

Speech
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Making predictions about the global economy is never easy, but now is a particularly challenging time to do so.

At one level, the picture is both clear and benign: in the short run we can expect to see continued and broad-based improvement in the global macro outlook. We are seeing growth gaining momentum in all the major advanced economies (in the case of the US, growth is re-gaining it after a very poor first quarter). Inflation is no longer falling. Unemployment is now finally near pre-crisis lows in the US, UK, Japan and Germany, and, crucially, real wages are even beginning to show signs of growth.

This is all good news that I would not have been able to give as recently as a couple of months ago. Indeed, until very recently, every time I have given a talk on the global outlook since the World Economic Forum in Davos meeting in January I had to revise down the inflation figures in the US, the UK as well as in Europe.

And while many emerging market economies are experiencing growth slowdowns, the Asian ones are still slated to outperform all the other regions. Of course, here, much will depend on China's performance; but so far despite financial market scares, GDP growth well above 6 percent seems within reach.

At the same time, we are facing exceptional uncertainty as to the timing, the speed, and the sustainability of this nascent return to economic health. To put it in slightly more technical terms, it is not clear whether what we are seeing is a mere cyclical rebound or a durable return to a structurally higher growth path. Let me emphasize the term uncertainty. It is not the case that we have a clear baseline with risks on both sides—though there are those too, as I will come to in a moment. But instead of risks with a given probability distribution, what we have is that we just don't know quite how the economy – and indeed the global financial markets - are going to behave in response to the various impulses they face.

The reason for this deeper uncertainty is that developments are strongly influenced by four unique and unprecedented forces:

- i. Despite the fact that it has been seven years since its violent outbreak, important parts of the global economy continue the healing process from the GFC with protracted headwinds from deleveraging; debt levels both in the public and

private sector have reached historic highs. Bringing them down will weigh on growth, and if they do not decline, the recovery will be built on very shaky grounds;

ii. Prolonged and enormous central bank presence in asset markets continues to distort asset prices. This, of course, is by design but what, precisely, will happen when this presence unwinds is anybody's guess. It is informative to keep in mind what happened just over 2 years ago when then Fed Chair Ben Bernanke alluded to the possibility of tapering the Fed's asset purchases soon (it turns out very prematurely!), or more recently when the SNB decided to abandon its exchange rate floor. In both cases, financial markets reacted very dramatically - albeit the overshooting was short-lived. These are certainly lessons to bear in mind for the Chinese authorities when they start thinking of unwinding the exceptional measures they have taken in response to recent stock market volatility.

iii. We continue to be in the midst of a transition to a new regulatory regime for banks with significant implications for the composition of their balance sheets and their business models; in particular, the world's largest banking groups have considerably reduced their market-making and repo activities.

iv. We are witnessing new technologies everywhere with vastly disruptive and hard-to-quantify consequences; is this technological revolution displacing workers and does it contribute to stagnant wages and higher inequality, or will it ultimately raise productivity and allowing more wealth creation from the same inputs? For example, consider Uber: in 2014 it made \$500 m of revenues where pre-Uber the market size for hired car services was \$120m; this is great for uber drivers, but also a tougher living for cab drivers. Probably both processes are at play. Which one will dominate?

Reflecting on all this uncertainty, we can think of there being two compelling narratives when considering the current outlook: Let's refer to them as "Renaissance 2.0", versus "Secular stagnation":

➤ First the optimistic one: "Renaissance 2.0" or a new machine age is really a benign but disinflationary-- technology revolution (e.g., the latest iPhone costs about half the price of the components bought separately at their 1991 price); combined with typically slow post-financial crisis recovery with more way to go; or

➤ The more pessimistic one has been coined by former US Treasury Secretary Larry Summers as a secular stagnation, or at least a lasting saving glut as described by former Fed Chairman Ben Bernanke. It is caused by insufficient investment and consumption globally. While there was a vigorous blog exchange between these two great minds, their diagnostics ultimately are not that different except in one important dimension: whether the ailment is self-correcting or not.

- In Bernanke's view, it is, provided countries with a large current account surplus do not artificially suppress demand, and all that is needed for a return to trend growth and hence policy normalization is the fading away of traditional post-crisis headwinds.

- In Summers' view, the factors pushing investment and consumption down are durable ones and trying to overcome them with monetary policy boils down

to relying on financial bubbles to prod growth; strong policy action to raise both demand and potential growth are therefore needed.

The difficulty we have is that data does not help us all that much to determine what scenario we are in:

➤ Let's take the example of depressed corporate capital expenditure. Is it depressed because firms cannot identify profitable opportunities, or simply because of past earnings weakness, typical of post-crisis phases? A recent IMF study ascribes over 2/3 of the recent weakness in investment to the weakness in output growth itself. This seems to validate the temporary headwind story, but also leaves room for less benign explanations, or at least explanations implying that investment might be permanently lower in future: for example, thanks to Airbnb, the house-sharing app, over 20,000 visitors to the upcoming Brazil Olympics are expected to sleep in private people's homes. That's equivalent to 60 hotels not needing to be built. And new technologies are allowing producers to do more with the same physical equipment. This too could permanently lower investment.

➤ Or consider long-term interest rates: Are they at historical lows across the world because investors expect protracted low growth and low investment returns? Or because they perceive the current wave of technological innovation as having a strong disinflationary impact, allowing healthy growth without inflation?

➤ When we look at equities returns around the world, one would give more credence to the second interpretation. But of course these returns may also just reflect the impact of the massive liquidity injections performed by global central banks rather than a belief in strong future earnings. In a way, the high stock market valuations we have seen since the start of QE - wherever it has been implemented - can be seen as borrowing from the future. That means that unless earnings continue to grow at the same high pace (and this seems unlikely given the low capex expenditure we have seen in recent years), there is likely to be a payback in returns at some point, or at least a period of flat returns even as real growth reaches a healthy steady state.

➤ Finally, consider commodity prices - often seen as a bell-weather of global growth. Are they much lower because of dim long run growth prospects? Or because innovation has made it possible to produce much more cheaply and brought new producers on stream, leading supply to exceed demand?

A key question underlying our Renaissance 2.0 vs. secular stagnation question is what is happening to productivity? Measured productivity—GDP per worker— and productivity growth have been much lower since the crisis than in the earlier part of the 2000s. This is not unusual following recessions. But one can certainly not take for granted that it will rebound to pre-crisis level, after many years of under-investment and high long-term unemployment leading to skills erosion. It might, if capital expenditure does rebound. But so far it hasn't, far from it.

Some argue that productivity has simply been underestimated recently because a growing share of GDP comes in qualitative and intangible forms that are not easily measured - e.g., software improvements, or the amount of web contents one can get access to today with the same internet subscription as two years ago. Indeed much of the most recent IT services are in fact completely free, and therefore not counted at all in measured consumption. Maybe this is part of the story. But just as likely a significant share of output growth in the pre-crisis years was driven by leverage and debt accumulation. As efforts are now made across all sectors of the economy to reduce debt, output growth could be reduced by as much as 30 percent, based on historical experience.

As you can see, there is uncertainty wherever we look and data alone doesn't provide us with any clear answer, at least not for the time being.

On balance, my own view is closer to the optimistic "Renaissance 2.0" or "second machine age" scenario than to the secular stagnation one - provided that policy makers do not become complacent and instead take advantage of the cyclical recovery to intensify structural reforms along the lines of the commitments they have made, for example in the G20 context.

But even if that is the case there are significant risks of accidents that could derail this story, and their impact would likely be compounded by the jitteriness observed in bond and FX markets for the past year. The most important risks I would point to are:

- a pace or timing mistake in the Fed interest rate normalization;
- a hard landing in China, and in the longer run a failure to rebalance as planned from an investment and export driven economy to a domestic consumption-driven one;
- renewed "Grexit" concerns down the road, given the political and economic fragility of the deal just agreed; and more generally concerns about the viability of the Eurozone in its current form;

I expect that, given most policy makers' preference for the short-term, really bad accidents will be avoided, or they will be promptly treated with whatever short term policy tools are still on hand; but that may well come at the cost of creating prolonging and distorted situations that are in fact unhealthy and unsustainable, with a higher cost to be paid down the road. For example: the Federal Reserve might be tempted to begin normalizing monetary policy too late rather than too soon, even if that means that asset valuations get more stretched and more divorced from realistic future earnings prospects. In that regard, I am very much encouraged by recent statements by Fed Chair Yellen that suggest she would prefer tightening earlier and with a slow path to waiting longer and then having to tighten steeply.

At any rate, even if policy mistakes and accidents are avoided, we are likely to see for some time quite a bit more volatility, than we have been accustomed to in the

past. This, of course, is not an entirely bad thing. After all, we now know - or rather have had to learn the hard way with this crisis - that prolonged low volatility fuels unhealthy amounts of risk-taking (as first posited by Hyman Minsky in the 1960s without any traction). In sum, if all goes well, we will have higher growth and lower systemic risk.

That sounds like something to look forward to. But for investors this context will require flexible positioning and solid understanding of the risks one's portfolio is exposed to.

Is this a bad time to embark on a portfolio diversification strategy away from low yielding assets such as government bonds? This is a question we get asked a lot by our central bank clients as well as institutional investors. And indeed there are strong reasons to consider diversification notably into equities. Here, to conclude, let me offer a few lessons from what we experienced at the Swiss National Bank, where we embarked on a wide-ranging reserve diversification programme more than a decade ago.

First, and this is a matter of fundamental principle, the investment policy needs to remain at all times subordinated to monetary policy. This may entail some limitations that must be recognized upfront, for example in terms of FX risk hedging in the case of Switzerland, we simply could not do such hedging within the confines of the minimum exchange rate against the euro once it became the centrepiece of our monetary policy.

Second, once a return objective is assigned to the investment policy alongside liquidity and security, it becomes imperative to adopt more sophisticated investment processes that allow to one to think of returns on a risk-adjusted basis. I should stress that having a return objective does not mean that return should trump the other objectives. Indeed one could think of return, at the most basic level, as an indispensable component of security: particularly in the context of a country whose currency will tend to appreciate over time (as emerging market currencies do), having returns sufficiently high to make up for this trend appreciation is essential to preserving the value of reserve holdings. In this era of low yields on government bonds, earning a high enough return will be helped considerably by adding equities into one's portfolio.

Third, in general, equities as an asset class offer attractive diversification features. In the case of Switzerland, given the safe haven properties of the Swiss Franc, the diversification benefits of equities are mitigated by the fact that at times of "risk off", equity prices would fall both in their original currency of denomination and in CHF terms (and of course the converse is true for "risk on" episodes). But for most countries, and in particular for emerging market economies, this would not be a problem: Here the diversification offered by foreign equities is among the strongest available.

Fourth, one must ask what is the optimal share of equities in a portfolio. Here the answer will depend on a central bank's risk/return preference. At the SNB, this trade-off is optimized with a 16 percent share of equities in reserves - but this share could conceivably be even higher for a central bank without an explicit or implicit exchange rate objective and therefore able to hedge FX exposures. Of course, once an optimal share is defined, it is prudent to build up to it gradually.

Finally, at the SNB we made a clear and conscious choice that we could not afford to get involved in stock-picking, for both reputational and efficiency reasons. Accordingly the investments are passive—we selected benchmark indices covering as wide a variety of markets and countries as possible, bearing in mind our high liquidity requirements. We only excluded bank stocks - to avoid perceptions of conflict of interest; and stocks of companies found by third parties to be blatantly violating ethical standards. This final dimension of defining appropriate standards for the sustainability of investments will, I suspect, become an increasingly important and challenging dimension around reserve management in years to come.

Ultimately there will be years of negative returns even in a diversified central bank reserve portfolio, and this is something the political masters should understand before embarking on such a diversification process. But the experience of the Swiss National Bank suggests that so long as there are rigorous and transparent investment processes in place, it is a step well worth taking. And, to conclude back with a reference to the global economy, today's global market environment provide as good a backdrop as any for this evolution.

Thank you for the wonderful opportunity to share these thoughts with you today in this glorious setting.

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