I. Making the most of borrowed time

Six years ago, in mid-2007, cracks started to appear in the financial system. Little more than a year later, Lehman Brothers failed, bringing advanced economies to the verge of collapse. Throughout the ensuing half-decade of recession and slow recovery, central banks in these economies have been forced to look for ways to increase their degree of accommodation. First they lowered the policy rate to essentially zero, where it has been ever since in the United States, United Kingdom and euro area. (And where it has stood in Japan since the mid-1990s!) Next, these central banks began expanding their balance sheets, which are now collectively at roughly three times their pre-crisis level – and rising.

Originally forged as a description of central bank actions to prevent financial collapse, the phrase "whatever it takes" has become a rallying cry for central banks to continue their extraordinary actions. But we are past the height of the crisis, and the goal of policy has changed – to return still-sluggish economies to strong and sustainable growth. Can central banks now really do "whatever it takes" to achieve that goal? As each day goes by, it seems less and less likely. Central banks cannot repair the balance sheets of households and financial institutions. Central banks cannot ensure the sustainability of fiscal finances. And, most of all, central banks cannot enact the structural economic and financial reforms needed to return economies to the real growth paths authorities and their publics both want and expect.

What central bank accommodation has done during the recovery is to borrow time – time for balance sheet repair, time for fiscal consolidation, and time for reforms to restore productivity growth. But the time has not been well used, as continued low interest rates and unconventional policies have made it easy for the private sector to postpone deleveraging, easy for the government to finance deficits, and easy for the authorities to delay needed reforms in the real economy and in the financial system. After all, cheap money makes it easier to borrow than to save, easier to spend than to tax, easier to remain the same than to change.

Yes, in some countries the household sector has made headway with the gruelling task of deleveraging. Some financial institutions are better capitalised. Some fiscal authorities have begun painful but essential consolidation. And yes, much of the difficult work of financial reform has been completed. But overall, progress has been slow, halting and uneven across countries. Households and firms continue to hope that if they wait, asset values and revenues will rise and their balance sheets improve. Governments hope that if they wait, the economy will grow, driving down the ratio of debt to GDP. And politicians hope that if they wait, incomes and profits will start to grow again, making the reform of labour and product markets less urgent. But waiting will not make things any easier, particularly as public support and patience erode.

Alas, central banks cannot do more without compounding the risks they have already created. Instead, they must re-emphasise their traditional focus – albeit expanded to include financial stability – and thereby encourage needed adjustments rather than retard them with near-zero interest rates and purchases of ever larger quantities of government securities. And they must urge authorities to speed up reforms in labour and product markets, reforms that will enhance productivity and encourage employment growth rather than provide the false comfort that it will be easier later.

After a review of the past year in Chapter II, this Report discusses these issues in Chapters III to VI, which are summarised here. Our message is simple: authorities need to hasten labour and product market reforms to boost productivity and unlock growth; the private sector must deleverage and the public sector needs to ensure fiscal sustainability; risks in the financial system need to be managed; and the expectation that monetary policy can solve these problems is a recipe for failure.

Enhancing flexibility: a key to growth

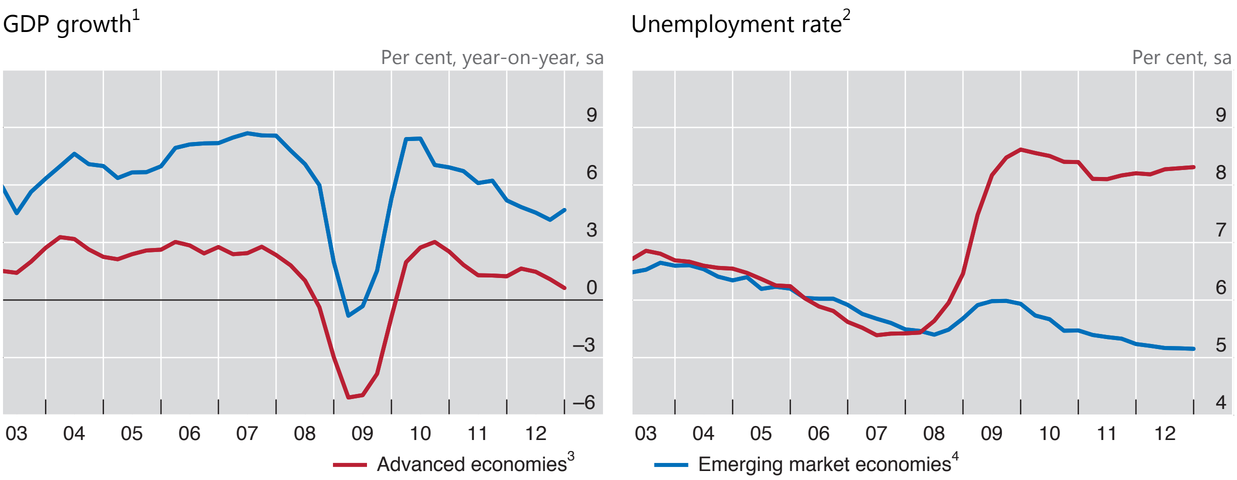
Sustained and balanced growth remains elusive in the global economy. In many advanced economies, growth rates have only partially recovered, and unemployment remains stubbornly high (Graph I.1). As discussed in Chapter III, rigidities in labour and product markets are among the most important obstacles standing in the way of long-term economic health. The financial crisis and its aftermath showed that such structural problems are exacerbated when the cycle turns and the boom becomes a bust. As a result, the recovery has been disappointing in many economies.

When a housing sector boom turns into a bust, as it did in a number of countries, rigidities limit the mobility of people across sectors. As Chapter III argues, tight employment protections slow the recovery and the growth of employment in economies that go into recessions with significant sectoral imbalances. The implication is obvious: countries stand to reap substantial benefits from moving towards less regulated and more growth-friendly labour and product markets.

Measures that make labour and product markets more flexible allow resources to flow more easily from low- to high-productivity sectors, with obvious gains for growth. In parallel, such reforms help foster entrepreneurship, paving the way for firms to boost productivity, grow and hire more workers. This means that simplifying regulations and reducing the power of special interests that are impeding productivity enhancements are essential for raising sustainable growth. To be sure, basic worker and consumer protections must be preserved, and the extent of desirable regulation will vary from country to country. But the costs of overly regulated labour and product markets are clear: they reduce flexibility to the point where long-run growth will suffer.

Global economic activity

Graph I.1



[1] Weighted averages based on 2005 GDP and PPP exchange rates. [2] Weighted averages based on labour force; definitions across countries may vary. [3] Australia, Canada, Denmark, the euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom and the United States. [4] Argentina, Brazil, Chile, China, Chinese Taipei, Colombia, the Czech Republic, Hong Kong SAR, Hungary, Indonesia, Korea, Malaysia, Mexico, Peru, the Philippines, Poland, Russia, Saudi Arabia, Singapore, South Africa, Thailand and Turkey.

Sources: IMF, *International Financial Statistics* and *World Economic Outlook*; Datastream; national data.

Given the evidence that structural rigidities are particularly harmful in the aftermath of a crisis, there is a strong case for undertaking reforms in good times instead of under pressure. Although such cases of pre-emptive reform are rare, countries that came through the financial crisis relatively unscathed have every reason to address labour and product market flexibility sooner rather than later.

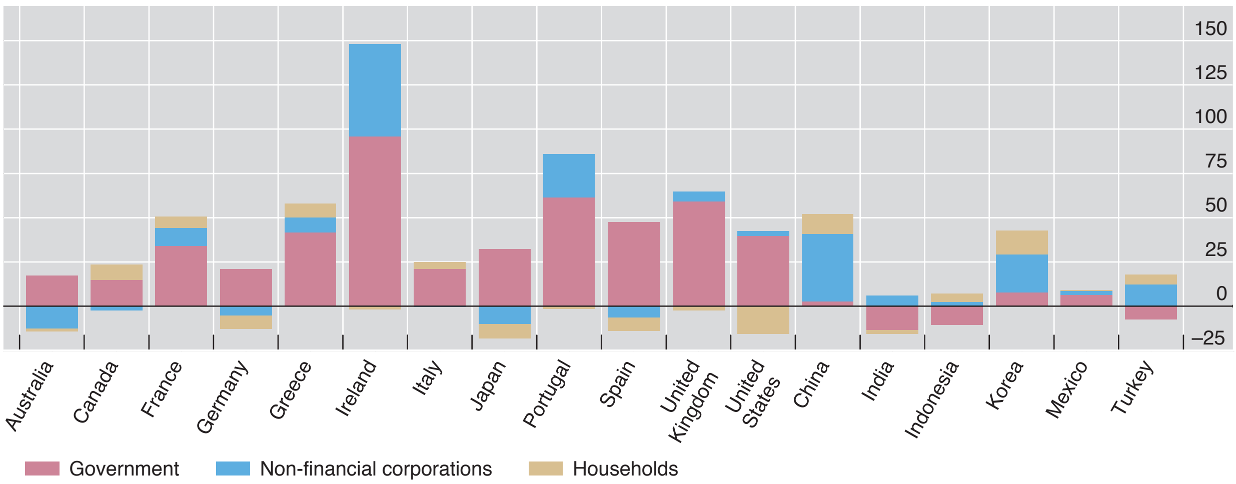
Fiscal policy: threats remain

As governments responded to the financial crisis with bank bailouts and fiscal stimulus, their indebtedness rose to new highs. And in countries that experienced a housing bubble in the run-up to the crisis, households had already accumulated large debts. In the half-decade since the peak of the crisis, the hope was that significant progress would be made in the necessary deleveraging process, thereby enabling a self-sustaining recovery.

Instead, the debt of households, non-financial corporations and government *increased* as a share of GDP in most large advanced and emerging market economies from 2007 to 2012 (Graph I.2). For the countries in Graph I.2 taken together, this debt has risen by $33 trillion, or by about 20 percentage points of GDP. And over the same period, some countries, including a number of emerging market economies, have seen their total debt ratios rise even faster. Clearly, this is unsustainable. Overindebtedness is one of the major barriers on the path to growth after a financial crisis. Borrowing more year after year is not the cure.[1]

Change in debt, 2007–12

In percentage points of GDP | Graph I.2



Sources: IMF, *World Economic Outlook*; OECD; BIS; national data.

1 Some research finds that, after a financial crisis, private sector deleveraging during the downturn is positively and significantly correlated with the strength of the subsequent recovery. See M Bech, L Gambacorta and E Kharroubi, "Monetary policy, leverage and the business cycle", *BIS Working Papers*, no 388, September 2012.

Households in the United States, and to a lesser extent in Spain and the United Kingdom, have made inroads on their debt. But as a share of GDP, the decline has been far less than the approximately 40 percentage point drop for private non-financial sector debt that, on average, has followed past financial crises. See G Tang and C Upper, "Debt reduction after crises", *BIS Quarterly Review*, September 2010, pp 25–38.

In a majority of the countries shown in Graph I.2, public debt is principally responsible for the increase. Although countercyclical fiscal policy was needed to combat the threat of depression at the height of the financial crisis, the situation is different today. As Chapter IV notes, studies have repeatedly shown that as government debt surpasses about 80% of GDP, it starts to become a drag on growth.[2] With public debt now above 100% of GDP in most advanced economies, and the prospect of large increases in age-related spending, finding the way to medium- and long-term fiscal sustainability remains a key challenge.

Ultimately, outsize public debt reduces sovereign creditworthiness and erodes confidence. By putting their fiscal house in order, governments can help restore the virtuous cycle between the financial system and the real economy. And, with low levels of debt, governments will again have the capacity to respond when the next financial or economic crisis inevitably hits.

Although the need for fiscal consolidation has become more and more pressing, as Chapter IV shows, tangible results have been meagre. In a number of countries, the cheap financing made available by low short- and long-term interest rates has taken the pressure off governments to make fiscal adjustments.[3] But the relief is temporary and not without risks. To see why, recall that in the two decades preceding the crisis, long-term interest rates in many advanced economies averaged about 6% (Graph I.3, left-hand panel). Today, long-term bond yields in major advanced economies are around 2% – in Japan, they are well below. When interest rates and bond yields start to rise, investors holding government bonds stand to lose huge amounts of money.

Consider what would happen to holders of US Treasury securities (excluding the Federal Reserve) if yields were to rise by 3 percentage points across the maturity spectrum: they would lose more than $1 trillion, or almost 8% of US GDP (Graph I.3, right-hand panel). The losses for holders of debt issued by France, Italy, Japan and the United Kingdom would range from about 15 to 35% of GDP of the respective countries. Yields are not likely to jump by 300 basis points overnight; but the experience from 1994, when long-term bond yields in a number of advanced economies rose by around 200 basis points in the course of a year, shows that a big upward move can happen relatively fast.

And while sophisticated hedging strategies can protect individual investors, someone must ultimately hold the interest rate risk. Indeed, the potential loss in relation to GDP is at a record high in most advanced economies. As foreign and domestic banks would be among those experiencing the losses, interest rate increases pose risks to the stability of the financial system if not executed with great care. Clear central bank communication well in advance of any moves to tighten will be critical in this regard.

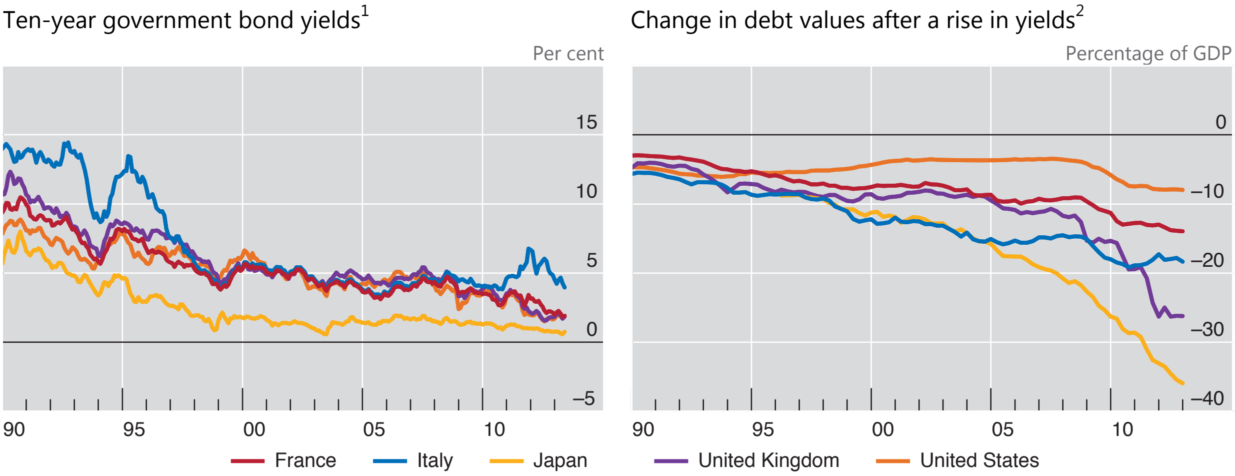
Governments must redouble their efforts to ensure that their fiscal trajectories are sustainable. Growth will simply not be high enough for fiscal consolidation to happen on its own; that is, the denominator of the debt-to-GDP ratio will not grow faster than the numerator. Postponing the pain carries the risk of forcing

2 Other types of debt have similar effects: corporate debt beyond 90% of GDP and household debt above about 85% have been found to become a drag on growth; see S Cecchetti, M Mohanty and F Zampolli, "The real effects of debt", in *Achieving maximum long-run growth*, proceedings of the Federal Reserve Bank of Kansas City Jackson Hole symposium, August 2011, pp 145–96.

3 Extraordinarily low yields reflect a combination of factors, including a continued weak economic outlook, safe haven flows from other economies, regulation-driven demand for safe and liquid assets, and large-scale central bank interventions.

Bond yields and interest rate risk

Graph I.3



[1] Monthly averages. [2] For each country, estimated change in the value of outstanding negotiable central government debt as a percentage of GDP at each point in time following a hypothetical 3 percentage point increase in yields across the term structure. Based on estimated negotiable outstanding amounts and average maturities excluding holdings of the domestic central bank for Japan, the United Kingdom and the United States and estimated negotiable outstanding amounts and average maturities for France and Italy. For France, Italy, Japan and the United Kingdom, data on estimated negotiable debt and average maturities are from the OECD, national sources and the BIS. For the United States, data on marketable debt and average maturities are from national sources.

Sources: OECD; Bloomberg; Datastream; Global Financial Data; national data; BIS; BIS calculations.

consolidation under stress – which is the current situation in a number of countries in southern Europe. Structural fiscal problems have to be tackled early. Doing so means avoiding much more pain later.

At the same time, as also argued in Chapter IV, the quality of fiscal adjustment is as important as the quantity. Waiting has not paid dividends. Some laggard countries have been forced to make drastic, indiscriminate cuts, slicing away at productive public investment and raising growth-unfriendly taxes. Those that still have the wherewithal to do so should focus their efforts on cutting expenditures by reducing government consumption and transfers. In countries where tax rates are still low, revenue increases should also play a role.

Importantly, many countries need to do more now to reduce future age-related spending. While long-term in nature, these measures will bring immediate positive effects as they strengthen perceptions of fiscal sustainability.

Public finances in many emerging market economies have remained well in hand, partly because those regions were not at the centre of the crisis. But the fiscal positions of some, while currently bright, have been buoyed by revenues from rising asset and commodity prices. Unlikely to be sustainable, these situations call for caution. In other cases, weakening global demand has reduced revenue and induced higher spending, driving up public debt levels. These early threats to fiscal sustainability, along with the possibility of age-related increases in public spending, will require policymakers in emerging market economies to remain vigilant.

The financial system: increasing resilience

The complexity of the financial system presents a continuing challenge for the prudential framework. Ensuring systemic stability requires adequate capital, liquidity and resolution regimes. All financial institutions must have ample, high-quality capital buffers to protect against losses and sufficient liquidity buffers to protect them from sudden collapses in market confidence. And we need resolution regimes to make it possible for large, complex institutions to fail in an orderly way.

Still, finding the best way to manage the risks arising from an increasingly global and intricate financial system remains a challenge for the world's policymakers. Chapter V argues that focusing on the measurement and management of these risks is central to creating a safer prudential framework.

An important example of the benefits of a prudential framework that embraces the evolving intricacies of the financial system is detailed in Chapter V. A simple rule, such as a leverage ratio, and a more complex risk-weighted metric each have their advantages and limitations as a barometer of bank strength. But they are complementary. Used in combination, the two reinforce each other, generating more information on the riskiness of a bank than does either of them alone. On top of that, manipulating these measures is much more difficult when they are used simultaneously. The policy response to the recent debate on the complexity of regulation should therefore rest on the mutually reinforcing ability of risk-sensitive metrics and simple balance sheet rules to monitor and mitigate financial system risk.

Limiting the permissible range of banking activities may help reduce systemic risk, but that is not likely to be a silver bullet. The limits will do little to reduce the complexity of banks, and even if they simplify the firm-level organisation of banks, their impact on system-wide risk is ambiguous.

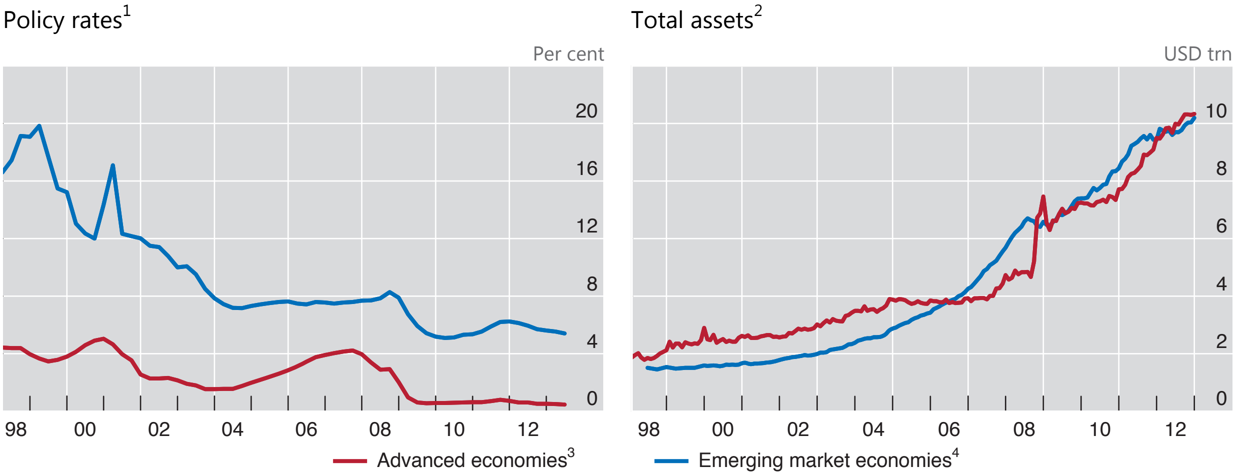
The evolving standards governing the global financial system must be based on simple principles: internalise systemic risks; require enough capital and liquidity to align private incentives with the public interest; set risk sensitivity to reduce shifts into high-risk assets; extend prudential reach to keep risks within view of supervisors (and managers); and allow the regulatory system to evolve along with the financial system. But what is simple in principle will usually be complicated in fact. This means that the success of financial reforms hinges on long and complex definitions and processes. And the reason for that is a simple, practical one: details are enforceable, principles are not.

Monetary policy: borrowing time

Since the outbreak of the financial crisis, central banks have found themselves pushing deeper into unconventional territory. Having hit the lower bound for interest rates, central banks in major advanced economies turned to amassing assets, which now stand at 25% of their countries' collective GDP. Meanwhile, central banks in emerging market economies have also expanded their balance sheets, and now hold assets worth more than 40% of GDP. Combined, central bank assets across advanced and emerging market economies have risen from \$10.4 trillion in 2007 to more than \$20.5 trillion today, and central banks remain pressured to do even more (Graph I.4).

But despite all the monetary accommodation, economic growth remains lacklustre, and job creation has yet to gain firm traction. Moreover, the low interest rates in advanced economies create international spillovers. These include capital flows to fast-growing emerging market economies and to some small advanced economies. The resulting upward pressure on the value of the currencies in those economies has hampered the domestic stabilisation efforts of their central banks.

Policy rates and central bank total assets Graph I.4



[1] Policy rates or closest alternative; for target ranges, the midpoint of the range; weighted average of the economies listed based on 2005 GDP and PPP exchange rates. [2] Total of the economies listed. [3] Australia, Canada, Denmark, the euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom and the United States. [4] 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; Global Financial Data; national data.

Delivering further extraordinary monetary stimulus is becoming increasingly perilous, as the balance between its benefits and costs is shifting. Chapter VI argues that policy frameworks anchored to price stability remain the foundation for growth. Without price stability, you have nothing. But, as the crisis has taught us, narrow near-term price stability is not enough: financial stability is also essential for long-term macroeconomic stability. The challenge is to modify traditional monetary policy frameworks to include financial stability considerations effectively and symmetrically.

All of this puts monetary policymakers in the largest advanced economies in a delicate position. How can central banks encourage those responsible for structural adjustment to implement reforms? How can they avoid making the economy too dependent on monetary stimulus? When is the right time for them to pull back from their expansionary policies? And in pulling back, how can they avoid sparking a sharp rise in bond yields? It is time for monetary policy to begin answering these questions.

Summing up

Six years have passed since the eruption of the global financial crisis, yet robust, self-sustaining, well balanced growth still eludes the global economy. If there were an easy path to that goal, we would have found it by now. Monetary stimulus alone cannot provide the answer because the roots of the problem are not monetary. Hence, central banks must manage a return to their stabilisation role, allowing others to do the hard but essential work of adjustment.

Authorities need to hasten labour and product market reforms so that economic resources can shift more easily to high-productivity sectors. Households and firms have to complete the difficult job of repairing their balance sheets, and governments must intensify their efforts to ensure the sustainability of their finances. Regulators have to adapt the rules to a financial system that is becoming increasingly interconnected and complex and ensure that banks have sufficient capital and liquidity buffers to match the associated risks. Each country needs to tailor the reform agenda to maximise its chances of success without endangering the ongoing economic recovery. But, in the end, only a forceful programme of repair and reform will return economies to strong and sustainable real growth.