Financial deleveraging, inflation and risks to global growth[1]

Notes for remarks by Malcolm D Knight, General Manager, Bank for International Settlements

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Let me speak about the "Interactions among financial deleveraging, inflation and the downside risks to global growth at the current juncture". I will make six points and then conclude.

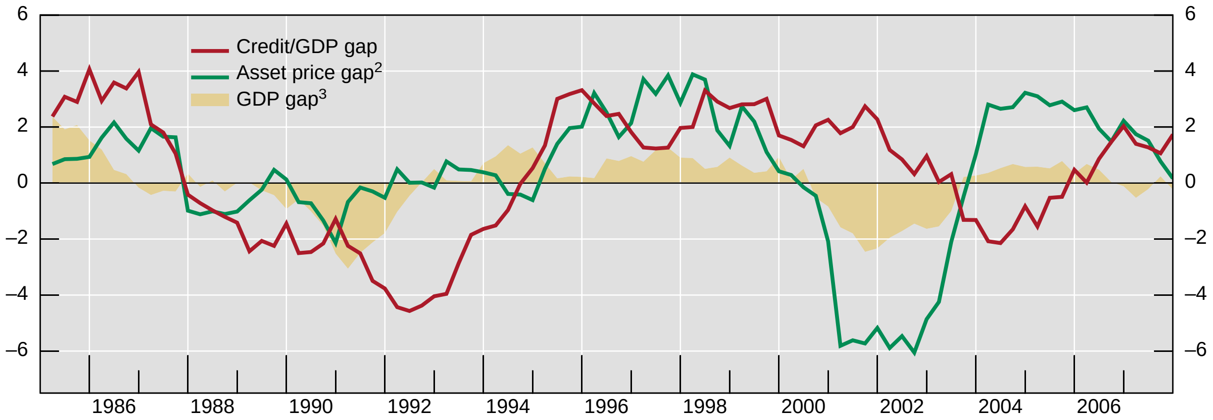
1. First, the financial deleveraging continues and we do not know how far along we are in the process.

- As you can see from the red line in Graph 1, US credit cycles have been quite pronounced throughout the past two decades. Leverage, crudely measured by the normalised credit/GDP ratio, has risen strongly during upswings, and has fallen equally strongly in downturns. And these turns in the credit cycle have usually been associated with market asset price declines (green line) and a weakening macroeconomic outlook (yellow shading). So Graph 1 certainly suggests that we are not at the end of the current deleveraging process.

Graph 1

United States: financial markets and the real economy[1]

In per cent



[1] Deviations from trend. Each trend is derived on the basis of data available in real time. [2] Based on an index of real equity and residential and commercial property prices; scaled down by a factor of 3. [3] Based on the logarithm of real GDP.

Sources: IMF; Bloomberg; Datastream; national data.

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[1] This presentation may differ slightly from that given at the Conference.

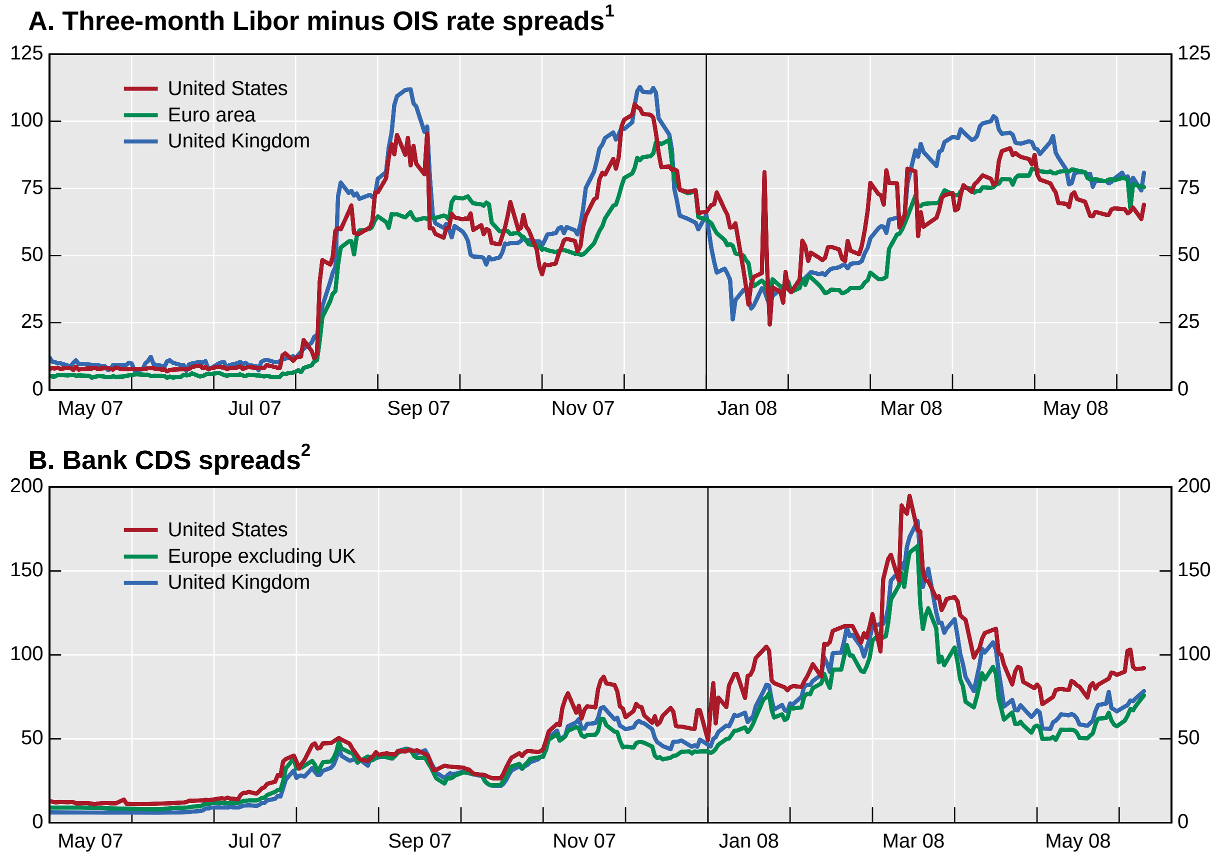
- Furthermore, although Graph 1 makes the present credit cycle look mild, relative to previous cycles, this is because much of the leverage this time round occurred outside the banking system as normally defined, and was concentrated in the less regulated "shadow" banking system. The bottom line: the deleveraging that has still to take place is hard to assess and may be extensive.

2. Second, as everybody in this room knows very well, major episodes of tension keep recurring in the international (unsecured) interbank money markets.

- As you can see from the upper panel in Graph 2, the spread between Libor and the overnight index swap (OIS) rate has remained large since January, despite the efforts of major central banks to ease tensions in term money markets, including coordinated liquidity provision operations, and the easing of policy interest rates, especially in the United States.

Graph 2

Libor and bank credit default swap (CDS) spreads



[1] In basis points. [2] Five-year on-the-run CDS spreads; simple average over major banks, in basis points. For the United States: Bank of America, Citigroup, JPMorgan, Wachovia and Wells Fargo. For Europe: Banco Santander, BNP Paribas, Credit Suisse, Deutsche Bank, UBS and Unicredit. For the United Kingdom: Abbey, Barclays, HBOS, HSBC, RBS and Standard Chartered.

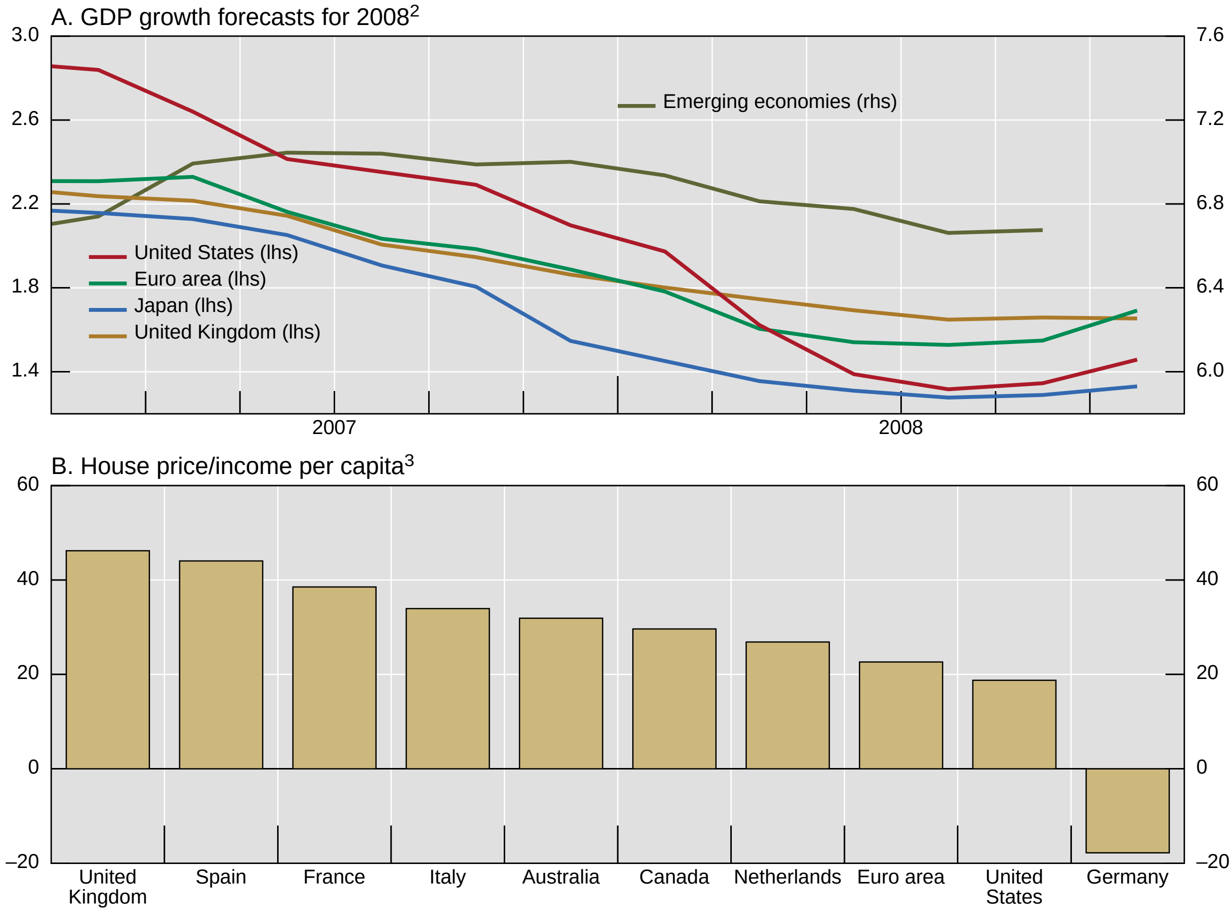
Sources: IMF; Bloomberg; Datastream; national data.

- In addition, tensions have risen markedly around the times of the banks' quarterly reporting, as they attempt to strengthen their reported liquidity positions. There are currently renewed concerns over possible further dislocation in money markets towards the end of the second quarter.

- But the lower panel of Graph 2 shows that CDS spreads have come down a lot since the Bear Stearns rescue in mid-March.
- This pattern of still high Libor-OIS spreads combined with lower CDS spreads suggests that the continued tensions in interbank markets are more associated with liquidity risk than with counterparty credit risk. This could be related to the risk of further drawings on credit lines committed by banks before the current turmoil began. This could, in turn, explain why measured credit growth has so far remained strong in the United States and other major economies despite the tightening of banks' credit standards.

Graph 3

GDP growth forecasts and house price/income per capita[1]



[1] In per cent. [2] Annual changes in real GDP. The observations are positioned at the midpoint of the month in which the forecast was made. [3] Deviation in 2007 from the long-term trend (1995–2005).

Sources: Eurostat; IMF; OECD; © Consensus Economics; Datastream; various real estate associations; national data; BIS calculations.

3. These financial developments – continued deleveraging and asset price declines; tensions in interbank markets; substantial and involuntary increases in banks' balance sheets – suggest increased restraint of new credits for productive activity. So they present significant downside risks to economic growth in the United States and other advanced economies.

- The upper panel of Graph 3 shows that consensus growth forecasts for 2008 have been revised down significantly for key economic regions.
- In the United States, a negatively reinforcing combination of adverse factors is likely to squeeze consumer demand: rising unemployment, higher consumer price inflation, falling housing prices, and the need to rebuild household financial savings. These knock-on effects heighten the downside risks to US demand.
- One obvious risk factor is the overvaluation of residential property in a number of countries where house price/household income ratios are unusually high, as shown by the lower panel of Graph 3.
- These factors are depressing the outlook for output and employment growth in the United States and other advanced economies, even though emerging market economies (EMEs) are still showing remarkable resilience.

4. These downside risks to the global growth outlook have prompted significant monetary easing in recent months.

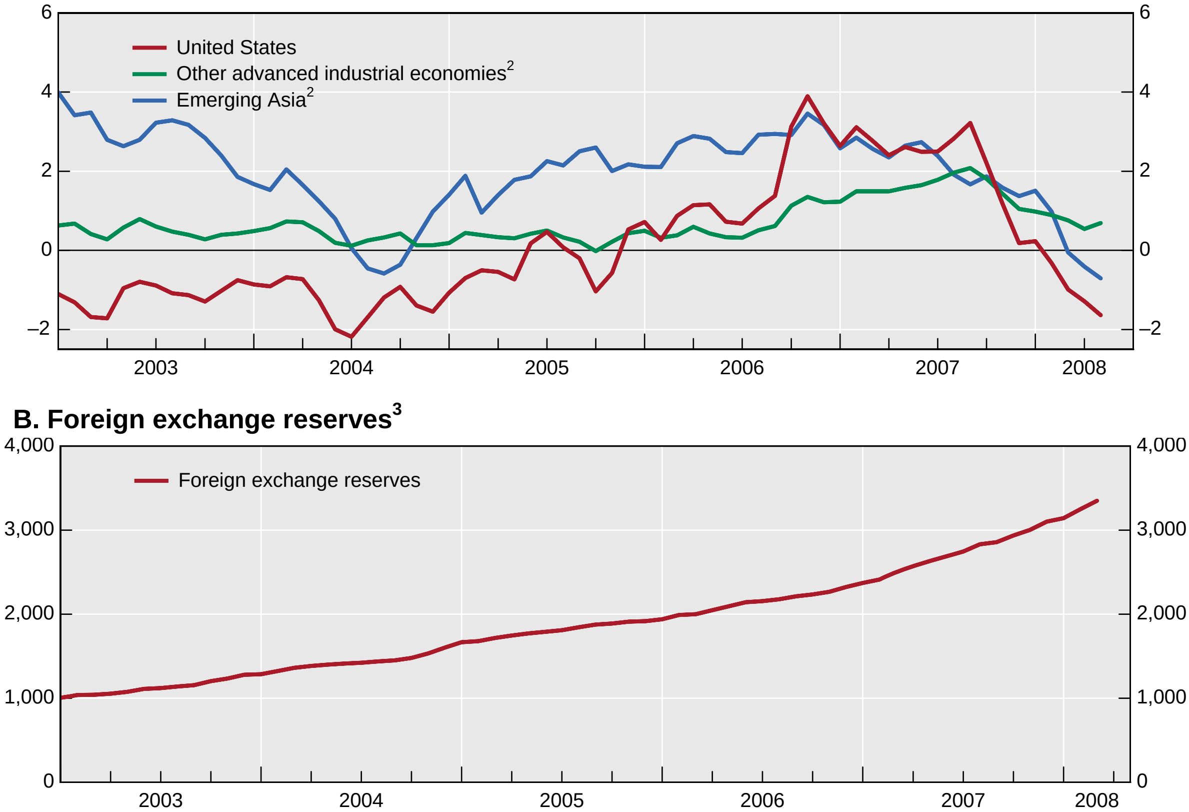
- As you can see from the upper panel of Graph 4, global real monetary policy interest rates, which had already been at low levels for some years, have recently dropped to negative levels in many key jurisdictions.

Graph 4

Real policy rates and foreign exchange reserves of major emerging market economies

A. Real policy rates[1]

B. Foreign exchange reserves[3]



[1] In terms of consumer prices, in per cent. [2] Weighted averages based on 2005 GDP and PPP exchange rates. [3] China, Hong Kong SAR, India, Indonesia, Korea, Kuwait, Malaysia, the Philippines, Qatar, Saudi Arabia, Singapore, Taiwan (China), Thailand, the United Arab Emirates and Venezuela; in billions of US dollars.

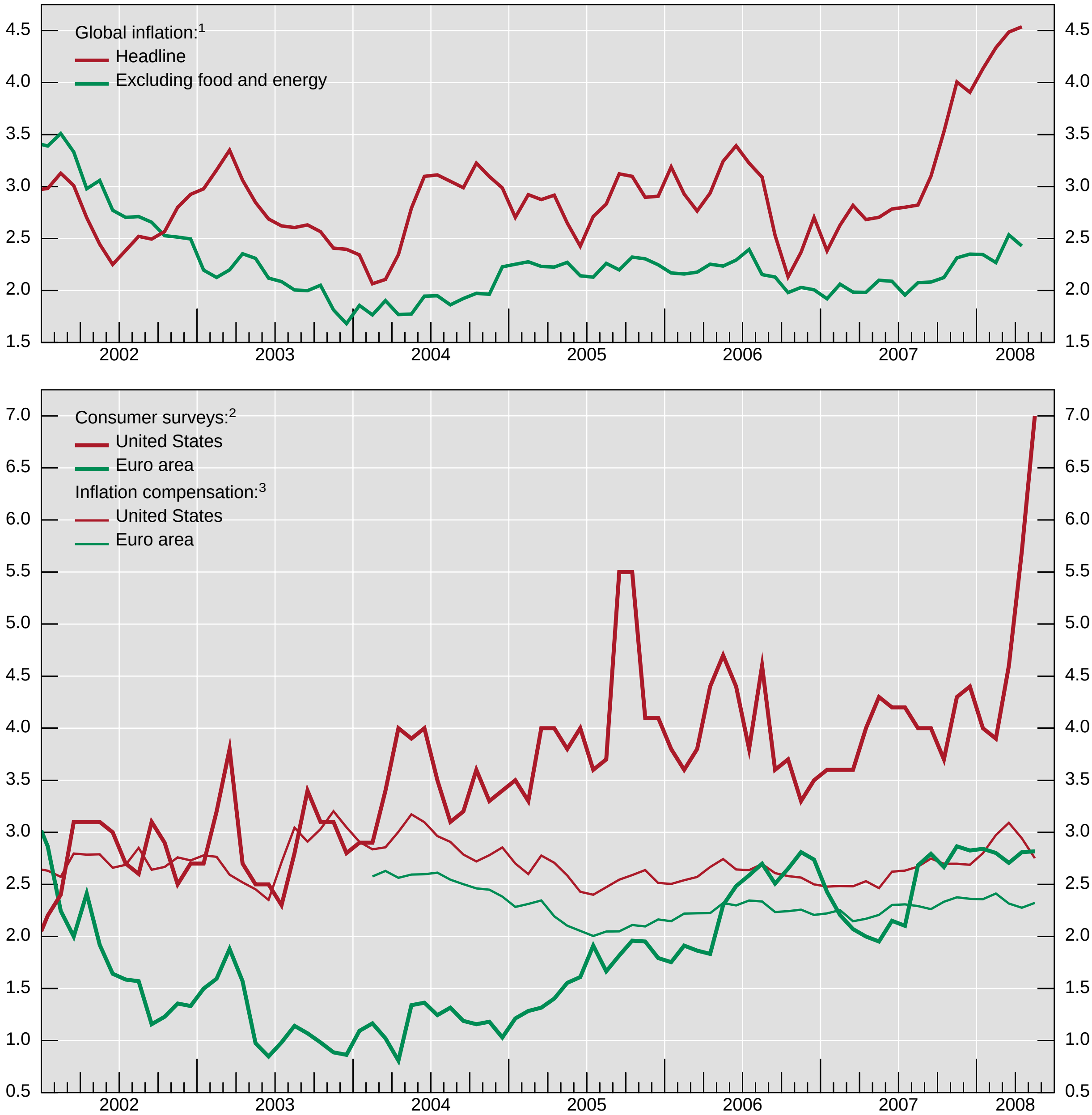
Sources: IMF; Bloomberg; Datastream; national data.

- In addition, and as the lower panel of Graph 4 shows, many countries, particularly EMEs, have been reluctant to allow their currencies to appreciate against the dollar and other key currencies, consequently continuing their massive forex intervention purchases.
- This combination of a rapid and very large decline in real policy interest rates in key jurisdictions and massive foreign exchange interventions by EMEs has been contributing to a large expansion in liquidity at the global level.

Graph 5

Inflation and inflation expectations

In per cent



[1] Twelve-month changes in consumer prices. Weighted averages based on 2005 GDP and PPP exchange rates. [2] Expected change in consumer prices over the next 12 months, based on consumer surveys; for the euro area, figures are normalised by mean and variance of actual HICP inflation rate. [3] Five-year forward break-even inflation rate five years ahead, calculated from estimated zero coupon spot break-even rates.

Sources: IMF; OECD; CEIC; Datastream; national data; BIS calculations.

5. It is arguable that the monetary policy actions taken in recent months to address continuing stress in the financial system and the weakening growth outlook are already inducing increases in actual and expected price inflation at the global level.

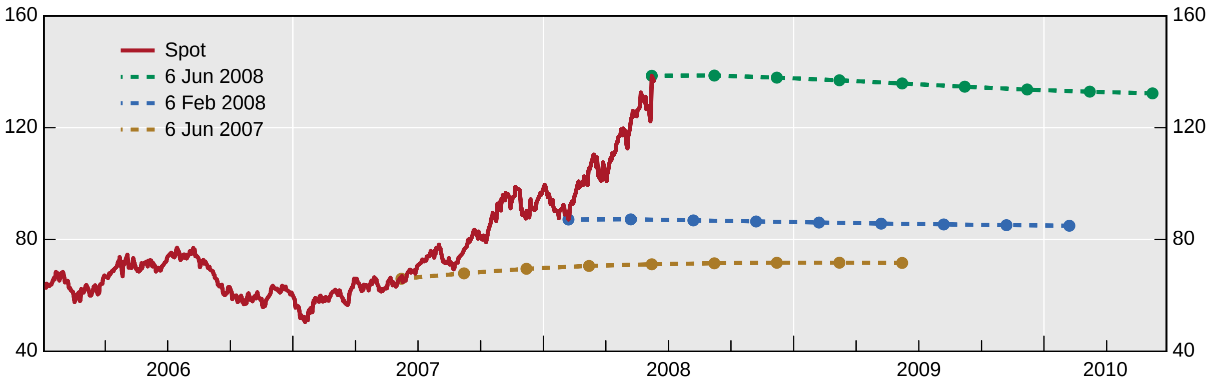
- The upper panel of Graph 5 shows that headline inflation has jumped worldwide and there are also signs that core inflation is picking up.
- Moreover, various measures of long-term inflation expectations have risen recently, as you can see from the lower panel of Graph 5, which shows inflation expectations derived from consumer surveys in the United States and the euro area. Expectations derived from index-linked bonds have also risen – though to a lesser extent.

6. I believe that recent trading and price developments in the oil market are a consequence and a key indicator of the recent pronounced loosening of monetary conditions in a number of key jurisdictions.

- Most observers and the press assume that increases in petroleum prices are an important cause of surging producer and consumer price inflation.
- I would take the opposite view, at least to set the basis for our discussions. I would argue that what we are seeing is an acceleration of expected consumer price inflation in the context of a sharp expansion in global liquidity. It is hardly surprising that the prices of those commodities, such as oil, for which the short-run price elasticities of supply and demand are low move upwards strongly when there is a rise in expected general price inflation. The oil market is a very convenient vehicle to speculate on expectations of higher levels of general price inflation. Hence my view is that the 40% jump in oil prices that has occurred over the past few months – roughly the period during which financial conditions have been loosened sharply – is a reflection of the expectation of either an acceleration of global inflation, or a depreciation of the US dollar, or some combination of the two.

Graph 6

WTI prices and futures[1]



[1] In US dollars per barrel; the red line represents the actual spot price; dashes and dots represent futures prices.

Source: Bloomberg.

- And the fact – as you can also see in Graph 6 – that the dollar price of long-dated oil futures contracts has risen in parallel to spot prices seems to support this view, rather than the alternative view that current spot prices are reflecting temporary tightness in the basic supply-demand balance.

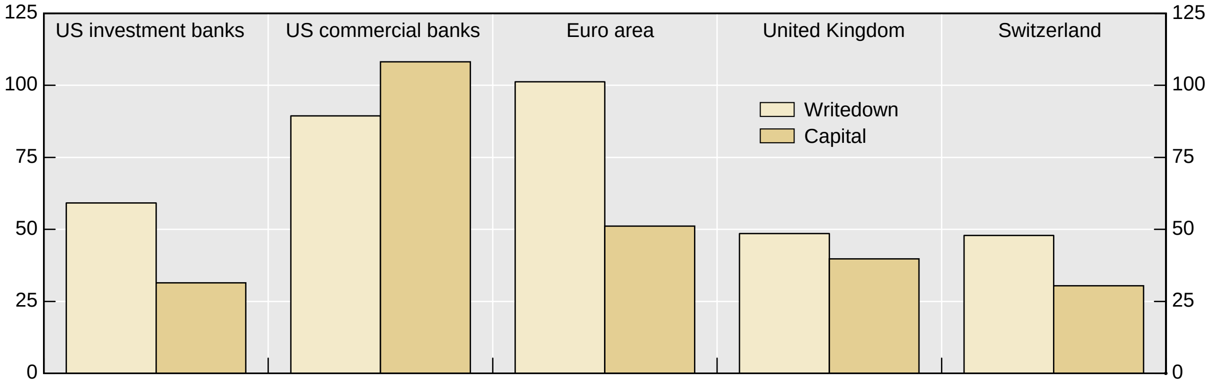
My conclusion: we appear to be entering a period of serious stagflation with sharply rising expected and actual inflation combined with large downside risks to growth and employment.

- These stagflation risks create major uncertainties for the world economy and for the global pattern of exchange rates. So they clearly confront central banks with major policy dilemmas. It is of utmost importance to ensure a less direct feedback effect from rising wages onto prices than in the 1970s. But to do that, central banks must act to keep expected inflation anchored.
- Moreover, while a few weeks ago there was a general expectation that large banks had disclosed the major part of their losses associated with the turmoil, recent reports suggest that further significant writedowns could be in the pipeline, particularly in response to the recent downgrading of the largest US monolines.
- Hence the uncertainties weighing on the global economic outlook are exacerbated by the potential need for banks to further strengthen their capital adequacy. Under normal circumstances, when banks raise more capital, they do so in order to finance profitable investment and, in turn, enhance their return on equity. But the capital raised by banks recently, as shown in Graph 7, has been mainly driven by the need to offset book losses. This capital will thus not contribute to enhancing the underlying profitability of banks or to providing additional credits to economic agents.

Graph 7

Writedowns and capital raised by major banks since the third quarter of 2007

In billions of US dollar



Source: Bloomberg.