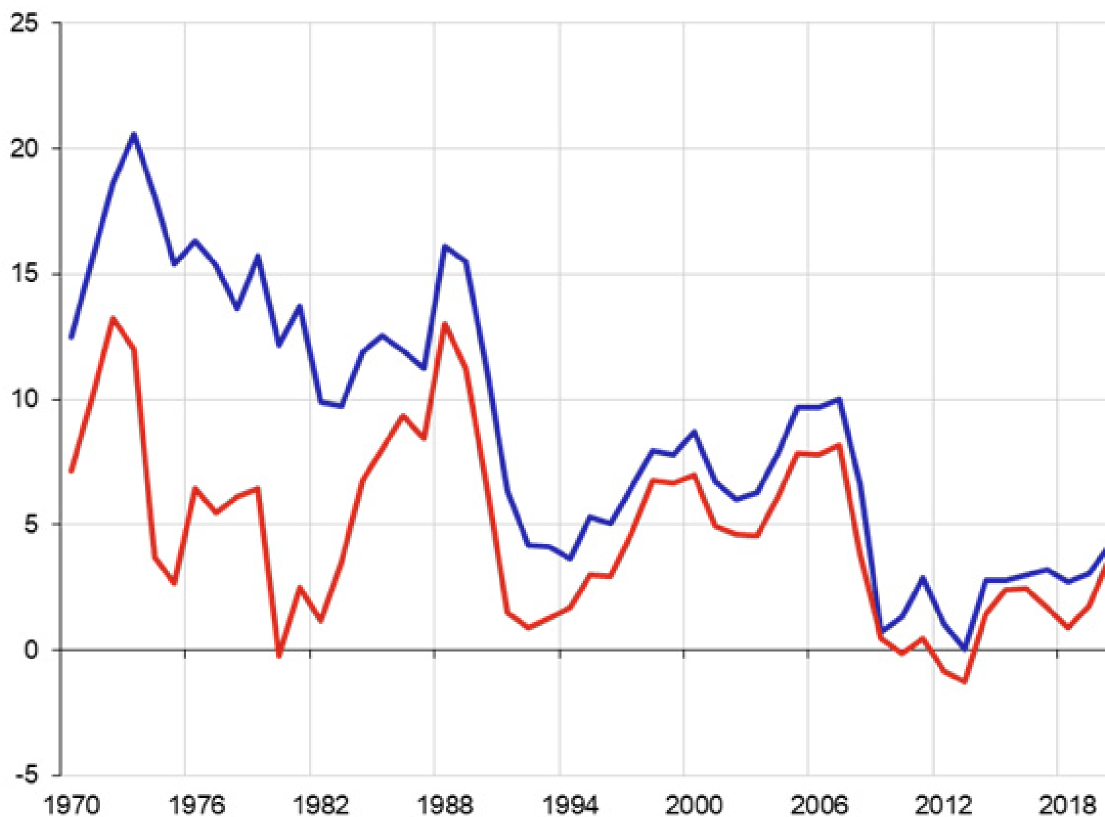
Source: BIS

Chart 14b – Histogram – German housing prices (y-o-y in %)



Source: BIS

Chart 15a – Growth of credit to private non-financial sector (%, y-o-y, in selected advanced economies)



Source: Jorda-Schularick-Taylor Macrohistory Database

Chart 15b – Leverage ratio in banking sector of selected advanced economies (capital to risk-nonweighted assets, %)

Source: Jorda-Schularick-Taylor Macrohistory Database

Jan Frait is the Deputy Governor of the Czech National Bank and Viktor Zeisel serves an advisor to the Bank Board of the Czech National Bank. At the ICFE 2024 conference, Jan Frait personally presented this lecture.