Malcolm D Knight: The financial system and the global recovery - what lies ahead?

Speech by Mr Malcolm D Knight, General Manager of the Bank for International Settlements, at the Annual Congress of the Swiss Society for Economics and Statistics “International Money and Finance”, Basel, 18 March 2004.

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Thank you for the opportunity to address this plenary session of your Society. Since the Bank for International Settlements is an international financial institution that is based in Switzerland, it is of key importance for us to maintain close ties with the community of professional economists in this country.

Indeed, the fundamental raison d’etre of the BIS is closely aligned with the subject matter of this conference - international money and finance. The overarching goal of the BIS is to promote the twin objectives of sustainable non-inflationary economic growth and financial stability.

As a result, analysing the current economic picture and prospects for the period ahead, as well as assessing possible challenges for financial stability, are key elements of our work at the BIS. I want to cover these areas in my talk this morning. In particular, I want to outline what I see as the current issues for international financial stability and to touch on the role of the BIS in meeting these challenges.

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The economic picture has brightened significantly over the past six months. A strong and broad-based global recovery is under way. China has become the second engine of global growth alongside the United States - and this buoyancy is evident throughout Asia. At present, consumer spending in Europe still lags, but there are some signs that confidence has strengthened. There are few indications of any generalised inflationary pressures, even if the recent surge in commodity prices does raise some questions.

The international financial system has recovered from a series of shocks - the collapse of the IT sector equity bubble, the global recession, the financial crisis in Argentina, and the demise of corporations like Enron, WorldCom and Parmalat. Global equity prices are well above the low point that was reached about a year ago. Interest rates are historically low across the whole maturity range. Credit spreads are tight, with many corporate and emerging market sovereign borrowers taking advantage of the unusually favourable funding conditions. Financial institutions are generally in much better shape than a year ago. Banks in many jurisdictions have reduced non-performing loans, and insurance companies have benefited from rising equity prices.

What should we be concerned about in this apparently benign environment? The thread of my argument is as follows:

- Global growth is at present being driven by three powerful forces:
  - (1) very expansionary ***fiscal policies*** in some countries, notably of course the United States;
  - (2) accommodative ***monetary policies*** almost around the globe; and
  - (3) an ***investment boom*** in China that is almost literally without precedent.
- Expansionary macroeconomic policies will, at some point, have to be reined in.
- Investment in China - and the credit expansion associated with it - needs to moderate to a pace that does not ignite an inflationary boom and bust.
- How these adjustments evolve in the next few years will have a major influence on global bond markets, on asset prices in other financial markets, and on financial institutions throughout the world. These financial market effects - which are my main focus today - will matter a great deal for the prospects for sustaining non-inflationary global growth.

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In the recent years of weak economic growth, fiscal policies in several large countries have provided a massive stimulus to aggregate demand. The cyclically adjusted fiscal balance in the United States has swung from a surplus of around 1% of GDP in 2000 to a deficit of 5% of GDP this year - a fiscal boost equivalent to 6% of GDP. Fiscal deficits in Europe have also widened, but by much less than in the United States. The deficit in Japan has been running at over 5% of GDP since 1998 and is still high.

The current stance of these fiscal policies cannot be sustained indefinitely. The large structural deficits add to a stock of public sector debt which, in many cases, is already high. As for the United States, under current policies the prospects are for significant fiscal deficits for many years. All this is even more worrisome as governments in industrialised countries must confront the extraordinary challenge of rapidly ageing populations over the next 15 years.

Central bank policy interest rates are also at historically low levels. The decline in short-term interest rates has been particularly dramatic in the United States, where the federal funds rate has been lowered from 6.5% at the end of 2000 to only 1% at present. The ECB and other European central banks have also eased monetary policies, although less aggressively. The Bank of Japan has pursued a policy of zero nominal interest rates over the past couple of years, in an environment of falling output prices and a banking system encumbered with a large stock of non-performing loans.

Historically low central bank policy interest rates suggest the need to return at some stage to a more “neutral” setting of monetary policy. There is still considerable slack in the major economies, suggesting that there is no imminent need for monetary tightening. But rising oil and commodity prices could suggest some emerging inflationary pressures, albeit at the very early stage of the production chain. This is not a problem now, perhaps, but it is certainly a development that needs watching. A related issue is that in order to slow their domestic monetary expansions, Asian central banks at some point will need to scale back interventions in foreign exchange markets that are currently holding down the appreciation of their currencies against the US dollar.

The investment boom in China also raises important issues. The present boom is in part simply one manifestation of what is little short of a new industrial revolution. Millions of new workers are being brought into the international economy. This promises to bring great benefits to all - and could provide a sustained boost to global growth.

But the long-term benefits of this process should not blind us to certain important near-term economic risks. One is that the current breathtaking pace of investment in China and elsewhere in Asia could be inflationary, as output bumps into the constraints imposed by the limited local infrastructure, and the constraints on the supply of raw materials and other non-labour factors of production. There are currently some important signs of overheating in the Chinese economy. And there is also some risk of overinvestment. The production capacities built up in some sectors may never be profitable, and an overhang of capacity could blight investment prospects in the future. As in every other country, ***sustainable*** growth in China depends on the implementation of effective macroeconomic and prudential policies.

How these different policy challenges are met will have an important impact on growth, inflation, and the prospects for global financial markets. In particular, abrupt revisions of expectations by investors could translate into gyrations in financial markets. It is to these financial system issues that I now turn.

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Global fixed income markets are likely to play a pivotal role in the way the global economy evolves. Current macroeconomic policies have significantly affected bond market conditions, and changing expectations regarding these policies could have a strong impact on the level and volatility of long-term interest rates.

Take the example of fiscal policies. Bond markets serve, among other things, as a yardstick of fiscal prudence. As a result, concerns about the future prospects for achieving sustainable fiscal policies are at some point likely to be reflected in higher interest rates in bond markets. Not immediately of course - in fact, deteriorating fiscal positions have not, to date, led to higher long-term interest rates. But the risk of an adverse impact on financial markets could increase, especially if fiscal deficits were expected to persist during a period of strong growth.

Monetary policies also face a challenge. As the global recovery proceeds, policy interest rates will need to return to more “normal” levels. There is of course no precise benchmark for the “normal” level of interest rates. Assuming a 2% inflation rate, some observers would put the “neutral” rate of interest in the United States at around 5% in nominal terms. Whatever is the true number for this natural interest rate, it is certainly well above the 1% federal funds rate that prevails at present. It is unusual for a gap of this size - and the associated steeply sloped yield curve - to persist for so long. The challenge is how to "exit" the current accommodative monetary policy stance without creating unnecessary uncertainty and generating excessive bond market volatility.

Equally, intervention by Asian central banks in foreign exchange markets is generating a heavy demand for US Treasuries and other dollar-denominated products, and is putting downward pressure on pivotal market interest rates. As intervention subsides from current exceptional levels - as it eventually must - market interest rates will probably rise. Nobody knows yet by how much of course - a lot will depend on how markets assess future inflation risks and the prospects for achieving sustainable fiscal policies in demanding medium-term conditions.

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It goes almost without saying that a long period of very low interest rates like the one we've been experiencing creates new types of risks in the financial system. One aspect of such risks is high leverage. There is evidence that carry-trades are indeed rising as various players take on increased duration risk financed with very low interest rate short-term liabilities. And with long-term interest rates on risk-free government bonds so low, many investors, whether leveraged or not, have been increasingly tempted to "search for yield". This has resulted in a large net flow of funds into risky credits. Improved fundamentals appear to explain only part of the narrowing in credit spreads for corporate and emerging market government borrowers. One piece of evidence that suggests that markets are to some extent driven by favourable liquidity conditions is the unusually high correlation of price movements across a very broad range of assets.

An additional challenge arises from the wider international imbalances resulting from uneven global growth. The main issue here is, of course, when, and how, the historically large US current account deficit - which is running at well over $500 billion a year - will narrow. The downward trend in US bond yields over the past couple of months provides no indication of increasing concerns among investors at present. But the strong depreciation of the US dollar against the euro and several other currencies over the past 12 months could be an indication of increasing pressure to adjust. And the increased volatility in financial markets may well indicate a marked degree of uncertainty as to what that adjustment process might entail.

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Nevertheless, indications are that key internationally active financial institutions are generally well placed at present to cope with higher interest rates. They are also better prepared to withstand increased volatility in financial markets, and structural improvements have enhanced the stability of the financial system. Better allocation and management of financial risks should provide a buffer against shocks.

Let me highlight three observations that support this assessment. First, the global financial system absorbed massive losses during the global economic downturn of recent years. Market-based intermediation has improved the dispersion of financial risks. For example, widely dispersed equity holdings have avoided a concentration of losses in the financial sector. Moreover, financial institutions appear to have used credit risk transfer markets quite effectively to manage their credit portfolios, and to diversify their risks regionally. This seems to have contributed to a better allocation of credit risk.

Second, the international financial system has already weathered the sharp rebound in bond yields that took place during June and July 2003, without experiencing systemic problems. Admittedly, this setback occurred from very low interest rate levels. Nevertheless, the global financial system did exhibit a noteworthy capacity to cope with a period of extreme volatility. This may reflect improvements in risk management. The dynamics of the increases in bond yields last summer were similar to those in the spring of 1994 - an episode so painful for the financial sector that it has become a standard scenario in the stress tests that major financial institutions perform to check their risk management systems. Hence banks and others have been able to learn from such past episodes.

Third, financial institutions have shown a greater capacity to absorb shocks than in the past. Of course, there have been significant differences in performance across major countries. Nevertheless, banking systems today are better capitalised overall than at any time in the 1990s.

This reassuring picture does not mean that the present situation is without risks. It is not difficult to paint a much less encouraging scenario. For instance, any sudden unwinding of positions by leveraged investors would itself accentuate volatility, and perhaps trigger further adjustments by the wider investor community. Higher interest rates could well undermine present asset valuations. Debt service burdens of households and corporations could rise and lead to a deterioration in loan quality across the financial system.

Whether this scenario is plausible or not depends on the answers to several questions. How far are borrowers and financial institutions prepared for higher interest rates? What would be the effect of a sharp, discontinuous adjustment? Could this phase of low interest rates and strong liquidity growth be creating new problems that may be difficult to discern just now? These questions need to be kept clearly in mind, even if one is broadly optimistic about near-term prospects.

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These issues underline the truly global challenge of maintaining financial stability, and the relevance of international cooperation among central banks and financial supervisors. So let me close with just a few remarks on the role of the BIS in addressing these - and of course other - issues relating to financial stability. Generally, the BIS contributes in two areas:

One is the exchange of information and the discussions that take place among central banks and other authorities who are responsible for financial stability. Central banks are not directly responsible for each and every aspect of financial stability, but they are the guardians of the overall soundness of their national financial systems. They are also seen as the lender of last resort - whatever that means in practice. Central banks therefore attach great importance to careful monitoring of the various building blocks of the financial system. The standing committees of experts hosted by the BIS - the Basel Committee on Banking Supervision, the Committee on the Global Financial System, and the Committee on Payment and Settlement Systems - cover these building blocks. And last but not least, financial stability issues occupy a prominent place on the agenda of the central bank governors when they meet every other month at the BIS, right here in Basel.

The other area of interest to the BIS comprises efforts to improve the structural resilience of the financial system. The challenge is to promote sound risk management practices in a way that ensures that financial institutions are adequately capitalised and prudently managed - while not hindering their ability to pursue opportunities and profits responsibly. To achieve this goal, BIS committees are involved in the formulation of various internationally accepted codes and standards for both financial institutions and markets.

The most important initiative in this regard is the New Basel Capital Accord, perhaps better known as "Basel II". The Accord is intended to reflect the improvements in banks' abilities to identify their risks. It is also intended to align regulatory capital requirements more closely with the actual degree of risk that banks face. But equally important, the New Accord will provide incentives for banks to improve their management of risks.

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Let me conclude. Very accommodative macroeconomic policies and the rise of China have been supporting global growth. These forces will at some point have to be brought onto a sustainable path in a way that avoids abrupt changes in expectations in financial markets. The main risk is high volatility in global bond markets, perhaps with an "overshooting" of bond yields. The chances that financial institutions can absorb higher interest rates are at present good, thanks to improvements in recent years in their identification and management of financial risks. The BIS has played its part in this process. And it will continue to do so. Ensuring monetary and financial stability is a permanent challenge which demands that policymakers keep their eyes open to risks and are prepared to address them.