Stepping out of the shadow of the crisis: three transitions for the world economy

Speech by Jaime Caruana

General Manager, Bank for International Settlements

on the occasion of the Bank's Annual General Meeting

in Basel on 29 June 2014

Good morning, ladies and gentlemen

This year's Annual Report offers our views on current challenges and aims to examine policies that might help us step out of the long shadow of the crisis. Our approach is to seek a long-term perspective with a view to shedding light on both the build-up of financial imbalances pre-crisis and their lasting consequences.

In my remarks, I will focus on my own observations on the Annual Report. Claudio Borio, Head of the BIS's Monetary and Economic Department, and Hyun Song Shin, Economic Adviser and Head of Research, will elaborate afterwards on some specific points.

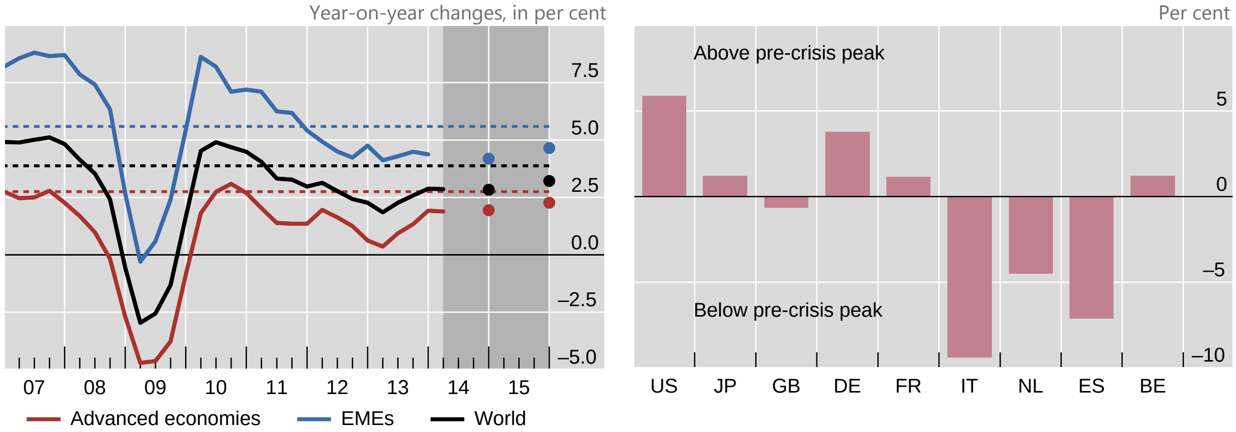
Seven years on, the Great Financial Crisis still casts this long shadow on the world economy. The good news is that the global economy is healing and global growth has picked up during the past year. Reforms have taken hold, if unevenly. The recovery in the advanced economies has broadened. The euro area has eventually emerged from recession, while the slowdown in emerging market economies (EMEs) seems to have abated. The consensus expectation is for global growth to gradually return to pre-crisis rates (Graph 1).

The less good news is that challenges continue to be serious and new risks are emerging. By historical standards, the upswing has disappointed. But this should not be surprising. Consumers, firms and banks in crisis-hit economies are still repairing their balance sheets and grappling with an overburden of debt. Private sector deleveraging is most advanced in the United States; in other countries, including large tracts of the euro area, it is still very much work in progress. During the boom, resources were misallocated on a huge scale, and it will take time to move them to new and more productive uses. Meanwhile, a number of EMEs have moved into the late stage of their own financial booms. While these booms have helped to extricate the global economy from the Great Recession, they are now confronting the EMEs with a range of economic risks. And these risks cannot be altogether offset by the additional room for policy manoeuvre that the EMEs have won for themselves over the last few years.

Yet the global economic upswing does provide us with the chance to step beyond the shadow of the crisis. Making full use of that opportunity will involve three transitions for the global economy: first, towards patterns of growth that are less debt-driven and therefore more sustainable; second, towards a more normal monetary policy; and third, towards a more reliable financial system. Let me briefly discuss each of these transitions in turn.

Global growth remains in the shadow of the crisis — Graph 1

Real GDP growth[1] | Output relative to pre-crisis peaks[2]



BE = Belgium; DE = Germany; ES = Spain; FR = France; GB = United Kingdom; IT = Italy; JP = Japan; NL = Netherlands; US = United States.

[1] Historical and expected real GDP; forecasts are shown as dots; the dashed lines show average annual growth in 1996–2006. Advanced and emerging market economies comprise 10 and 28 major economies, respectively; weighted averages based on 2005 GDP and PPP exchange rates. [2] Pre-crisis peak calculated over the period 1996–2008.

Sources: OECD, *Economic Outlook*; Consensus Economics; Datastream; national data; BIS calculations.

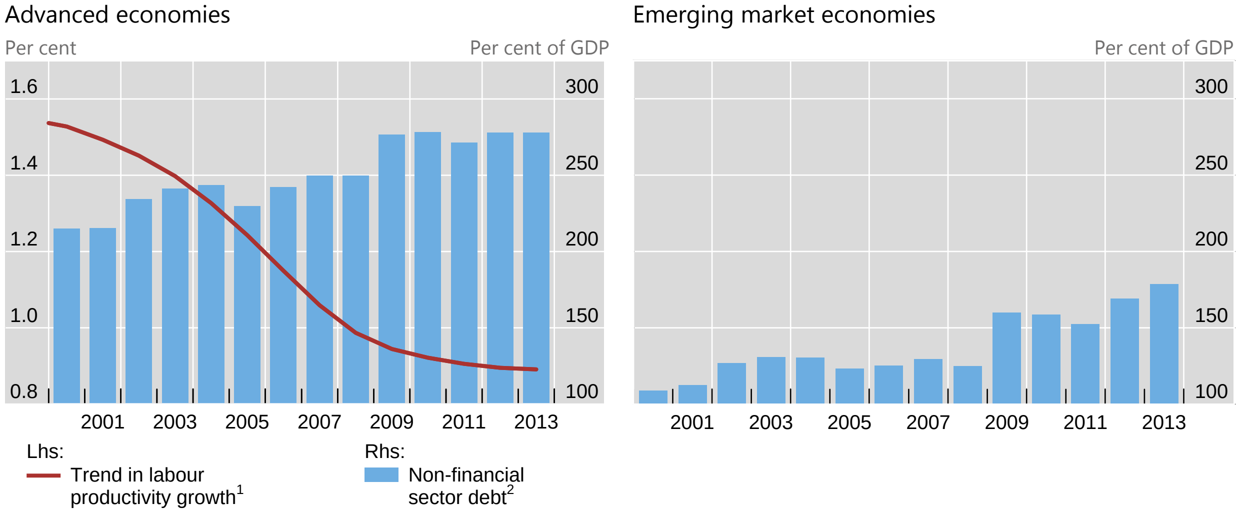
First transition: towards a less debt-driven growth model

Over the past decades, growth has relied heavily on debt. Financial booms have led to severe resource misallocation in many economies. These booms have also masked an erosion of growth potential and, in the advanced economies, a trend decline in productivity growth that started decades ago.

Since 2007, in the G20 economies, the ratio of total non-financial sector debt to GDP has risen by more than one fifth. This is the legacy of the massive fiscal stimulus during the Great Recession in the advanced economies and the significant new issuance of debt by corporates in EMEs. Since then, the advanced economies have made some progress in reducing their fiscal deficits. But the upshot is that aggregate debt levels continue to grow. Overall, debt-to-GDP ratios are now 275% in the advanced economies and 175% in EMEs.

This surge in debt has certainly helped to prop up current demand. What is less clear is whether it will generate higher income in the years to come and thus ensure sustainability.

An unsustainable growth model | Graph 2



Advanced and emerging market economy aggregates comprise 10 and 14 major economies, respectively.

[1] Hodrick-Prescott (HP) filter applied to annual growth of output per person employed. Aggregates are weighted averages of trend growth based on GDP at current PPP exchange rates. [2] Includes credit to the private and public sector converted to US dollars at market exchange rates.

Sources: IMF, *World Economic Outlook;* OECD, *Economic Outlook;* Conference Board, *Total Economy Database*; national data; BIS calculations.

A negative aspect of this debt-driven growth pattern is the relative weakness in investment in advanced economies. True, at the global level, total fixed investment as a share of GDP has continued to rise thanks to rapid growth in the EMEs. It is also true that, in some countries, a correction of overinvestment in housing and construction was overdue. But other investment patterns do not bode well for future growth. In many advanced economies, for example, companies are holding back on investment in plant and equipment. Infrastructure investment is also languishing, particularly in a number of EMEs but also in some advanced economies.

Rising private and public debt has created a range of vulnerabilities. As debt increases, the ability of borrowers to repay becomes progressively more sensitive to drops in income and to interest rate rises. Thus, higher debt translates into greater financial fragility and financial cycles that may become increasingly disruptive. How to cope with those cycles is a major theme of this year's Annual Report, as Claudio Borio will explain in a minute.

But what about the risk of secular stagnation? Debt is not the only headwind to growth; there are also structural deficiencies. In the advanced economies, productivity growth has been on the decline since long before the crisis, a trend previously masked by the financial boom (Graph 2). And the drag from ageing populations is well known. In addition, there are country-specific factors, including a structural fall in participation rates, or a sectoral misallocation of credit and resources. All these are structural impediments to demand and growth.

It is hard to see how additional debt-driven demand can help. As we argued last year, monetary and fiscal stimulus has won us some breathing space. But it cannot substitute for structural reform. Ever-rising public debt cannot shore up confidence. Nor can a prolonged extension of ultra-low interest rates. Low rates can certainly increase risk-taking, but it is not evident that this will turn into productive investment.

Most importantly, if they persist too long, ultra-low rates could validate and entrench a highly undesirable type of equilibrium – one of high debt, low interest rates and anaemic growth.

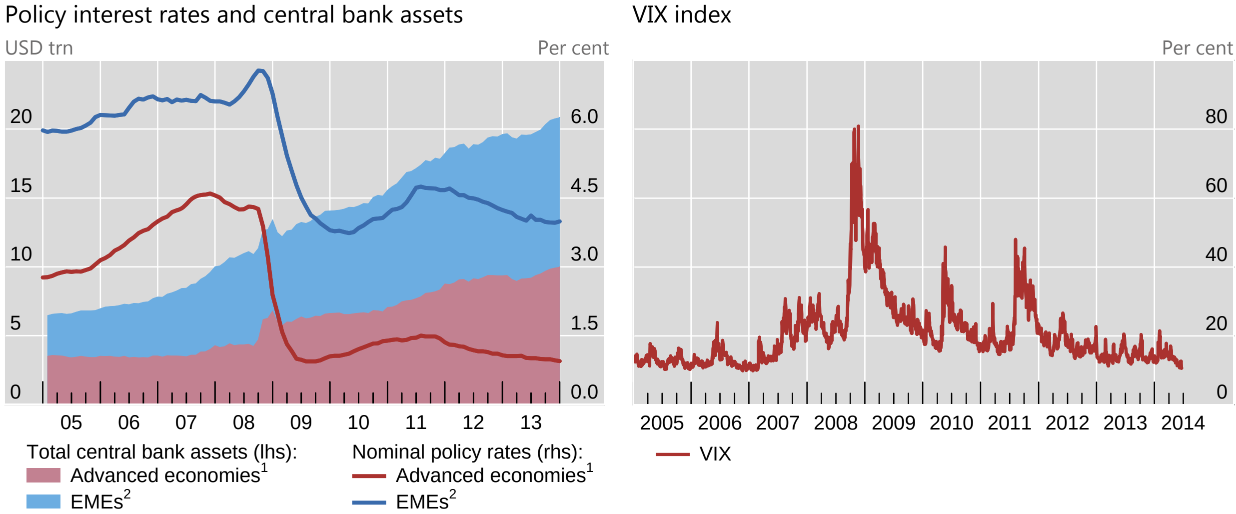
The right way to avoid this trap is to tackle the structural headwinds head-on. The priorities are to reverse the decline in productivity growth and to address structural deficiencies. Doing so will require supply side reforms that promote a more flexible and profitable use of resources and create confidence in employment and income prospects. Although such reforms need to be very country-specific, they are likely to include further liberalisation of product and labour markets, revised tax codes and more focused use of public spending. And, not incidentally, monetary policy will be more effective in a more flexible and less leveraged economy.

Second transition: towards a more normal monetary policy

Monetary accommodation is testing its limits. Monetary policy loses a great deal of its effectiveness in the recovery phase of a balance sheet recession when households, corporates and banks are all struggling to repair their balance sheets, thus entrenching the weakness in aggregate demand. There is a threat to financial stability too, as ultra-low interest rates promote debt accumulation and risk-taking.

Policy normalisation has a long way to go. By tapering, the Federal Reserve is merely putting an end to its loosening. Central bank balance sheets – including the Fed's – have continued to expand and now exceed $20 trillion in aggregate, worldwide. Policy rates sit at the zero lower bound in major currency areas, and are well below pre-crisis levels in EMEs (Graph 3). Globally speaking, therefore, monetary policy remains extraordinarily accommodative.

Monetary and financial conditions remain very easy — Graph 3



[1] Economies included: Australia, Canada, the euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom and the United States. [2] Economies included: Argentina, Brazil, Chile, China, Chinese Taipei, Colombia, the Czech Republic, Hong Kong SAR, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, the Philippines, Poland, Russia, Saudi Arabia, Singapore, South Africa, Thailand and Turkey.

Sources: IMF, *International Financial Statistics*; Bloomberg; Datastream; national data.

The road towards normalisation is bound to be bumpy and full of challenges. Let me mention two.

The first is how to make financial markets less dependent on monetary policy. During the past few months, volatility in global markets has fallen to historically low levels (Graph 3). At the same time, the search for yield has gathered pace and credit spreads have narrowed. It is hard to see this as a consequence of receding global risks. Rather, market participants seem to have become convinced that monetary conditions will remain very easy for a very long time. But markets may be taking more assurance than central banks wish to give, and they may be considering only a very narrow spectrum of potential outcomes. Such overconfidence is dangerous. It may encourage excessive risk-taking, and may add to the pressure on central banks to postpone policy normalisation.

The second challenge is to cope with the international spillovers of monetary policy. Many EMEs have struggled with the knock-on effects of last year's global bond market sell-off. Some of these effects have resembled past episodes of EME stress, including large exchange rate pressures and the heightened vulnerability of economies with weak fundamentals. But other features are new, including the strong linkages via domestic bond markets in EMEs. This reflects the shift from bank to market-based finance during the past few years – a shift that may have a bearing on financial stability risks during policy normalisation. We have yet to learn whether a market-driven boom is more or less risky than a bank-driven boom. Hyun Shin will elaborate on this "second phase of global liquidity" later, and Chapter IV of the Annual Report deals with these issues.

Taking account of monetary policy spillovers is a shared responsibility. Advanced economies need to better understand the international transmission and feedback of very accommodative monetary conditions and internalise this in their decisions. This goes beyond assessing the feedback effect of domestic policy actions via exchange rate movements and trade. It requires a clear sense of financial linkages and exposures and of the impact of monetary policy decisions on markets. EMEs, in turn, cannot ward off global shocks. But they can reduce macroeconomic and financial vulnerabilities at home. Addressing the risks associated with the late stage of domestic financial cycles is critical in this regard.

This leads me to the question of persistently below-target inflation and what it implies for monetary normalisation. True, low-inflation, low-growth environments are not helpful from the perspective of those with heavy borrowings. But let me make two qualifications here. First, central bank inflation projections and well anchored long-term inflation expectations seem to suggest that the risk of persistent and self-reinforcing disinflationary pressure is low. Moreover, there are good reasons to believe that downward pressure on inflation reflects positive supply side effects in the global economy, at least in part. Greater competition in markets for goods and, increasingly, also for services reduces the scope for raising prices, and it may even force them downwards. This year's Annual Report documents the important role of such global factors for domestic inflation. All this suggests there are significant uncertainties in projecting inflation. And there is a need for more research about the new dynamics of inflation, the growing role of international factors and the shrinking sensitivity to domestic output gaps.

Second, the low rates of inflation worldwide are another sign that, coming out of a balance sheet recession, monetary policy typically has much less traction in stimulating demand than it does during a normal recovery. One piece of evidence is the stark disconnect between very accommodative financial conditions on the one hand and sluggish corporate investment on the other. It is therefore important to take a critical look at what monetary policy can realistically accomplish right now. After years of easy money, we need to pay more attention to the risks of normalising too late.

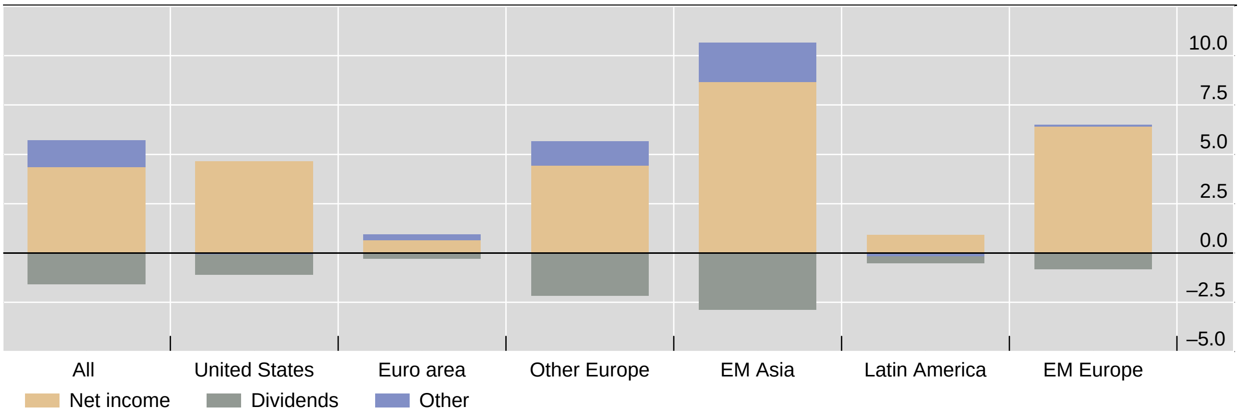
Third transition: towards a more reliable financial system

Appreciable progress has already been made in the transition towards a more resilient financial system. Banks have made progress in recouping their strength. They have, on average, rebuilt capital levels to meet more demanding regulatory standards. In particular, stronger profits have allowed banks to strengthen their capital base (Graph 4).

But pockets of weakness and uncertainty persist, especially in Europe. Despite an improvement in aggregate profitability, many institutions are still struggling with high levels of government and household debt. Standalone ratings remain weak. Investors continue to ask questions about asset quality. Elsewhere, in some economies that largely escaped the effects of the crisis, financial booms have created new vulnerabilities.

Profit retention boosts banks' regulatory ratios[1]

Sources of bank capital, changes between end-2009 and end-2013, in per cent — Graph 4



[1] All figures are weighted averages using end-2013 total assets as weights.

Sources: B Cohen and M Scatigna, "Banks and capital requirements: channels of adjustment", *BIS Working Papers*, no 443, March 2014; Bankscope; Bloomberg.

New prudential instruments and policies can reduce such risks. In Europe, the asset quality review, a rigorous stress test and the introduction of the single supervisor offer a unique opportunity to restore confidence in the banking system – and to remove one major roadblock to stronger growth, especially in crisis-hit countries. Macroprudential instruments are being used more actively. Basel III has introduced a countercyclical buffer for banks as part of a broader trend towards establishing national macroprudential frameworks. EMEs have used other tools to increase the resilience of banks. But the jury is still out on how effective such measures can be in containing late-stage financial cycle risks. Prudential measures need help from monetary policy.

Major regulatory initiatives are nearing completion. The focus has shifted towards ensuring consistent implementation and to monitoring the effects, both intended and unintended. These regulatory initiatives cover an ample spectrum, from capital and liquidity requirements to dealing with the too-big-to-fail problem, resolution regimes, financial market infrastructure and shadow banking. It is important now to place more emphasis on rigorous supervision.

A reliable financial system requires more than resilience. Resilience is the starting point, but let me mention some other key elements.

The first is confidence in banks' risk management. This goes all the way from the overall risk culture to the risk models themselves. The large reported dispersion in risk-weighted asset calculations suggests that there is still plenty of scope for inconsistency, and perhaps even for gaming the rulebook. Stringent regulation can alleviate this problem. Constraints on modelling assumptions can improve comparability and curb arbitrage. If calibrated rigorously, the leverage ratio can create a credible backstop for the risk-weighted ratios. And, implemented consistently, global minimum regulatory standards can reduce the risk of fragmentation along national borders and increase credibility. But no regulation, whether simple or sophisticated, can obviate the need for proactive, rigorous and intrusive supervision. This is the best way to ensure that solid liquidity and capital buffers are in place. And it is a good way to encourage a prudent risk culture, one that allows for diversity and risk sensitivity, but penalises and prevents attempts to game regulations.

Second, and more generally, a reliable financial system depends on public confidence. That confidence has been repeatedly dented by allegations of manipulation in some financial markets. Trust needs to be rebuilt if the financial system is to function as it should.

Third, a reliable financial system needs to be alert to the continuous changes in financial markets and the emergence of new risks. I have already mentioned the additional work that is needed to analyse the nature of market-based financial booms, where the behaviour of traditionally less leveraged institutions such as asset managers may be capable of triggering financial strains. The incentives driving such investors could result in sudden, non-linear, leverage-like amplification of market dynamics.

Time to step out of the shadow of the crisis

It is time that we stepped out of the shadow of the crisis. Stronger growth provides an opportunity to push through structural reforms and set balance sheets on a firmer footing. We can hardly expect such efforts to be popular. But they may pay off even in the short run if they help to restore confidence.

The time is right because delaying any of the three transitions poses risks. A first risk is financial dominance: delaying policy action for fear of market volatility and financial fragility. A second threat is fiscal dominance: that is, pressure to pursue a policy of easy money so as to sustain high debt levels. And a third threat is expectations dominance: namely, unrealistic expectations of what central banks can do. Failure to ensure the success of any of these transitions would exact a high price in terms of growing risks to financial and macroeconomic stability.

The key to mastering the three transitions is close international cooperation. Post-crisis, Basel III has become a synonym for successful cooperation in the area of financial regulation. As a result, the case for closer cooperation in other areas has strengthened. The past year has served as a reminder that domestic policy actions are increasingly likely to have global repercussions. This much is obvious for the big advanced economies, but it has become increasingly true for policy decisions in large EMEs too. A better understanding of how policy actions will affect others in a highly integrated world is therefore more important than ever. For its part, the BIS stands ready to promote this cooperation in the area of monetary and financial stability.