BANK FOR INTERNATIONAL SETTLEMENTS

General Manager's speech

Policy challenges from resurgent inflation and financial market turmoil

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

Almost one year after the onset of serious international financial market turmoil – which many expected to exert a deflationary effect on the world economy – we now face the spectre of rising inflation worldwide. The threat posed by the resurgence of inflation has come just at the time when downside risks to global growth from the sharp rise in oil prices and tightening credit conditions in some key economies have increased. This has presented central banks with a major monetary policy challenge. And the global financial turbulence has raised new questions about other aspects of central bank policies. A much wider range of approaches to certain functions of central banks is now under discussion than was the case even a year ago.

Confronting the quandary of rising inflation on the one hand, and the fallout from the financial market turmoil on the other, represents the greatest challenge central banks have had to face in a number of years. In my remarks today, I will first discuss the threat of resurgent inflation. Clearly, the downside risks for future growth complicate the task of monetary policy. But there must in the end be a forceful response to confront the danger that inflation expectations could rise appreciably, with all the attendant problems that would bring.

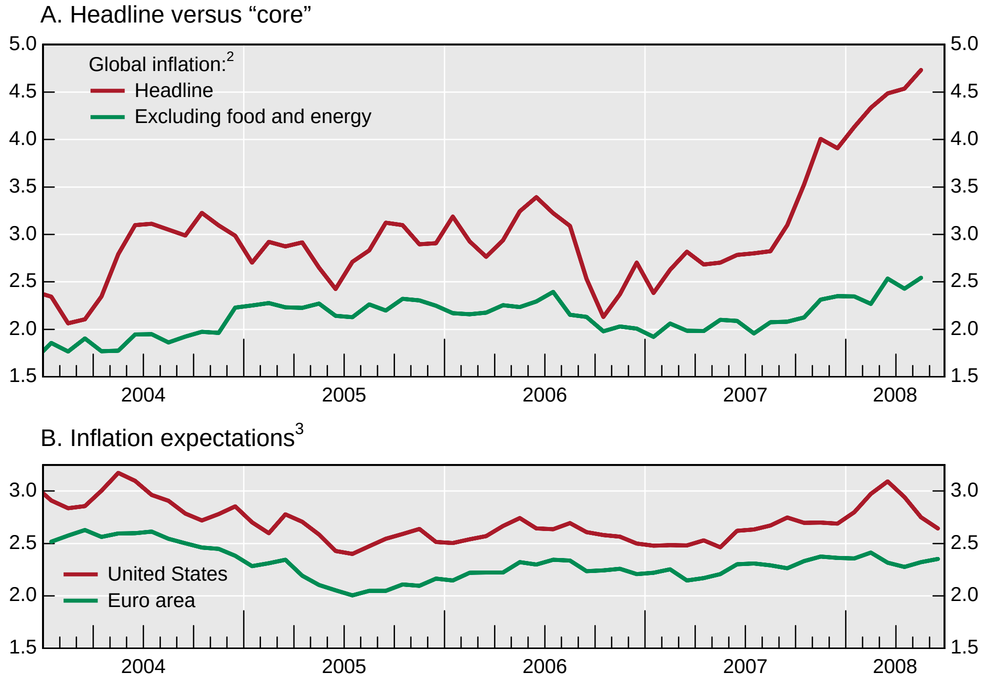
I will also review two medium-term issues confronting central banks as a result of the financial market turmoil: the role of the central bank as provider of liquidity; and the role that central banks play in the mechanisms of financial system oversight. Both of these challenges require close cooperation among the world's central banks. The BIS has played, and I trust will continue to play, a key role in facilitating this cooperation.

The inflation threat

Let me begin by saying a few words about the ominous and immediate challenge of the return of inflation. Coming after many years of low and declining rates of inflation globally, this is a great concern. Global headline inflation is now around 4.7% (Graph 1) and, depending on the path of oil and

Graph 1

Inflation[1]



[1] In per cent. [2] Twelve-month changes in consumer prices. Weighted averages based on 2005 GDP and PPP exchange rates. [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.

food prices, could go higher in the months ahead. Inflation has risen most strongly in emerging economies.

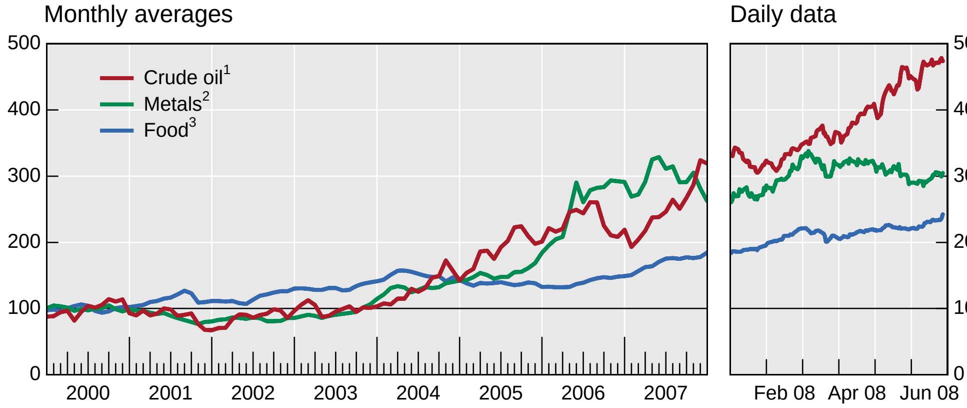
For several years, general price inflation had remained quiescent even though the prices of industrial raw materials and many other commodities were rising strongly. Furthermore, for some time now, world demand seems to have been close to a level that, relative to capacity, eventually produces inflation pressures. Just how close is difficult to judge – because growth has been most rapid in those areas where it is hard to obtain well substantiated estimates of potential output. But it is quite clear that the steep rise in the prices of virtually all internationally traded commodities over the past two years (Graph 2) is due more to strong global demand sustained over many years than to product-specific supply factors. Since the beginning of April, however, oil prices have risen more rapidly than the prices of other commodities. This suggests the influence of not only specific oil market forces but also the role of the oil market as a vehicle for speculating on expectations of higher generalised price inflation.

Assessing the inflation threat in these circumstances is therefore challenging. And central banks face a difficult dilemma because these inflation pressures have come to the surface just when downside risks to growth have increased. The recent spike in oil prices has hurt confidence and may depress global demand. Another important source of downside risks is the current retrenchment by the major banks, in particular in the form of tighter lending

Graph 2

Commodity prices in US dollar terms

2000 = 100



[1] UK Brent. [2] London Metal Exchange index composed of aluminium, copper, lead, nickel, tin and zinc. [3] Commodity Research Bureau Spot Index Foodstuffs.

Source: Datastream.

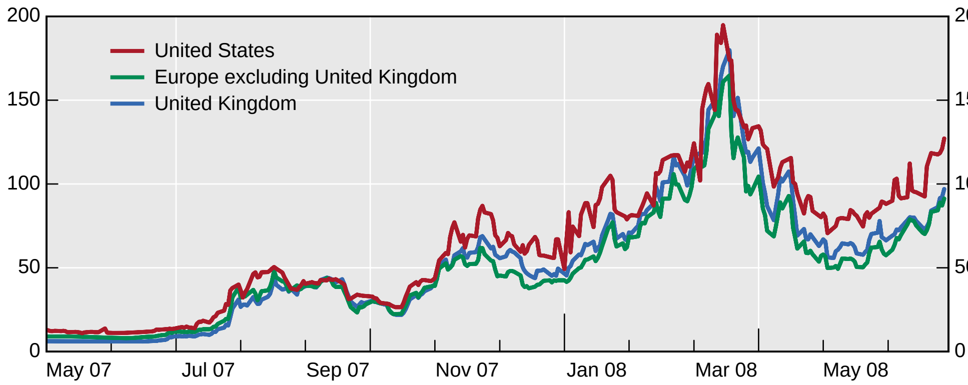
conditions for households, amid a widespread increase in risk aversion in capital markets. Several segments of the credit markets have been disrupted. Concerns about the health of major banks in both Europe and the United States persist. Bank credit default swap spreads show that protection against the risk of default remains much more expensive than before the turmoil, and CDS spreads have recently widened again (Graph 3). It is not implausible that there could be additional significant writedowns by some banks. This could mean further tightening of lending conditions for households and non-financial firms, on top of existing high debt service levels in many cases, and this is likely to further weaken spending.

The housing market downturn is showing signs of spreading. Declining house prices will restrain residential investment and construction. Wealth and

Graph 3

CDS spreads in the banking sector[1]

In basis points

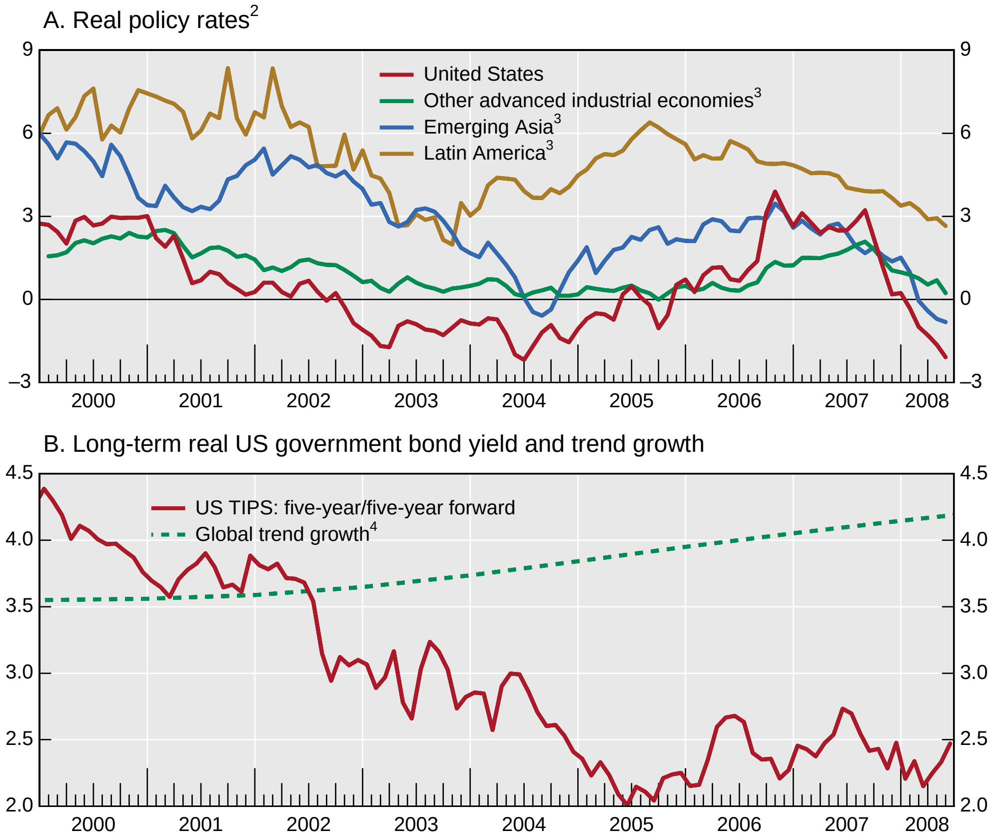


[1] Five-year on-the-run CDS spreads; simple average over major banks.

Source: Bloomberg.

Graph 4

Interest rates: short-term and long-term[1]



[1] In per cent. [2] Deflated by consumer prices. [3] Weighted averages based on 2005 GDP and PPP exchange rates. [4] Hodrick-Prescott filter applied to yearly changes in real GDP.

Sources: IMF; © Consensus Economics; Datastream; national data; BIS calculations.

collateral effects from lower equity and house prices could further dampen consumption, especially in countries with low saving rates. Consumer and business confidence has fallen in the United States, as well as in Japan and Europe.

So far, the financial turmoil has had its main negative impact on growth and growth expectations in the United States. According to consensus forecasts, a US slowdown will be accompanied by a less marked weakening of growth in Europe and Japan. And growth in emerging market economies is expected to remain strong, though slowing somewhat. A welcome consequence of this would be a reduction in global external imbalances.

The strength of global demand over the past few years also owes much to the fact that global monetary policy has been very accommodative for some time. As can be seen from the top panel of Graph 4, real policy interest rates have been low. Monetary and credit aggregates have also grown strongly. In addition, the long-term real risk-free rate of return has been very low in recent years. As a proxy measure of this, the bottom panel of Graph 4 shows US real bond yields. Such low real interest rates are hard to square with the high apparent growth potential of the world economy – the dotted line in the graph. However, this outcome does seem consistent with the exceptionally easy global monetary conditions and, particularly in Asia, a massive accumulation of foreign exchange reserves which has been channelled into low-risk bonds in the world's major financial centres. In turn, low real yields at the long end of the maturity spectrum had, in the years before the recent turmoil, tempted some market participants to take on too many risks and to price them too generously.

At present, most forecasters think that the recent rise in headline inflation in industrial countries represents a temporary blip and that, based on current expectations of how monetary policy will react, inflation will fall back in 2009. But we cannot be entirely confident about this reassuring assessment. Forecasters did not expect the successive increases in commodity prices and so underpredicted the present level of headline inflation. And inflation expectations, particularly those indicated by consumer surveys, have edged up significantly higher in recent months. All of this indicates that central banks will need to continue to monitor inflation very closely in the months ahead.

Monetary policy challenges

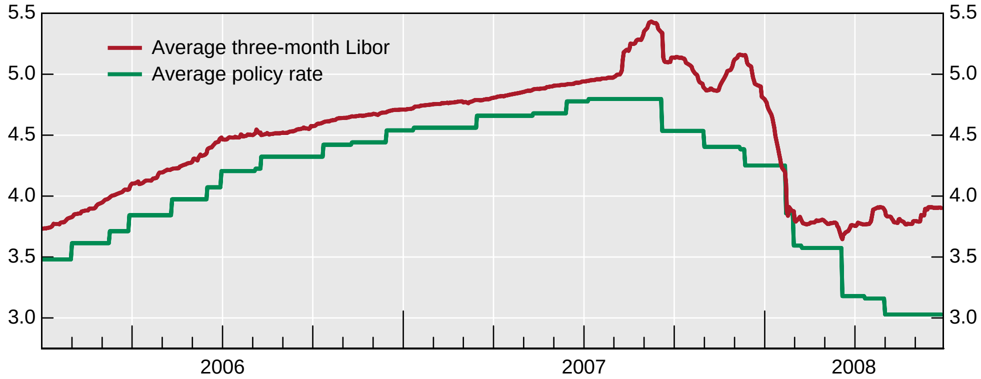
Almost all central banks nowadays focus on keeping inflation down – whether they are formal inflation targeters or not. Such a focus is particularly attractive, because it can help anchor expectations in the face of the commodity price shocks we are currently facing. But this will work only if the framework remains credible. We must therefore be particularly responsive to the clear and present danger of rising global inflation and inflationary expectations. A dilemma is posed by the possibility that global growth might slow, in response to unwinding imbalances and the recent financial turmoil. This is clearly a complication. But, in most countries, it would seem imprudent from an inflationary perspective to rely heavily at this stage on such an outcome.

The challenges confronting emerging economies are particularly great. Food prices have had a much larger effect on inflation in low-income countries, since food makes up a greater share of consumers' expenditure and thus of the CPI basket. In those countries where overall demand pressures are still strong, it would seem appropriate to raise interest rates and allow the exchange rate to appreciate in order to contain inflation. But worries that this would reduce export competitiveness and lead to further capital inflows have led many central banks in recent years to resist currency appreciation. Moreover, several years of forex intervention on an unprecedented scale have gone hand in hand with a major expansion in the balance sheets of both central banks and commercial banks. Indeed, in several countries, bank credit to the private sector has expanded at rates that are probably unsustainable. And, as foreign exchange reserves have been invested in the major financial centres, this has provided a further spur to liquidity growth worldwide.

As I said, these are formidable policy challenges in the emerging economies, and their responses will affect us all. The days when the course of global economic progress was set in a few large advanced economies are over. The growing economic weight of emerging market countries clearly has advantages, but it also creates new international responsibilities. Over the past year or so, as inflationary tendencies have become more apparent, a number

Graph 5
Interbank and policy interest rates[1]

In per cent



[1] Weighted average of the euro area, the United Kingdom and the United States, based on 2005 GDP and PPP exchange rates.

Sources: IMF; Bloomberg; Datastream; national data.

of important emerging economies have come to accept the need for currency appreciation, and this is much to be welcomed.

Let me now turn to the two important medium-term issues raised in the renewed debate about central bank policy frameworks. I choose the word "debate" deliberately. There are, of course, no settled answers in these areas. Instead, we have to think hard about these questions, and be prepared to re-examine our preconceptions.

The central bank as liquidity provider

The first issue for debate is the role of the central bank as a provider of liquidity. We had been aware for some years that the major commercial banks were increasingly becoming the "liquidity providers" for growing and more complex capital market intermediation. Yet the extent and duration of liquidity problems afflicting banks at the core of the financial system still came as a surprise.

As you are well aware, the size and persistence of the funding difficulties of major banks have required central banks to take extraordinary measures. These have included: providing liquidity over longer terms; accepting a much wider range of collateral (including difficult-to-value paper that does not often trade); and offering facilities to a broader range of institutions. New facilities have also been put in place to help overcome the stigma of using standing facilities.

The readiness of the major central banks to take decisive action together in providing liquidity to financial markets has clearly helped to avert a worsening financial crisis. Even so, the spread between central bank policy interest rates and three-month Libor remains unusually wide (Graph 5). Moreover, while enhanced liquidity provision by central banks has helped to alleviate liquidity pressures at times of financial stress, it should not be allowed to permanently replace market mechanisms. At some point, distressed assets must be traded in markets, not parked with central banks. Ways must be sought to allow this to happen as quickly as possible.

Nor should central bank liquidity be allowed to reduce banks' prudential management of their own liquidity risks in the longer term. This is why the regulators have been working actively to strengthen the prudential oversight of banks' liquidity management. The banking industry is also taking steps in this respect. A greater reliance on short-term liquidity borrowed in wholesale markets, together with the growing use of securitisation and large-scale maturity transformation hidden by off-balance sheet funding techniques, had made banks more vulnerable to liquidity shocks than they appreciated. Consequently, banks have sought to increase their longer-term funding as well as their holdings of liquid assets.

Financial system oversight

The second major theme is the renewed debate on the mechanisms of financial system oversight and the role that central banks play in such mechanisms.

An important general lesson from the financial turmoil of the past year is that central banks need to consider more comprehensively the implications of financial innovation for their policy settings. One obvious reason is that financial innovation can have effects on aggregate demand that are akin to those of monetary policy. For example, by pushing risk into the tails of distributions, financial innovation can reduce investors' perceptions of aggregate portfolio risk. In turn, this tends to reduce risk premia and lead to lower long-term yields. Moreover, financial innovation can ease the credit constraints on households, allowing spending to continue even in the face of weak income growth, but potentially leaving households with unwelcome debt burdens in the future. A second reason for paying close attention to financial innovation is that central banks will, in practice, be called upon to deal with the consequences of excessive risk-taking – and very often the first resort of a commercial bank in difficulty will be to approach the central bank for liquidity.

Central banks will need to work very closely with finance ministries and financial supervisory authorities. In this regard, the coordination provided by the Financial Stability Forum has proved invaluable as this episode of market turbulence has unfolded. As you know, the FSF has conducted a major strategic review of what went wrong, and has followed up with recommendations for a wide range of concrete measures. These include steps to ensure that banks have more adequate capital and better risk management, to enforce greater transparency (particularly as regards off-balance sheet vehicles) and to foster better valuation methods. The FSF also recommended changes in the role and use of credit ratings, which had been relied on heavily by some investors. The Committee on the Global Financial System, hosted by the BIS, has provided significant support for several elements of this strategic review. The Basel Committee on Banking Supervision, also hosted by the BIS, has announced auxiliary steps to make the banking system more resilient. These include a push to implement the Basel II Framework more rapidly, as well as to further improve it. Based on the second pillar of this Framework, banks' risk management and capital planning practices are to be strengthened. Moreover, disclosure practices are to be enhanced based on a review of the third pillar – disclosure and market discipline – especially as applied to complex off-balance sheet and securitisation activities. An important consideration is that these changes are to be phased in over time so as to build up confidence without amplifying market problems in the near term.

More thought should also be devoted to the need for a new macrofinancial stability framework. Could regulatory instruments, and indeed monetary instruments, be used to offset what seems to be a natural tendency for credit markets to be excessively "procyclical" – that is, optimistic to an unwarranted degree in the upturn and similarly pessimistic in the downturn? In the upturn, how might we ensure that some combination of monetary tightening, increase in bank capital and provisions, fair valuation practices and margining practices move systematically to moderate these tendencies? The challenge is to achieve a reasonable balance between promoting financial innovation, risk sensitivity and timely market signals on the one hand, and mitigating the negative impact of excessive market cycles on the other.

New regulation must not stifle financial innovation. We should not forget, for example, that securitisation in principle brings substantial benefits, such as helping to spread risks and improving the efficiency of credit markets. But, commercial banks and others still need to take significant steps to restore investors' confidence in the securitisation process if these benefits are to be realised in practice. This may require not only more transparent and less complex products, with better credit assessments, but also a larger allocation of bank capital to such activities.

Conclusion

Let me conclude. There are clear signs that inflation is resurgent worldwide. Central banks need to be particularly vigilant to keep inflation expectations under control. They also need to think hard about the many other challenges they face – including as liquidity providers, and as part of the public sector oversight of the financial industry. The BIS looks forward to working closely with both central banks and regulators in developing better analytical frameworks for addressing all these important issues.