The only game in town

In their quest to cement their victory over the scourge of inflation, which had eroded living standards around the world, especially in the 1970s and early 1980s, central banks realized they needed help.

They needed a more robust degree of operational autonomy from a political system that was prone to opt for pro-inflationary actions as a means of buying short-term political support. They also needed to manage forward-looking inflationary expectations in a way that influenced wage negotiation and thus preempted excessive wage settlements that could fuel future inflation.

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Banks' activities involved risk taking that they only partially understood but that seemingly appeared too lucrative to pass up. More generally, their operational focus became increasingly divorced from basic economic functions.

The result was a generation that mistakenly fell in love with the notion that credit rather than income could underpin a growing standard of living and national prosperity. Debt became an entitlement rather than a bridge to be used cautiously. One financial bubble after the other emerged and remained unaddressed. Central banks essentially sat on the sidelines, comforted by the notion that banks and institutional investors were mature and responsible enough to mitigate risks in a timely manner. They believed in the self-regulation of these influential market participants, and they were confident that markets had the ability to self-correct in a timely and orderly fashion.

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In effect, good old-fashioned human blind spots, inadequate mindsets, cognitive narrowness, hubris, and institutional rigidities were in play. Their potentially disastrous impact was amplified by excessive risk taking associated with misaligned financial incentives, classic principal-agent problems, and excessive short-termism.

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Too many advanced economies lack proper growth engines—though it’s not surprising, since they had gotten deeply hooked on an unsustainable approach that substituted financial engineering and credit entitlement for proper drivers of growth.

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In the context of sluggish growth in the advanced world and only partial policy responses, their (brazil & india) economies have been on the receiving end of volatile and disruptive capital flows whose major drivers have had a lot more to do with developments abroad than what is going on in these two economies. It’s the issue of the “tourist dollar,” and it is an important and persistent one.

During periods of large capital flows induced by a combination of sluggish advanced economies, robust risk appetites, and highly stimulative central bank policies, emerging markets serve as destination for a huge pool of crossover funds, or what I refer to as tourist dollars. Because these crossover funds have such large total assets under management, the flows they devote to emerging markets—while small for them—tend to be a multiple of those invested by more knowledgeable dedicated funds (what I refer to as the "locals"). And their drivers have a different and more volatile mix.

Rather than "pulled" by a relatively deep understanding of country fundamentals, this type of capital is typically "pushed" there by the prospects of low returns in their more traditional habitats in the advanced world.

Instead of being associated with specialized vehicles, they tend to come from more general accounts typically managed against benchmarks dominated by advanced-country securities. Searching for higher yields and/or greater possible price appreciation, their investment managers are "crossing over" into smaller (and typically off-benchmark) market segments.

Once they are invested, it doesn't take long to observe that crossover flows lack the conviction and staying power of the dedicated funds. As such, they often act as tourists rather than locals.

At the first sign of instability, they essentially tend to rush to the airport, looking to get out quickly; this can even occur when the initial source of instability has little to do with the emerging markets themselves (as was the case, for example, during the May–June 2013 "taper tantrum," when financial markets in advanced countries were disrupted by a statement from Fed Chairman Bernanke indicating that the central bank could start reducing the support it was providing via QE programs).

Crossover tourist investors are usually inclined to stay in emerging market investments for only a limited amount of time. They have a decisive home bias, and they tend to overreact to unanticipated news.

The resulting fluctuations in capital inflows and outflows have tended to overwhelm financial markets in the emerging world. Remember, the flows are not driven primarily by individual country fundamentals. Rather, they are more the product of credit factories in the advanced world and central bank policies there. And they are large relative to the absorptive capacity of the local financial system.

To my knowledge, no emerging economy has as yet found a robust policy approach for dealing with this challenge—but it is not for lack of trying. As such, their growth performance has been subject to sizable headwinds.

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Inequality also creates adverse economic feedback loops that make it much harder for the advanced countries to emerge from their generalized economic malaise.

beyond a certain threshold, inequality begins to undermine economic dynamism and therefore also investment, employment, and prosperity.

Affluent households tend to spend less of their incremental income (what economists call the “marginal propensity to consume”). As such, with the bulk of the gains going to this group, income growth does not translate into anything like the historical increase in demand. This aggravates the broader problem of inadequate aggregate demand, which itself hinders the structural reforms that are key to increasing productivity over time. That is to say, income and wealth inequality go from being part of a dynamic capitalistic system to undermining it.

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Whether you label it “goosing” or “stimulating” markets with the hope of enhancing economic growth, this is what central banks have been doing for a number of years. It reflects the few instruments they have at their disposal and the fact that they have essentially been acting on their own. And it is a path that is difficult to alter without the risk of ending up being the cause of disruptions and dislocations.

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The cautious approach taken by corporations flush with cash stood in stark contrast to the ever-expanding risk taking in capital markets:
1. Liquidity risk
2. Timeframe of policy transmission mechanism
3. Time assessments and related incentive structures
4. Risk of potential regulatory changes.

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Looking at the Eurozone situation, one cannot but regret the extent to which advanced countries resisted internalizing lessons from the history of emerging market crises. They remained too focused on cyclical solutions when the answer also involved structural and secular components. They focused on flows when stocks also mattered. They avoided talking about debt reduction despite the fact that their emergency liquidity support to highly indebted countries was associated with growth rates that consistently undershot their own expectations and projections. And they underestimated the societal and political implications of a prolonged period of economic underperformance and financial insecurity.

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Ali vs Foreman story speaks to more than simply recognizing a bimodal distribution, responding accordingly, and, in the process, overcoming narrow mindsets, outmoded framing, and blind spots. It is also about actively working to alter the distribution of the two modes in favor of the better one. It also points to the importance of using structure, incorporating new insights, and altering game plans that worked well in the past but need revamping in the face of an unusually uncertain outcome. And it highlights the close interconnections of optionality, resilience, and agility.

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