

Watching financial stability risks

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*Views expressed here are my own and don't represent, in any way, those of D.E. Shaw & Co

Outline

- What financial stability risks should monetary policy worry about?
- Will Fed keep rates low as suggested by the dots if the economy evolves as expected?
- Is there too much euphoria in the euro area periphery?
- Is there a risk of an EM crisis as QE ends?

How should monetary policy think about financial stability?

- Growth/Uncertainty approach – (stabilize inflation, maximize growth), (stabilize uncertainty/risk taking).
- Stabilize residual macro risks – what macroprudential and regulation can't handle
- In normal times, don't make big mistakes, don't create one way bets, don't overpromise
- At ZLB, monetary policy operates via providing certainty and fostering risk taking. How much is too much?

Is current Fed guidance too strong?

- Current certainty/risk taking doesn't look excessive – VXV above 2004-07 levels [Figure 1](#)
- But Fed's forward guidance very strong. Describes interest rate path via language – “late, slow, and low” - and dots chart. Belt and suspenders.
- Market believes it - priced below the dots.
- “Slower and lower” than “measured” pace. [Figure 2](#)
- What if policy time inconsistent?

Are periphery spreads too narrow?

- Periphery spreads/rates back to 2010/PSI worries levels [Figure 3](#). Correction of a mistake.
- Portugal yields (BB) < Brazil yields (BBB-)
- If EMU economic framework sustainable, rating is wrong - periphery real rates still too high [Figure 4](#)
- Greece ready to tap markets. 10yr rates \approx 6 percent. OSI credible
- Worry more about low inflation. What if negative shock? [Figure 5](#)

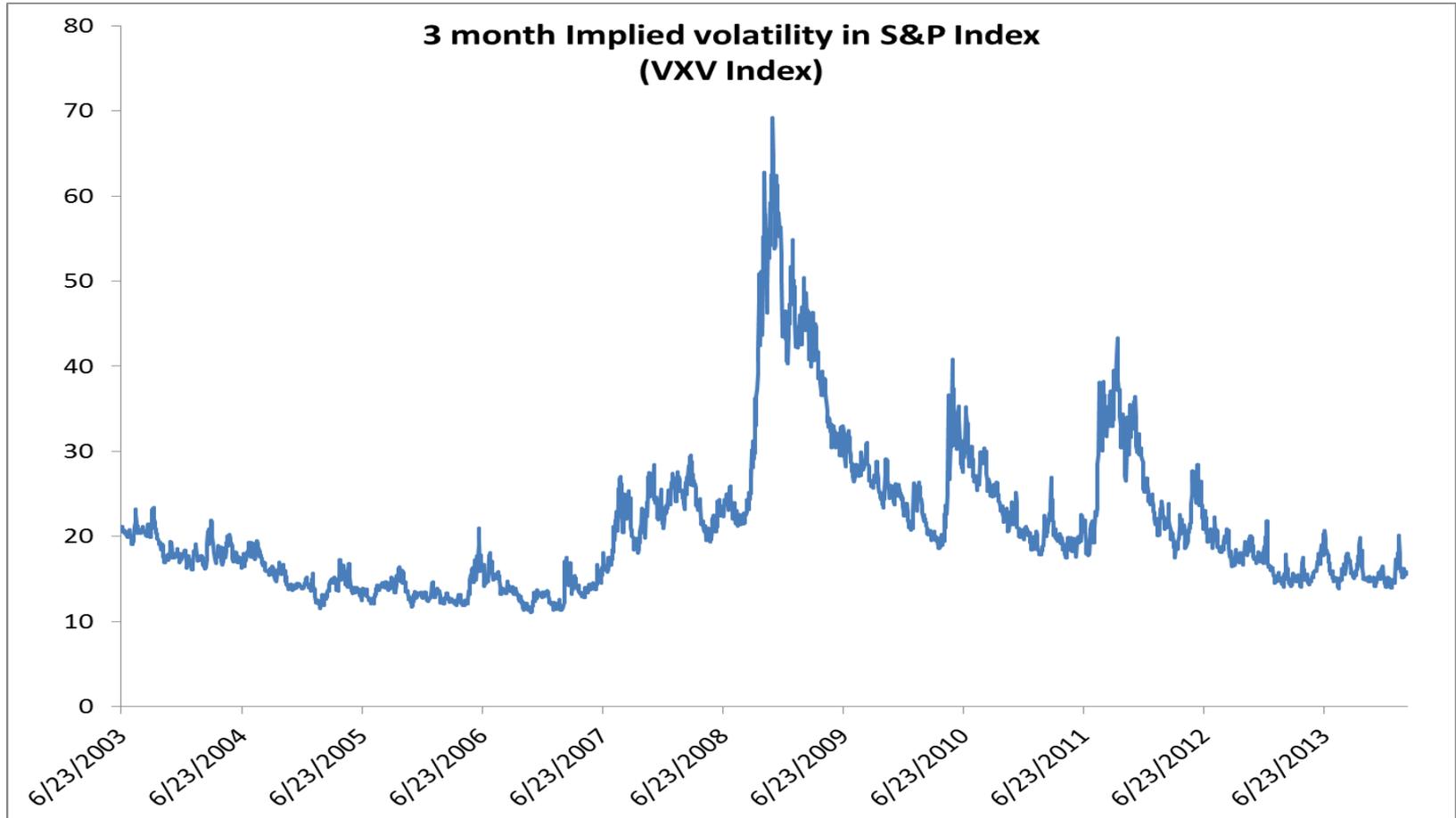
Is there a risk of an EM crisis with end of QE?

- Tapering priced in. (Some) rate hiking cycle priced in.
- Problem was weak fundamentals in EM, not Fed strategy
- EM policy mix slowly improving – Carry trade returning [Figure 6](#)
- Watch rapid expansion of EM corporate bond issuance – were low rates/stable fx assumed?
- It's a (potential) growth problem, not a financial stability problem

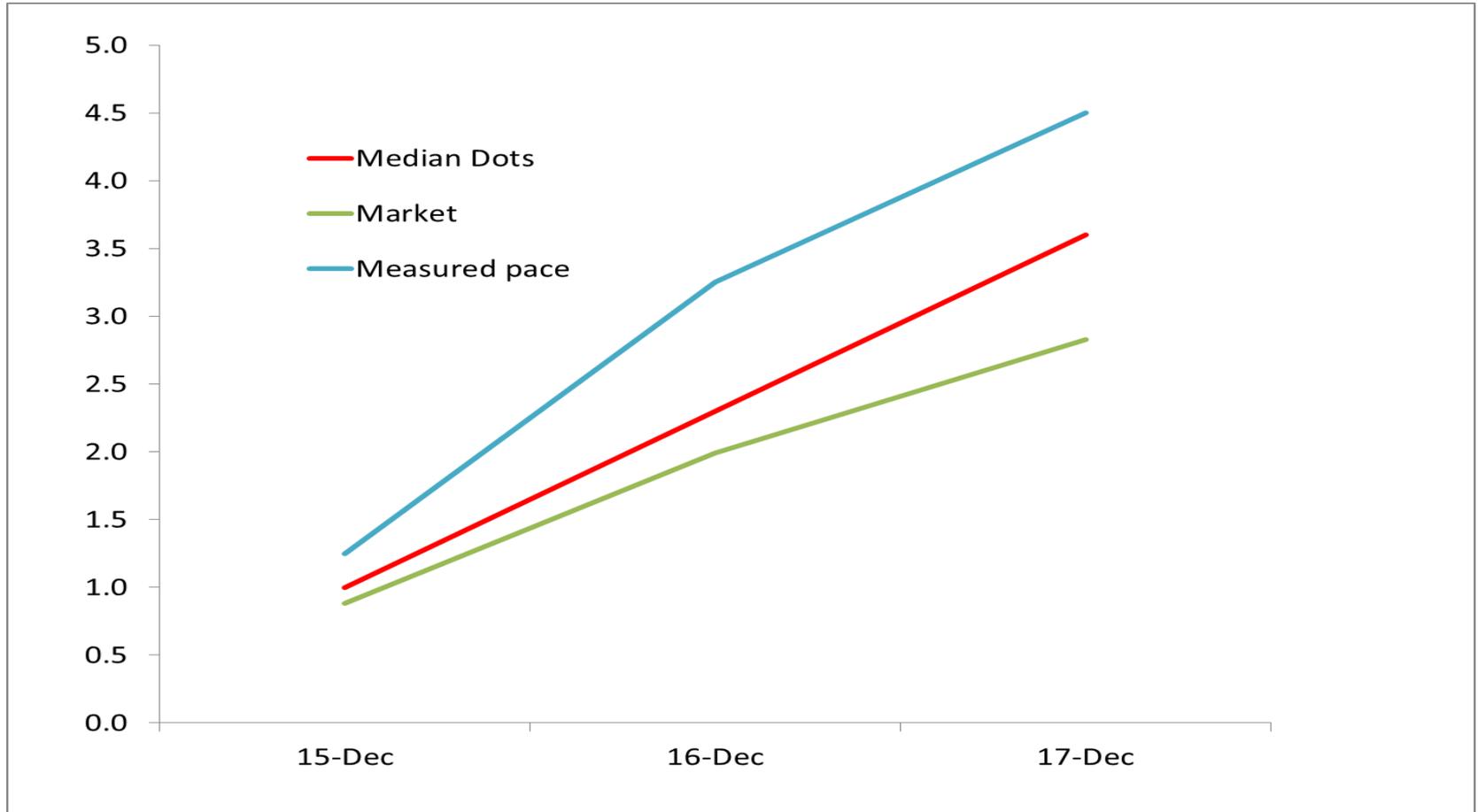
Summing up

- Monetary policy at ZLB must generate risk taking to stabilize risk aversion.
- As normalcy approached, worry promised rate guidance may be difficult to deliver
- Euro area periphery rates still too high
- Watch euro area low inflation
- EM growth problem, not financial stability problem

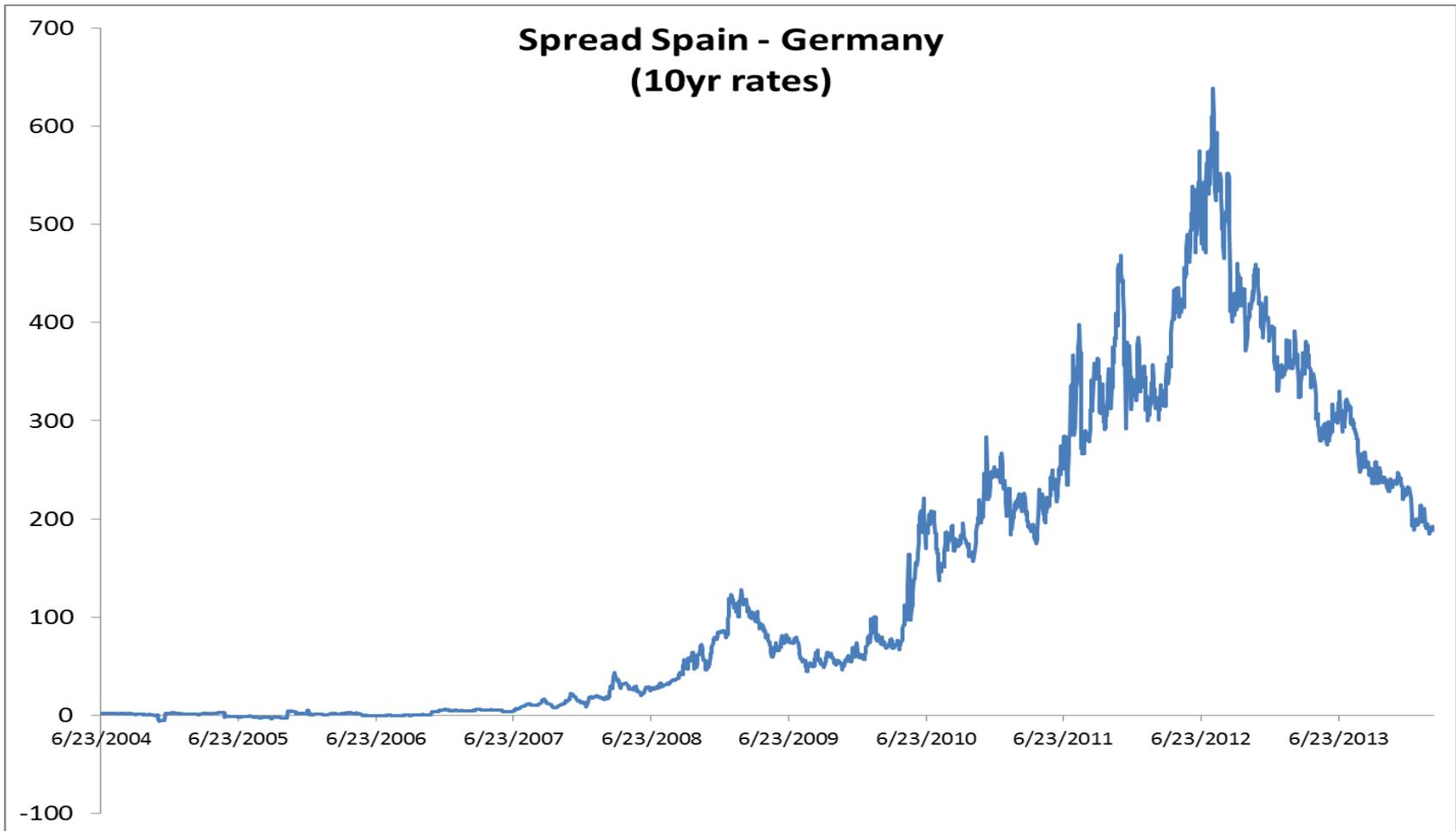
A measure of uncertainty



The Fed vs the market

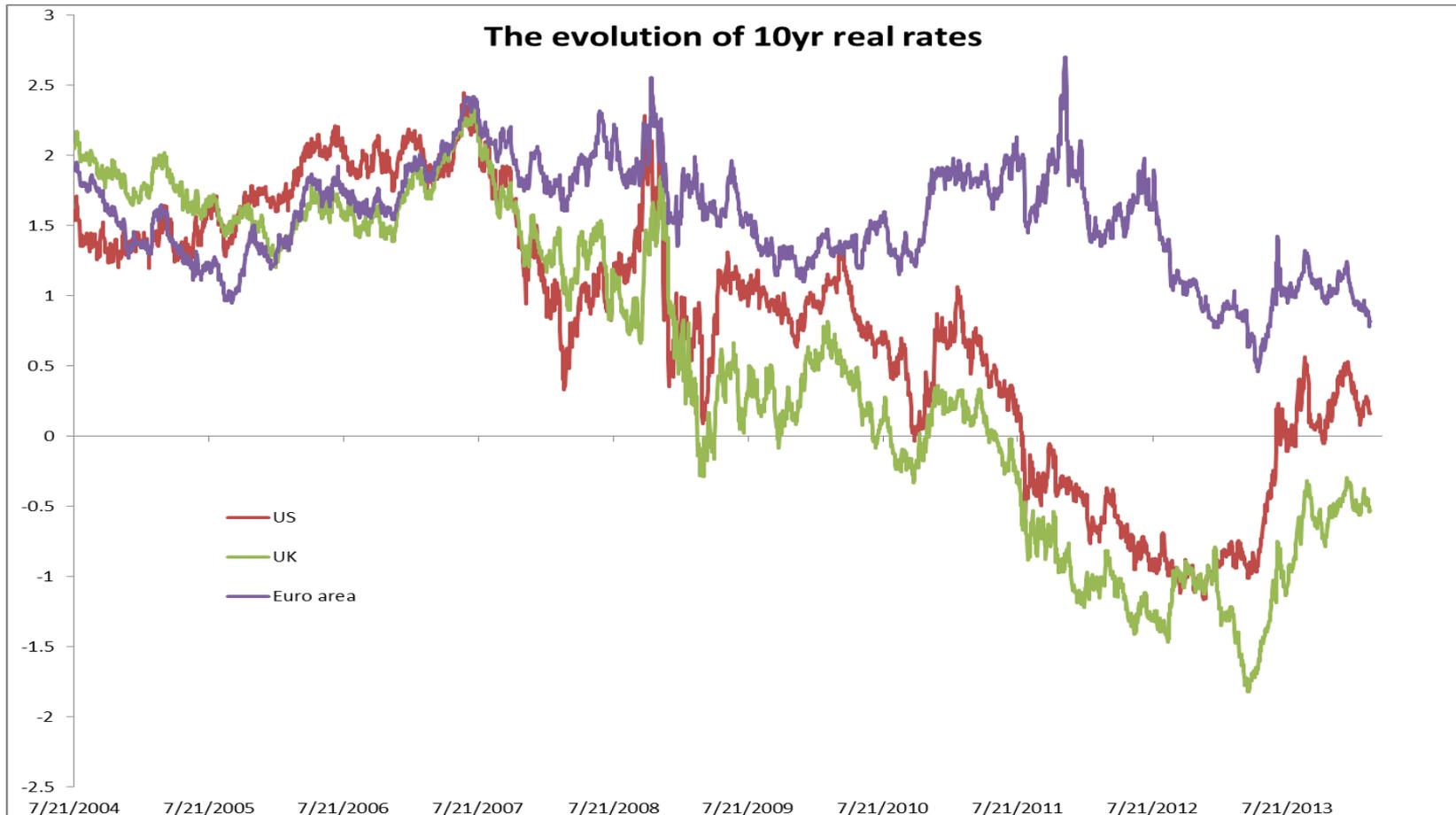


“Whatever it takes”

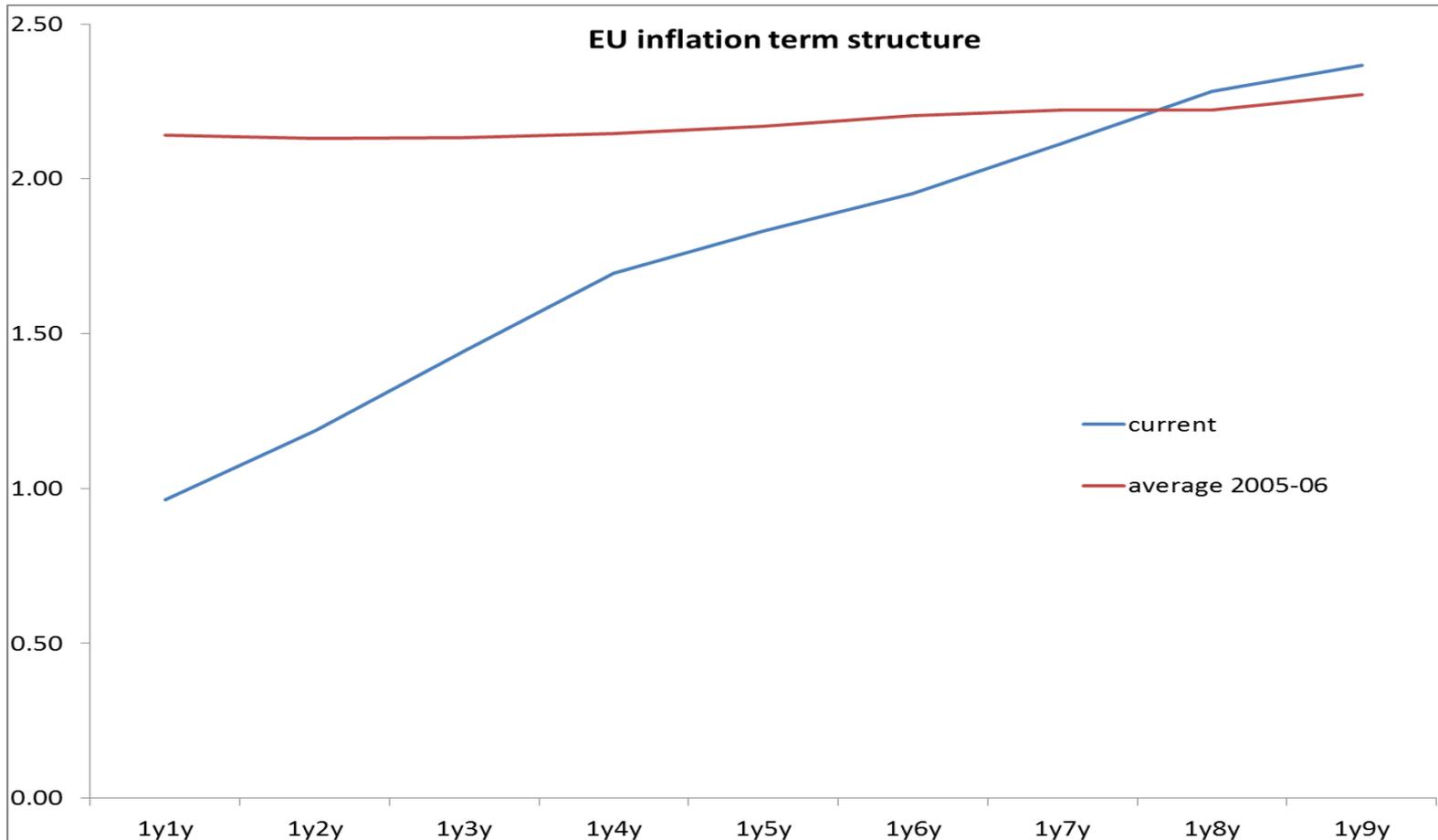


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Real rates in the euro area are too high

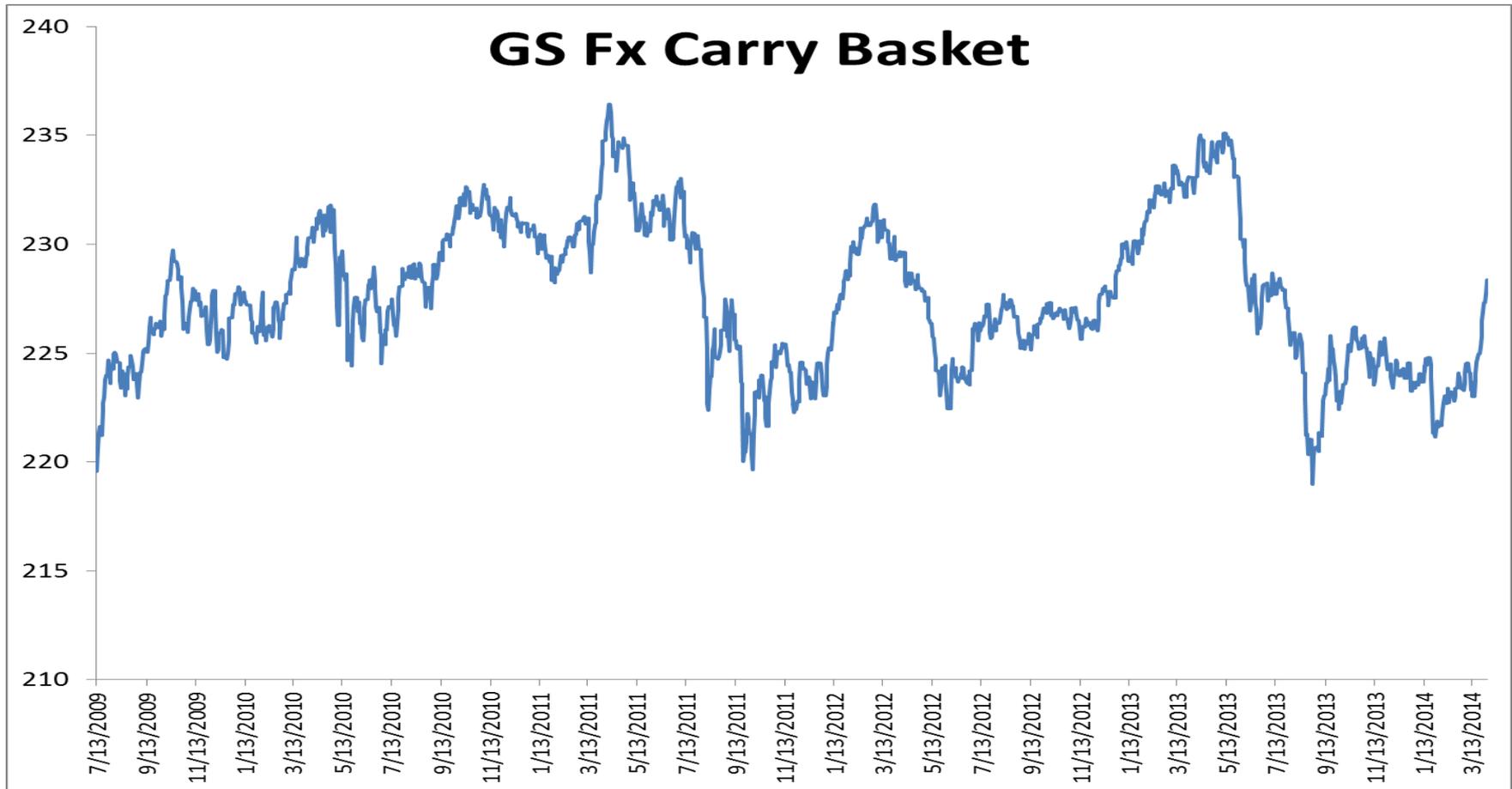


Is this price stability?



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Are the EM wobbles over?



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