BANK FOR INTERNATIONAL SETTLEMENTS

General Manager's speech

Prospects and policies for the global economy

Speech delivered by Malcolm D Knight
General Manager of the BIS

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General Manager of the BIS

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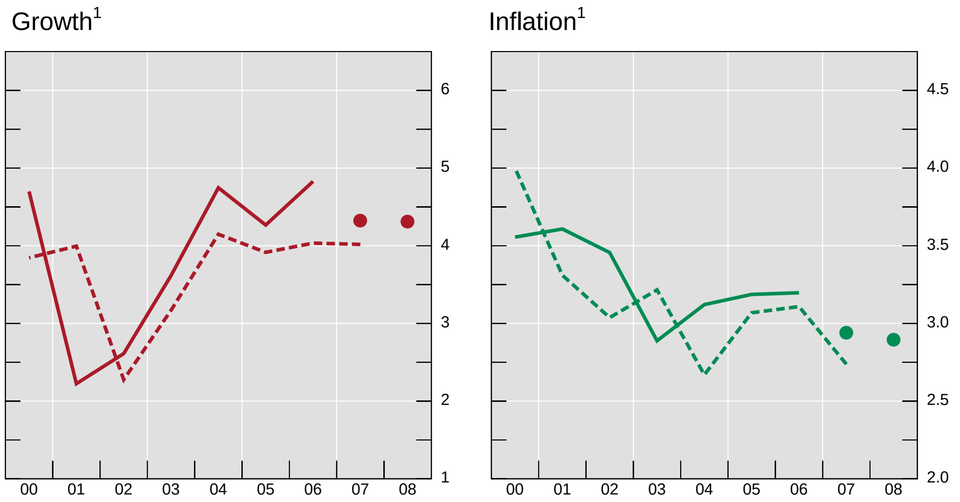
Ladies and Gentlemen

The year 2006 was another remarkable one for the world economy. The left-hand panel of Graph 1 shows that global growth exceeded consensus forecasts by a wide margin. Total world output expanded by more than 4% for the fourth consecutive year, one of the strongest spells in the postwar period. Moreover, compared with recent experience, the expansion was more broadly based internationally. As a result, the unemployment rate tended to decline in a large number of countries. At the same time, inflation remained generally subdued in most countries, much as expected, as can be seen in the right-hand panel of the graph. And all this went hand in hand with continued strong performance in the financial sector.

Remarkable macroeconomic performance



[1] In per cent. The dashed lines show the consensus forecasts made at the end of the preceding year; the dots show forecasts for 2007 and 2008 as of May 2007. Annual changes in real GDP and consumer prices. Average of countries available in Consensus Economics.

Sources: © Consensus Economics; national data; BIS calculations. Graph 1

From a longer-term perspective, the past year was only the latest confirmation of what some observers have called the "Great Moderation" – the extended historical period of comparatively low volatility of both output and inflation that we have been witnessing. To be sure, the road has not been smooth for all: since the late 1980s, a number of countries have experienced serious financial and macroeconomic distress, not least Japan and other Asian economies. Even so, the last decade at least may well go down in history as a "golden age".

The consensus forecast for 2007 and 2008 points to a continuation of these recent developments. As the red dots in the left-hand panel of Graph 1 indicate, the rise in global output is forecast to moderate towards estimates of trend growth. It is also expected to become more balanced, both across expenditure categories, with corporate spending firming and residential investment slowing down, and across countries, with the rest of the world gaining further in relation to the United States. Likewise, inflation is expected to remain quiescent, as indicated by the green dots in the right-hand panel.

Policymakers can and should draw considerable satisfaction from this sustained strong performance. To a large extent, it has been the result of the remarkable force of globalisation, both real and financial, supported by sounder and market-oriented macroeconomic and structural policies. Central banks' anti-inflation resolve has played a key role in this achievement.

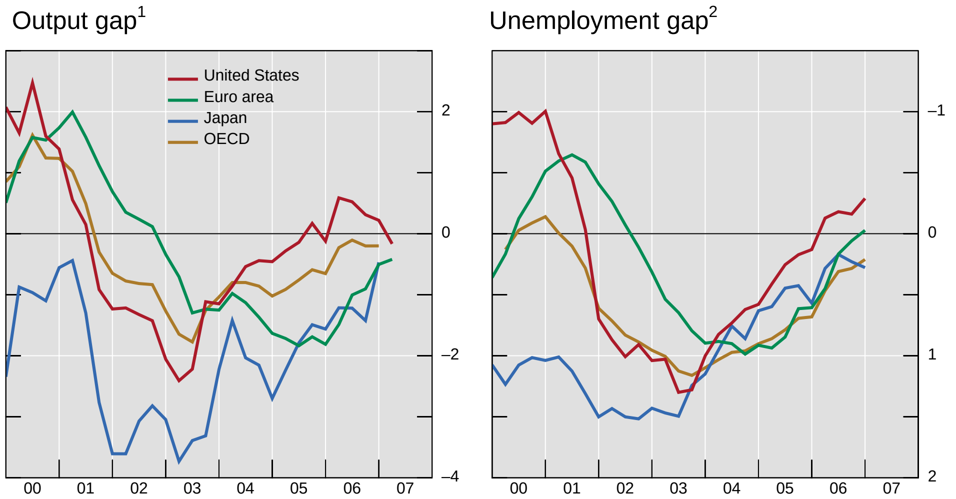
And yet, it is precisely at times like these that we should avoid complacency. It is incumbent on prudent policymakers to scrutinise the economic landscape to see whether, under the tranquil surface, tensions might be building up. For it is not prudent to base policies on central scenarios alone. And we should openly admit the limitations of our knowledge.

In that spirit, let me put on a geologist's hat, if you will, and try to explore some potential fault lines in the tectonic structure of the world economy, looking for signs of the slow build-up of pressures that might suddenly erupt. In particular, I would like to focus on three potential fault lines, associated, respectively, with the inflation outlook, the features of the financial cycle under way, and the global configuration of countries' external positions.

Inflation performance was again remarkably benign in 2006 and the first half of 2007. Headline inflation broadly tracked the fluctuations of energy prices, but remained moderate overall. In addition, inflation continued to prove less sensitive than in the past to indicators of domestic tightness or slack. And, barring some isolated hiccups, long-term inflation expectations hardly budged in response to changes in the headline figures.

Beneath the surface, however, tensions might be building up. Inflation excluding food and energy prices seems to have gradually trended higher in 2006. There are signs that excess capacity is being absorbed simultaneously in a number of large economies around the world. As you can see in Graph 2, this is so regardless of whether excess capacity is measured in terms of deviations of output from trend or deviations of unemployment rates from estimates of the non-accelerating inflation rate of unemployment (NAIRU). Wage demands appear to be increasing and in some countries surveys indicate that firms seem to be regaining pricing power. The tailwinds of globalisation may have abated,

Declining economic slack



[1] As a percentage of potential output. [2] Unemployment rate minus NAIRU, in percentage points; inverted scale.

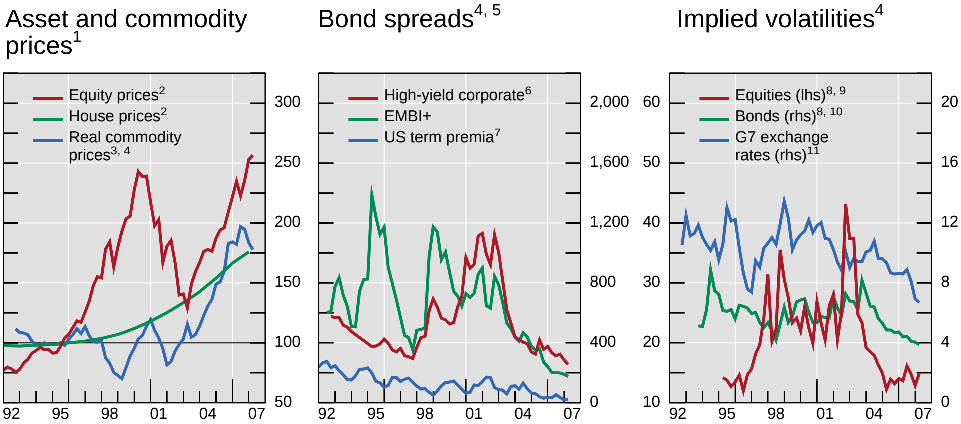
Sources: OECD; national data. Graph 2

at least temporarily, as suggested by rapidly rising wages in countries such as China. More generally, considerable uncertainty surrounds the potential cumulative effect of having kept policy interest rates so low for so long, as also reflected in the cumulative expansion of monetary and credit aggregates – a point I will return to later. And it would not be prudent to take much comfort from the stability of inflation expectations, given how little we know about their determinants.

What about financial vulnerabilities? The three panels of Graph 3 all present indices which show that *financial markets* have had a remarkable run during the global recovery since the slowdown in 2001. As can be seen from the left-hand panel, asset prices have been surging. The strong growth of residential property prices in large parts of the world has supported unusually buoyant mortgage markets. Equity prices have recovered from the global crash of 2000, and commodities as an asset class have been yielding very attractive returns to investors for some time. As shown in the centre panel, risk premia, especially for fixed income assets, have been reaching historical lows, whether such securities are subject to default risk or not. And, as indicated in the right-hand panel, except for very brief periods, measures of short-term volatility have been unusually low across a broad spectrum of asset classes, including foreign exchange. More generally, activity has been very strong and has underpinned record profitability in many sectors of the financial industry worldwide.

These trends may well continue for quite some time. But the question is whether they might not already have gone too far. To be sure, the robust performance of the world economy can in part justify such vibrancy. Even so, it is hard not to detect in the current climate that sense of exuberance, even hubris, that in the past has not augured well for subsequent developments. The rapid recovery following the two spikes in volatility in the past year, in

Buoyant asset markets



[1] 1995 = 100. [2] Sixteen OECD countries; weighted averages based on 2000 GDP and PPP exchange rates. [3] Goldman Sachs Commodity Index, in US dollar terms, deflated by US CPI. [4] Quarterly averages. [5] In basis points. [6] As from December 1997, simple average of US and euro area high-yield indices, otherwise US index only. [7] Estimated for 10-year zero coupon Treasuries. [8] Simple average of United States and Germany. [9] Derived from the price of call option contracts on stock market indices. [10] Price volatility implied by the price of call options on 10-year government bond futures contracts. [11] JPMorgan benchmark index for the level of G7 currencies' implied volatility.

Sources: Bloomberg; Datastream; Merrill Lynch; JPMorgan Chase; OECD; national data. Graph 3

May–June 2006 and February–March 2007, has no doubt pointed to considerable resilience in financial markets. But it is also another sign of the continued high risk tolerance that pervades markets.

Under these conditions, the risks are twofold. First, financial markets could themselves be a source of disturbances and strains. Second, and more importantly, vulnerabilities there could tend to amplify any slowdown that might occur in the real economy. In particular, the performance of financial markets during the two spikes in volatility does not provide much evidence of how they might cope in a more testing macroeconomic environment.

From this perspective, any downside risks to the global economy merit particular attention. Here, the picture is mixed. On the one hand, some risks are indeed present. The US economy, for instance, could turn out to be less robust than is currently anticipated, especially if the problems in the housing markets prove longer-lasting. While the rest of the world may appear better able to withstand the corresponding knock-on effects than earlier in the decade, too little is known about the strength and nature of the financial and psychological linkages in an increasingly globalised world. More generally, broader questions could be asked about the resilience of consumer spending, supported as it has been in many countries by strong perceived wealth gains from asset prices, especially housing, and rising indebtedness. On the other hand, the welcome gradual normalisation of policy interest rates that has taken place, and a certain improvement in fiscal positions, have increased the room for manoeuvre to respond to any slowdown. The room would definitely be more constrained, however, if the trigger was a surprise resurgence of inflation that induced a sharp monetary tightening.

The global configuration of countries' large *external positions* has also proved remarkably robust. Indeed, current account deficits continued to be easily financed in the past year. And the fact that, as shown by the lines for various regions in Graph 4, current account balances broadly stabilised as a share of GDP contributed to the apparent benign neglect of these developments in financial markets. At the same time, gross and net capital flows into emerging market economies continued unabated. The result, as shown by the bars in Graph 4, was a further accumulation of foreign exchange reserves on an unprecedented scale, especially in some Asian countries and among net oil exporters.

These trends in global imbalances and reserve accumulation, too, could well continue for quite some time. Again, however, the question is what collateral damage and distortions they may be generating. Some of these distortions pertain to the domestic economy. In current account deficit countries, the positions have largely tended to reflect buoyant consumer spending and associated declines in household saving as opposed to the accumulation of productive capital that could raise future incomes. As regards current account surplus countries, in those economies that have been building up reserves it has proven increasingly difficult to forestall rapid monetary and credit expansion and asset price rises, which could be aggravating vulnerabilities to financial strains and future inflationary pressures. The efficiency of domestic financial systems could also be compromised by these developments. Other distortions pertain more to the global financial system. The management of unprecedented volumes of foreign exchange reserves by the public sector, concentrated in a handful of countries, is bound to raise

Large current account balances and unprecedented accumulation of reserves

In billions of US dollars

Data for 2007 and 2008 are forecasts.

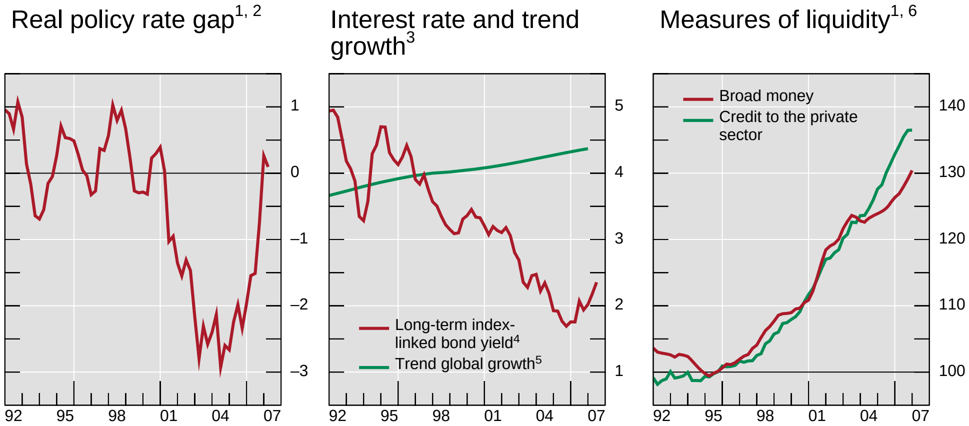
Source: IMF. Graph 4

major challenges of an economic and even a political nature. More broadly, the threat of economic protectionism should not be underestimated.

No doubt there are many factors behind the three fault lines on the fronts of inflation, financial market developments and external positions. But if pressed to choose a single one that, to varying degrees, lurks behind them, either as a cause or as a symptom, I would point to the unusually low level of inflation-adjusted interest rates that has prevailed for so long, as indicated in the left-hand and centre panels of Graph 5. And this at a time when, paradoxically, the long-run equilibrium level of such rates may well have risen, in line with the higher growth potential of the world economy shown in the centre panel, and linked to globalisation and the spreading of technological gains.

Although longer-term interest rates have risen in recent weeks, the footprints left by this long period of remarkably low real interest rates can easily be traced. Resistance to exchange rate appreciation – resistance which has been accompanied by that form of risky financial arbitrage known as "carry trades" – has helped to transmit the low levels of interest rates prevailing on some key currencies to the rest of the world. The investment of the unprecedented volumes of reserves in government securities denominated in key currencies has in turn added to the downward pressure on term premia. A lower discount factor has been a powerful influence behind rising leverage and asset prices, both real and financial. And low interest rates have encouraged the pervasive search for yield in asset markets. As is highlighted in the right-hand panel of the graph, the rapid expansion in monetary and credit aggregates that we have observed for some time is part and parcel of the same phenomenon – what market participants succinctly refer to as "liquidity", a sense that funds are easily available on extraordinarily enticing terms.

Low interest rates and ample global liquidity



[1] Sixteen OECD countries; weighted averages based on 2000 GDP and PPP exchange rates. [2] Real policy rate minus natural rate. The real rate is the nominal rate adjusted for four-quarter consumer price inflation. The natural rate is defined as the average real rate 1985–2005 (for Japan, 1985–95; for Switzerland, 2000–05) plus the four-quarter growth in potential output less its long-term average. [3] In per cent. [4] From 1998, simple average of Australia, France, the United Kingdom and the United States; otherwise, only Australia and the United Kingdom. [5] Trend world real GDP growth as estimated by the IMF. [6] Relative to nominal GDP; 1995 = 100.

Sources: IMF; OECD; Bloomberg; national data; BIS calculations and estimates. Graph 5

Based on this analysis, what are the policy challenges ahead? Some of them pertain to authorities other than central banks. There is, for instance, a need for further prudence in fiscal policy, so as to take advantage of the good times. The continuing build-up of hidden liabilities associated with social security and health care costs adds to the urgency of such action. In addition, structural policies aimed at further increasing the flexibility of labour and product markets would be welcome. Not least, policies aimed at facilitating the shift of resources between tradable and non-tradable sectors in both surplus and deficit countries would help to support the smooth adjustment of external positions. Other challenges pertain more directly to central banks and supervisory authorities that are in charge of monetary and financial stability.

As regards monetary policy, the authorities should continue gradually to normalise the level of policy interest rates as long as domestic conditions allow. This would help to contain any inflationary risks. And it would also have the collateral effect of helping to lean against any build-up of further vulnerabilities in financial markets associated with the underpricing of risks. Such normalisation would also mean allowing the exchange rate to do more of the work in those countries where the authorities have been intervening heavily.

As regards prudential policy, the authorities should take action along a number of mutually supportive lines. First, they should redouble efforts to strengthen the financial infrastructure. The steps taken in the recent past to improve confirmation and settlement of credit derivatives trades are an excellent example. In emerging market economies, the good work done to develop domestic capital markets should continue. Second, authorities should take steps through the supervisory review process to encourage prudent behaviour. The recent report by the Financial Stability Forum calling for greater transparency of risk profiles and better counterparty risk management vis-à-vis hedge funds is a useful step in this direction. So are efforts to encourage improvements in stress testing or to instil caution in lending behaviour, not least in emerging market economies. Third, the authorities should continue to make progress in upgrading regulatory arrangements. Further decisive steps towards the implementation of the core principles for effective banking supervision would be welcome. More generally, as elaborated in this year's BIS Annual Report, further thought should be given to ways of strengthening the macroprudential orientation of regulatory and supervisory frameworks. Last but not least, quiet efforts to improve the mechanisms for addressing potential financial distress, if it were to emerge, should continue.

In pursuing these policies, regardless of their specific nature, one thing is clear. An increasingly globalised world puts a premium on close dialogue and cooperation among national authorities. The BIS will – as it has done throughout its history – continue to act as a forum to foster and deepen such dialogue among all those authorities with responsibility for monetary and financial stability.