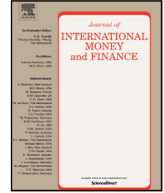




Contents lists available at [ScienceDirect](#)

Journal of International Money and Finance

journal homepage: www.elsevier.com/locate/jimf



The new normal: An introduction to the special issue



1. Introduction

The financial crisis has left deep scars in many economies. An important issue is whether these scars are so deep that economies will be heading into a ‘new normal’ after the crisis. The post-crisis new normal was the theme of a conference held in Hong Kong on 21 and 22 May 2015, organized by the City University of Hong Kong, De Nederlandsche Bank, and the *Journal of International Money and Finance*.¹ The conference papers focused on the question of whether after the Global Financial Crisis (GFC), economies have fundamentally changed relative to the years preceding the crisis. This special issue contains selected papers of the conference. In this introduction, we briefly summarize these papers and put them in perspective.

2. Lower growth?

An important question is whether economies will return to pre-crisis growth levels. This issue has received attention in previous studies. For instance, in their seminal paper, [Cerra and Saxena \(2008\)](#) conclude that output does not rebound quickly from recessions caused by financial crises; in fact, their evidence suggests that the weakest recoveries occur after banking crises. Does this also hold for the GFC? In other words, is there evidence that growth rates will be lower after the crisis than before? Bertrand Candelon, Alina Carare and Keith Miao estimate the impact of crises on output growth, augmenting [Cerra and Saxena's \(2008\)](#) analysis by extending the data until 2010, and by taking globalization and contagion effects into account. The authors find that the declines in output growth rates following currency, banking and stock market crises are much larger in the sample ending in 2010, than in the one ending in 2001. These results are robust across different specifications and crisis databases. The authors therefore conclude that lower output growth will be the new normal, especially in more advanced economies, and that this will be the case for a longer period than in a usual cyclical recovery.

¹ See <http://www.cb.cityu.edu.hk/ef/events/past/JIMF2015/>. We thank the Hung Hing Ying and Leung Hau Ling Charitable Foundation (孔慶熒及梁巧玲慈善基金) for their support through the Hung Hing Ying Chair Professorship of International Economics (孔慶熒講座教授(國際經濟)).

3. Financial markets: risk, exchange rate, and capital flows

Another important question is whether financial markets have changed their behavior since the GFC. Several issues are at stake here. For instance, is the role of risk and market uncertainty in determining financial market prices different before and after the GFC? What is the role of capital flows in determining exchange rates and can capital controls mitigate exchange rate pressure? China is a country that uses capital controls extensively to restrict and manage cross-border capital movements. Although these capital control measures are deemed effective, they do not eliminate all capital flight.² An important question is whether capital flight out of China has increased after the GFC, and if so, what drives this capital flight?

In their contribution, Eli Remolona, Marlene Amstad and Jimmy Shek address the changing role of risk. They examine two issues: First, how do investors decide to go into emerging markets or get out of them and, second, has their behavior changed since the GFC? The authors tackle these questions by focusing on sovereign risk as reflected in monthly returns on credit default swaps (CDS) for 18 emerging markets and 10 developed countries. They find that tests for breaks in the time series of these returns suggest a new normal. Under the 'old normal,' a single global risk factor drives half of the variation in returns, while under the new normal that risk factor becomes even more dominant. The authors' evidence also suggests that in both the old and new normal, the way countries load on this risk factor primarily depends on whether they are designated as an emerging market.

Two papers in this special issue deal with exchange rates, albeit from very different perspectives. First, Rasmus Fatum and Yohei Yamamoto investigate safe haven currency behavior during the GFC. The US Dollar is often heralded for its global importance and safe haven properties (see, for instance, Prasad, 2014 who argues that the dollar will remain the ultimate safe-haven currency). The authors define a safe haven currency as a currency that increases its relative value against other currencies as market uncertainty increases. They first assess which safe haven currency is the "safest" and then use non-temporal threshold analysis to investigate whether intra-safe haven currency behavior changes as market uncertainty increases. Their evidence suggests that the Japanese Yen is the "safest" of the safe haven currencies; in fact, this is the only currency that appreciates as market uncertainty increases regardless of the prevailing level of uncertainty. The US Dollar comes in third, after the Swiss Franc. The results of Fatum and Yamamoto also suggest that market uncertainty can influence currency behavior in a systematic fashion and that, therefore, market uncertainty should constitute an important element in our understanding, and modeling, of exchange rates.

Second, Joshua Aizenman and Mahir Binici examine the impact of capital flows on exchange market pressure before and after the GFC. Utilizing a comprehensive database on capital controls, the authors investigate whether control measures have a significant impact on mitigating exchange market pressure (EMP) associated with gross and net capital flows. They use three different measures for EMP and find that these measures for both OECD and emerging market countries indicate a slight downward trend prior to the GFC and a heightened volatility during and after the crisis. Using quarterly data over the 2000–2014 period and a dynamic panel model estimation, the authors report that external factors played a significant role in driving exchange market pressure for both OECD countries and emerging market countries, with a larger impact on the latter. Their evidence suggests that short-term portfolio flows and long-term foreign direct investment flows have a significant impact on exchange market pressure for emerging market economies and no significant effect for OECD countries. The evidence also suggests that capital controls seem to significantly reduce exchange market pressure. This is an interesting result as not so long ago the prevailing view among economists was that capital controls were not useful. More recently, the use of capital controls as part of a country's "policy toolkit" under certain circumstances has become more popular (see Ostry et al., 2011 for a discussion).

The final paper in this special issue on financial markets deals with capital flight out of China. Yin-Wong Cheung, Sven Steinkamp and Frank Westermann document that China's capital flight, especially

² See Cheung and Herralá (2014), and Ma and McCauley (2008).

the one measured by trade misinvoicing, exhibits a weakened response in the post-2007 period to the covered interest disparity, which is a theoretical determinant of capital flight. Further analyses indicate that the post-2007 behavior is influenced by quantitative easing and other factors including exchange rate variability, capital control policy and trade frictions. Their results suggest that China's capital flight pattern and its determinants are affected by the GFC. Further, both the canonical and additional explanatory variables have different effects on different measures of capital flight. These results highlight the challenges of managing China's capital flight, which requires information on the period and the type of capital flight that the policy authorities would like to target.

4. Banking regulation and unconventional monetary policies

What definitely has changed in response to the GFC is banking regulation which has been tightened to strengthen the stability and resilience of the banking system (see [Aiyar et al., 2015](#) for an excellent discussion). An important question here is whether banks reduce their lending in response to tighter regulation. In their contribution, Marcel Fratzscher, Philipp Johann König and Claudia Lambert use a country panel for 50 advanced and emerging market economies to analyze how the post-crisis tightening in supervision and regulation affected aggregate bank stability and aggregate credit growth. Their findings suggest that higher capital buffers improved aggregate bank stability after the GFC. They also find that credit growth declined in response to tighter regulation. However, a strengthening of supervisory independence helped to reduce the decline in domestic credit and also improved the stability of banks. The evidence suggests that both effects have been stronger for countries with relatively poor institutions.

The recession following the GFC pushed short-term nominal interest rates to or near their effective lower bound (ELB) – which, as some central banks learned, was negative – thereby rendering traditional policy instruments almost useless. In response, many central banks turned to unconventional monetary policies, such as lending to banks (and sometimes even to nonbanks) and large-scale asset purchases (“quantitative easing” or QE). As Peter Tillmann points out in his contribution, these policies may have considerable spillover effects on emerging market economies (EME). Previous attempts to quantifying these effects mostly use high-frequency data around announcement dates, panels or VAR models. Tillmann proposes an alternative way to estimate the effects of QE on emerging markets that allows including macroeconomic data together with announcement dates. A so-called Qual VAR is estimated that integrates binary information of QE announcements with an otherwise standard VAR including US and emerging market variables. His results suggest that QE has significant effects on EME's financial conditions and plays a sizable role in explaining capital inflows, equity prices and exchange rates.

5. Policies under the new normal

What are the implications of the new normal for policymakers? Is it possible and desirable to go back to pre-crisis practice? This special issue opens with the keynote speech of Stephen Cecchetti who addresses the important issue of how monetary and macro-prudential policies relate to each other. Macro-prudential policies are increasingly being used ([Cerutti et al., 2015](#)). Before the GFC, it was widely believed that these policies could be separated as the objectives and instruments could be assigned to different policymakers, while the differences in time horizon reduced the need for any one authority to worry about the objectives of the other. In answering the question of whether after the GFC this is still a proper view, Cecchetti analyzes whether the monetary policy stance creates financial stability risks. He argues that in the short-term there is no apparent conflict between macroeconomic stability and financial stability. However, if interest rates remain low for several years, leverage will increase and that, in turn, will almost surely reduce the resilience of the financial system. In that case, financial stability risks become a concern for monetary policymakers. Cecchetti also argues that higher risk-weighted capital requirements are unlikely to be effective in stemming booms in credit, but they can improve the resilience of the financial system. In his view, Basle III's countercyclical capital buffer is not the proper instrument though. He favors stress tests as perhaps the most powerful prudential

tool for safeguarding the resilience of the financial system, because it is more flexible, faster, and less politically contentious than Basel III's countercyclical capital buffer.

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Available online 30 December 2015