BANK FOR INTERNATIONAL SETTLEMENTS

General Manager's speech

Speech delivered by Malcolm D Knight
General Manager of the BIS

Basel, 26 June 2006

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General Manager of the BIS

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in Basel on 26 June 2006

Ladies and Gentlemen

We can draw a good deal of satisfaction from economic performance over the past 12 months. The world economy grew much more rapidly in 2005 than was anticipated this time last year, and inflation has remained low despite big increases in oil prices. Most forecasters expect a similarly favourable outcome in 2006. And, until very recently at least, a remarkable degree of calm pervaded financial markets.

In the past several weeks, however, volatility in financial markets has risen across the globe. A sustained but moderate increase in real long-term interest rates – which are in many ways central to the pricing of assets, both real and financial – seems to have finally occurred. Equity price indices in some markets have fallen by more than 20% from their peaks earlier in the year. Trading in certain instruments has been heavy, and some investors have suffered sizeable losses; but the financial system has up to now proved to be quite resilient to a significant shift in market sentiment.

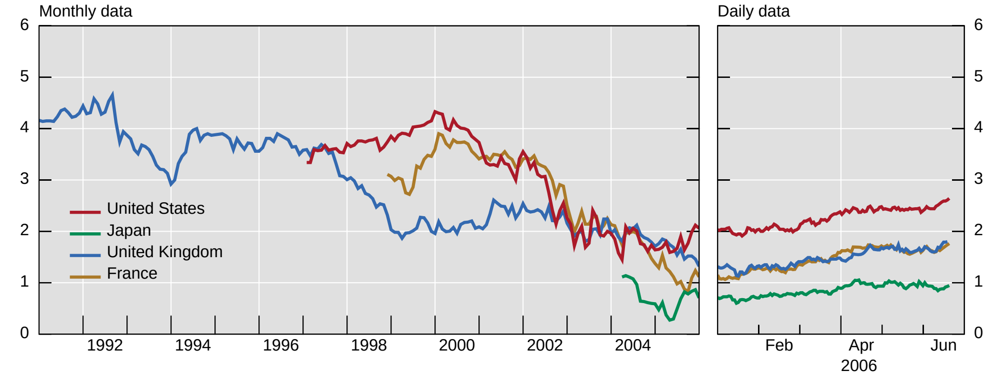
Even so, the financial environment has changed. In order to understand why this may well have implications for central banks, it is useful to step back and to analyse the links between growth and financial market developments over the past few years.

Real interest rates had been on a declining trend since the late 1990s. Graph 1 shows the movements of index-linked yields in some key currencies. It is striking that the decline that began in the late 1990s continued in 2004 and 2005 despite a marked rise in global growth. Real interest rates in the United States and most of Europe went down to between 1 and 2% – extremely low by historical standards. Although an unusually long period of easy monetary policies has played a part, this trend appears to have been secular, international and market-driven – and remains rather puzzling.

Graph 1

Yields on long-term index-linked bonds

In per cent



Sources: Bloomberg; national data.

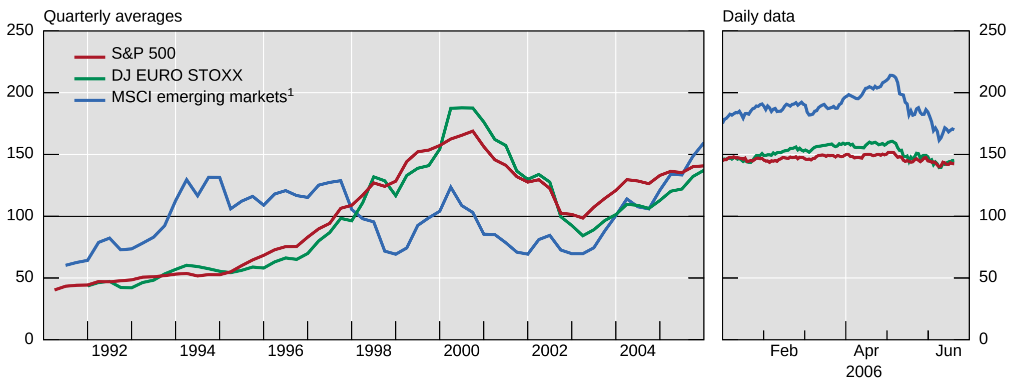
Many explanations have been put forward for lower real long-term rates. These include: higher global saving combined with only moderate investment demand; low and stable inflation, which has reduced the inflation risk premium; financial innovation, which has enabled investors to reduce aggregate portfolio risk, and thus made them more willing to hold longer-term assets; and, finally, rising demand for bonds on the part of both institutional investors and central banks. As long as such elements remain in place, there may be reason to believe that the average level of real yields over a full interest rate cycle could well be lower in the future than it has been in the past.

Whatever the reasons, the secular decline in real yields over the past decade had doubtless lowered the discount factor applied to future incomes. This would have a major impact on the pricing of durable real and financial assets even if expected future incomes did not change. Equity and house prices, as well as the prices of many other asset classes, have indeed risen substantially in recent years. By way of illustration, Graph 2 shows three common indices of equity prices, which – even after the recent correction – are still high by historical standards.

Graph 2

Equity prices

1991–2005 = 100



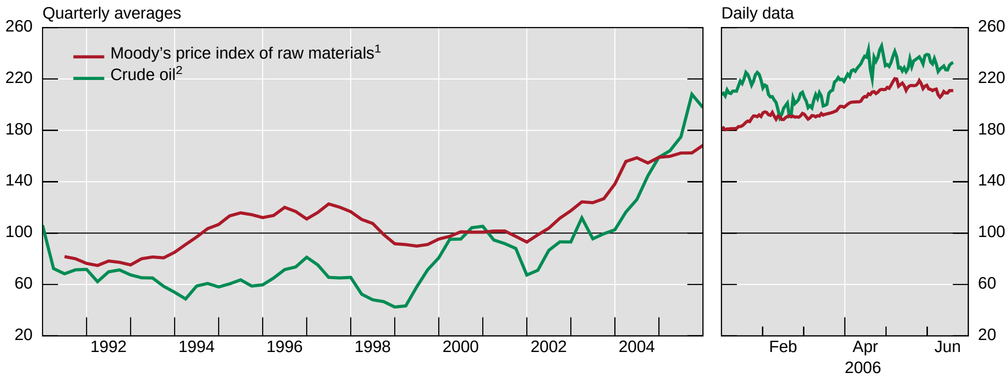
[1] In US dollar terms.

Sources: Morgan Stanley Capital International; national data.

The rise in commodity prices has also been broadly based, and seemed to gather pace in 2004 and 2005. Again, this happened just at the time that long-term interest rates were falling to low levels. As you can see from Graph 3, the upward momentum of commodity prices – very strong earlier this year – appears to have been broken in recent weeks. But price levels remain high.

Graph 3 **Commodity prices**

2000 = 100



[1] Made up of 15 commodities (cocoa, coffee, copper, cotton, hides, hogs, lead, maize, rubber, silk, silver, steel scrap, sugar, wheat and wool) weighted by the level of production or consumption in the United States. [2] West Texas Intermediate.

Sources: Bloomberg; Datastream.

The big surprise has been that strong aggregate demand growth for several years, rising asset prices and very large increases in commodity prices have not yet led to a generalised rise in inflation. Many explanations of this puzzle have been proffered: greater central bank credibility; more competitive domestic markets; and increased supply from China, India and other countries. The jury is still out on this question. But we do know that this long disinflation was not the result of large increases in policy interest rates – which played such a large role in the late 1970s and 1980s – because policy interest rates in many countries have been rather stable and have remained low until recently.

Since we do not fully understand the underlying causes of this "great disinflation", it would be imprudent to count on the happy combination of strong growth and low inflation lasting indefinitely. At some point, central banks may well have to act more forcefully on policy rates than they have needed to do in the past few years. This is understood by many market participants, who have attributed the recent rise in market volatility to worries about central bank reactions to more uncertain macroeconomic prospects.

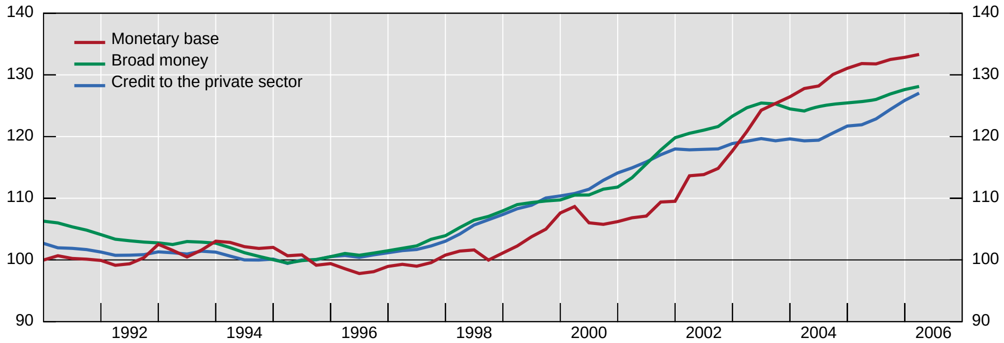
Inflation risks are now seen to be greater than they have been for some time. During the past 12 months or so, the pattern of world growth has become more broadly based and global excess capacity has been reduced. Hence the risk has become greater that positive shocks to demand could trigger a generalised rise in inflation worldwide. At the same time, it has become much harder to assess a number of important medium-term forces affecting inflation. We have witnessed a substantial rise in house prices in many countries: will this eventually feed into consumer price indices and wages? What will be the net impact on inflation of the further integration of China and India into the world economy? What if the price of oil were to climb even further over the next two to three years?

One particular concern for central banks has to do with the ultimate consequences of the large expansion in monetary aggregates and in credit in recent years. Graph 4 shows the weighted G3 monetary base (red line), broad money (green), and credit to the private sector (blue) relative to nominal GDP since 1991. As you can see from the graph, these measures of liquidity consistently grew at about the same rate as nominal GDP until around 1997. But since then all aggregates have grown much faster than nominal GDP, and the pace shows little sign of abating. Could this contribute to future inflation pressures? Indeed, has it already contributed to the elevated asset prices I have just referred to?

Graph 4

G3 monetary and credit aggregates

Relative to nominal GDP; 1995 = 100



Note: Data for the G3 (the United States, euro area and Japan) are weighted averages, based on 2000 GDP and PPP exchange rates. Prior to 1999, euro area data are calculated from member countries' statistics.

Source: National data.

All these uncertainties about inflation and asset prices mean that, at the current juncture, central banks need to be especially vigilant towards the threats to medium-term price stability. Most observers still expect inflation to remain low. But some early signs that inflation expectations may have edged higher and consumer price inflation has increased are worrying.

Monetary policy in the United States has already been tightened significantly. Policy has also become somewhat less accommodative in the euro area. Japan has indicated its intention to move away from an extremely accommodating monetary policy, but the policy rate is still at virtually zero. Several Asian central banks have increased policy rates, although in many cases rates are still low or even negative in real terms.

It is not clear how far policy rates will need to rise. Because it is only recently that long-term interest rates have increased and financial conditions tightened, the lagged effects of earlier policy tightening may take longer to be felt than in the past. In addition, a near-simultaneous tightening by all central banks might have a larger than expected impact on markets and on global demand. Given these uncertainties about both the outlook for growth and inflation and the monetary transmission mechanism, policy must remain pragmatic. Assessments of the macroeconomic outlook will have to evolve in the light of incoming data. This may be harder than usual in current circumstances as changing risk appetite can itself have implications for domestic demand.

In any event, financial market participants need to be aware that the future path of short-term interest rates cannot be predicted with any certainty: the major central banks are rightly committed to taking whatever measures are required to maintain price stability.

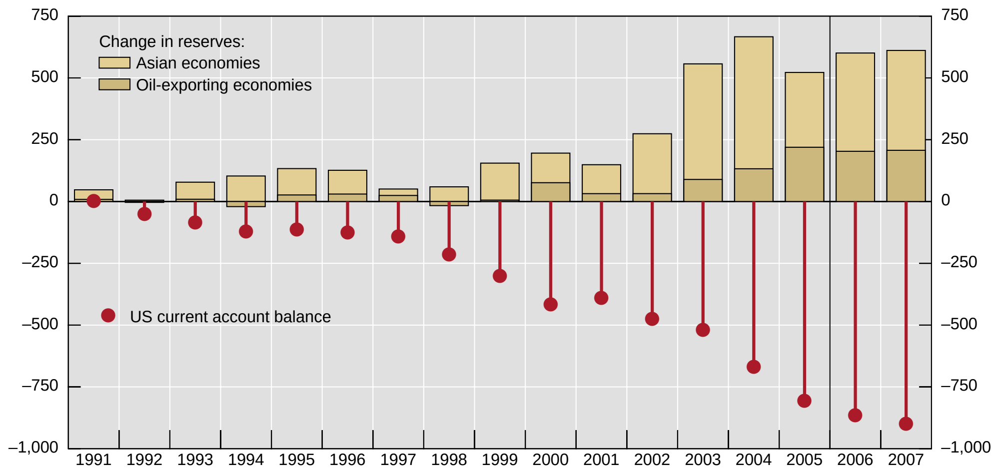
Central banks and other institutions responsible for the oversight of the financial system had been warning market participants for some time that the combination of very low interest rates and exceptionally limited volatility in the markets could not last for ever. The recent jump in volatility should remind financial firms of the need to regularly stress-test their positions for adverse shifts in market or economic conditions.

Another major imponderable is the impact of large and widening current account imbalances. The latest forecasts from the IMF are for a US current account deficit of almost 7% of GDP this year and in 2007 (the red lines in Graph 5). A deficit of this size, reflecting in part inadequate national saving in the United States, cannot continue forever. We can, it is true, take some reassurance from the fact that the United States has such a strong and vigorous economy that the attractions of US assets to millions of foreign investors can sustain a current account deficit of some size.

What is less reassuring is that a significant part of this deficit has been financed by prolonged and massive intervention by central banks in countries with current account surpluses resisting exchange rate appreciation. During the period 2002 to 2005, the official foreign exchange reserves in Asia (including Japan) rose by about 1,400 billion dollars. Yet many expect this pattern to continue into this year and next: Graph 5 shows the current working assumptions of the IMF.

Graph 5 **US current account deficit and reserves of Asia and oil-exporting economies**

In billions of US dollars



Note: Data for 2006 and 2007 are forecasts.

Source: IMF.

There are good international and domestic reasons why reserve accumulation on this scale cannot continue indefinitely. Internationally, delaying exchange rate adjustment almost always runs the risk that any eventual realignment could be more abrupt, and harder to control, than if a greater degree of flexibility had been allowed earlier. Domestically, it has become more and more difficult to effectively contain the expansionary monetary consequences of large purchases of foreign exchange. In some cases, the scale of intervention is causing distortions in the local financial system.

Several Asian countries have indeed allowed their currencies to appreciate over the past year or so. China, which has long recognised the medium-term need for exchange rate adjustment, has begun a transition to a more market-based mechanism. This should in time also give it more supple instruments of monetary control. Much depends on how well these objectives are translated into early and effective action.

Up to now, I have concentrated on the challenges for central banks. Before I conclude, I would like to stress that governments also have work to do to ensure steady non-inflationary growth in the years ahead. Two areas, in particular, are important.

The first area that needs action is fiscal policy. The US government budget deficit has averaged around 4½% of GDP over the past four years – and the budget was in surplus as recently as 2000. Fiscal deficits in some large economies in the euro area are also much too high. Given current high debt levels as well as future spending implied by current health and pension commitments, the medium-term prospects for fiscal positions in many industrial countries are worrying.

By contrast, the progress that some emerging economies have made in tackling fiscal deficits is encouraging. And numerous major oil exporters – including Algeria, Nigeria, Russia, Saudi Arabia and several other states in the Gulf – have taken care to manage the windfall gains from higher oil prices more prudently than in the past. Nevertheless, deficits and debt levels in some large developing countries are still too high.

The second area that should not be neglected is microeconomic reforms. One important reason the world economy has grown so strongly in the past five years with so little overt inflation is that a greater proportion of global economic activity has come to be governed by the market. Radical reform in the large command economies and in other over-regulated economies in the developing world has transformed their growth prospects. In addition, trade liberalisation in recent years has helped keep inflation low.

Those who resist reforms need to bear this experience in mind. It is true that structural reforms often have short-term costs and do not produce results quickly. But the evidence of the past decade is that they really do work. The environment of a more competitive world economy requires greater adaptability and even greater determination to conclude multilateral trade agreements that benefit us all.

We should not underestimate the difficulties of managing a new world in which the new economic giants – Brazil, Russia, India and China, to follow the order of the well known BRICs mnemonic – are increasingly shaping the world economy. Their rise has changed the global inflation process and the international adjustment mechanism in ways we must strive to better understand. The pace of change within the new economies themselves has been very rapid, and policy frameworks, governance structures and so on have not always kept up. Growing economic weight itself creates new international responsibilities. At the same time, the structures of multilateral cooperation need to adapt to these new economic realities. As you know, change is under way at the BIS to help central bank cooperation evolve accordingly. We firmly believe that this will position the BIS to pursue its long-standing mission of fostering frank dialogue and debate among central banks about these major global issues.