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UNDERSTANDING THE CURRENT GLOBAL REGIME SHIFT AND THE STANDING OF THE MACRO-FINANCIAL SYSTEM RESILIENCE

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ABSTRACT

Purpose- Governments and Central Banks are critical actors in avoiding big swings like recessions, destabilizing inflations, or stagflations. On top of that, they might interact with different tools and resources to realize their own macro-financial purposes and interests. They engage in concrete macro-financial processes to reshape monetary regimes. Indeed, in the aftermath of the Global Financial Crisis (GFC) of 2008, major central banks held interest rates at zero or in a negative zone, yet global inflation remained low anyway. Though, as stated by Bernanke, this instrumental flexibility prevented a total meltdown in the world (Bernanke 2013, 87), where the experience of the post-GFC period until the post-COVID era (2021) has shown, how rigid implementation of this "meta-power" solely for the sake of "inflation or not" objective may result in "outside-the-box surprises". Therefore, we must understand within which the internal actors (central banks) of an econofinancial system and the contours of "outsiders" who influences central bank policies on the non-technocratic political fronts. Now, a moment of awakening is on the way as global inflation has surged out of this box to a 9.8% level pushing the strongest economies in the world to the limits of a deflationary spiral, if not to stagflation. Our paper will argue that great regime changes and policy reversals on the monetary and fiscal policy fronts are on the way at the post-COVID era. In this regard, "Tight Fiscal and Loose Monetary Policies" are replaced with "Loose Fiscal and Tight Monetary Policies" at the new regime. To this end, our paper aims to analyze those regime shift processes within the macro-financial neoclassical and Keynesian synthesis of "regime switching". Notwithstanding with this primary objective, the paper sheds light on the quasi "tug-of-war" (Economist October 8th, 2022) between the governmental- and central banker actors under the framework of Actor Oriented System Dynamics Theory (ASD), which is used to model socio-economic systems and phenomena. Consequently, we will try to make educated guesses about the possible effects on the financial system resilience, where the financial system will be in need of to redesign their playing rules and strategies within these new meta-power rules.
Methodology- The macro-financial analysis of regime change processes will rely on the current trend to combine historical Classical and Keynesian approaches. This synthesis depends on the assumption of stationary equilibrium in the Keynesian approach. The switch from the Keynesian regime to the Classical one would be depicted within the IS-LM models, resulting in Inflation and Stagnation. This result is in line with our predictive findings, as explained below. Didactically, this macro theoretical approach will be strengthened by relying on the Actor Systems Dynamics Theory. It should be stressed from the outset that the Keynesian or Classical framework took certain institutional power dynamics and games for granted. In this regard, part II will explore a new paradigm that is needed to provide an adequate model to understand the "fiscal dominance versus independence" phenomena, whereby governments as "recession fighters" put political pressure on their central banks to keep interest or borrowing costs low and the will of central bankers for institutional independence to exercise their other missions. Understanding the macro-financial problems today requires a transdisciplinary paradigm and the reconceptualization of "independence" (Conti-Brown, 6). The interaction of the new regime of "Stagflation" with the financial system on the "Financial System Resilience" front will be elaborated within the models related to systemic risk modelling approaches such as RAMSI-style structural models of systemic risk and DSGE models for financial stability policy, which are summoned under the heading of "Network Model of Financial System Resilience".
Findings- Within the context and framework of ASD theory, the collision between the Governments and Central Banks will result in the new games that were once characterized by expansionary monetary and fiscal policy, resulting in record low-interest rates and Inflation (Asset Price and Consumer Products) will change to less expansionary monetary policy combined with a still expansionary fiscal policy. This new art of policy collisions will increase interest rates, control inflation, and decline in asset prices. If the interest rate hikes worsen the debt-to-GDP ratios and the central banks would prefer to fight against inflation by selling assets like government bonds, central banks, including private and public banks, would suffer from capital losses on the bond sales and their insolvency combined with the need for extra capital would erode further confidence within a macro-financial system. This would again push for higher rate hikes that would also increase the borrowing costs for the Treasuries and the corporates, no matter how they would enforce repressive measures to push down the borrowing costs.

Facing a new fiscal deficit burden on the front as new defence, health care and ESG issues are pressing the governments, “rating weak” countries would face a risk of sovereign downgrades as well. Under the shadow of fundamental trends like zero-emission and decarbonization policies, increasing defense and energy spending, aging populations, and higher healthcare costs, there will be great spending governments, and the world will return to the second version of the 1970s with rampant and persistent patterns of macroeconomic shocks giving possible ways to corporate defaults, credit losses for banks and financial system resilience risks. To stop any market or systemic failure due to the contracting real balances and liquidity within the econo-financial systems, Governments and Central Banks might return to an older kind of financial repression through regulations. This will result in more losses of independence, not just of the Central Banks combined with state-owned banks; the remaining private sector banks will be in a different game context within the borders of ASD Theory. Consequently, all of those actors will find themselves in a zero-sum-game.

Conclusion- One of the major macro conclusions is the fact that the FED and the other central banks cannot fight against inflation while massive amounts of cash are burned by the fiscal policy implementors within the macro-financial system. This is the point where monetary policy-based solutions cannot be taken for granted. In infected money and capital markets in the post-COVID era, we observe an “Illusion of Control” and strive for more recognition by the governments. The Central Bank authorities and governmental fiscal agencies would think that everything would be under “control” even though the markets were showing higher volatilities and governments were pressing for more asset values. Contrary to the fundamental macroeconomic theories where central banks would stimulate the markets by exercising macro-prudential instruments, corporates would rest and slow down their investment activities during higher volatility and interest rates hikes; the corporates would further find themselves in a more stochastic investment-financing processes with higher volumes of disinvestment or default processes, whereas the political elite would try to reverse this process by injecting more governmental deficit into the society. Consequently, unfavourable shocks under the new regime can trigger unwinding of the intended credit cycles with dramatic default and sizable scales of new debts, which should be monetised by the central banks at higher inflationary costs. Consequently, the results of the aggregate loss distributions modelled by systemic risk measurement approaches within a financial system may address a forthcoming stagflation on the econofinancial horizon.

Keywords: Behavioral finance, financial crisis, criteria for decision-making under risk and uncertainty, regime switching
JEL Codes: D52, D81, D83, G11, G01

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