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BIS Quarterly Review March 2016 – media briefing

On-the-record remarks by Mr Claudio Borio, Head of the Monetary and Economic Department, and Mr Hyun Song Shin, Economic Adviser and Head of Research, 4 March 2016.

Claudio Borio

The uneasy calm has given way to turbulence.

In the previous Quarterly Review issue, we highlighted the uneasiness of the calm reigning over financial markets. The tension between the markets' tranquillity and the underlying economic vulnerabilities had to be resolved at some point. In the recent quarter, we may have been witnessing the beginning of its resolution.

The new year greeted investors with one of the worst sell-offs on record. Investors had just breathed a sigh of relief following what had turned out to be an uneventful, if historic, 25 basis point increase in the federal funds target range in mid-December – the first hike since the overnight rate had been pushed to zero seven years earlier, marking the longest postwar phase of immobility. Just two weeks later, markets tumbled. As in the summer, the trigger was China, as signs of a slowdown there hinted at broader emerging market weakness. Equity prices took a dive worldwide, volatilities soared, credit spreads widened, emerging market currencies fell, especially vis-à-vis the US dollar, and the oil price sank to new lows, below the troughs reached during the Great Recession. In turn, these developments fed pessimism about other economies, notably the United States, thus spreading gloom further.

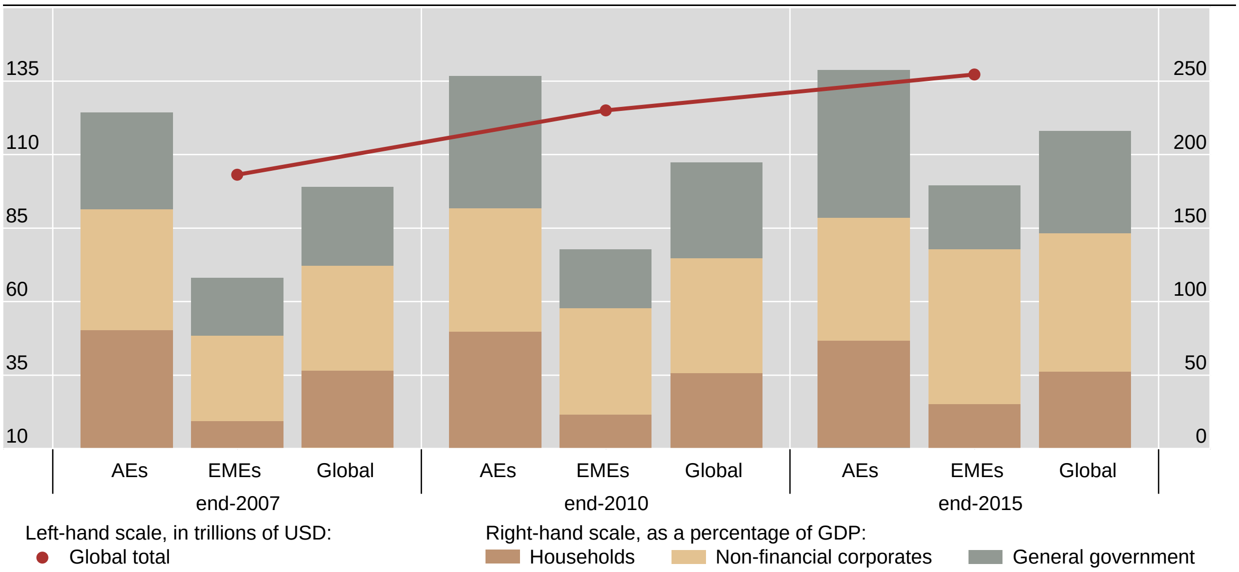
And this was only the first phase of the turbulence. A second, briefer but perhaps more worrying episode in the first half of February focused on the health of global banks. Their valuations, which had been under pressure for quite some time, plunged to new lows while their credit default swap (CDS) spreads rose. Price-to-book ratios hovered around levels not seen since the most acute phase of the crisis. Disappointing global growth prospects and earnings announcements added to jurisdiction-specific worries, such as stubbornly high non-performing loans and regulatory-driven concerns about coupon suspensions for contingent convertible bonds (CoCos) in the euro area. Most likely, defensive dynamic hedging strategies made matters worse, as investors sold bank equities and CDS to cut losses on CoCos. But the main source of anxiety was the vision of a future with even lower interest rates, well beyond the horizon, that could cripple banks' margins, profitability and resilience. Anxiety grew and spread following the Bank of Japan's decision to adopt negative policy rates. At its peak, more than USD 6.5 trillion worth of sovereign paper was trading at negative yields – stretching once more the boundaries of the unthinkable.

Only more recently have markets regained a certain composure.

But if we wish to look for clues to the deeper forces at work, we need to go beyond the markets' all too familiar oscillation between hope and fear. Once we do so, the clues are not hard to find. Against the backdrop of a long-term, crisis-exacerbated decline in productivity growth, the stock of global debt has continued to rise and the room for policy manoeuvre has continued to narrow – a set of factors that might be termed the "ugly three". Let me just say a few words about rising debt and the narrowing room for manoeuvre, in particular.

Debt was at the root of the financial crisis, and it has risen further globally in relation to GDP since then (see graph). In the advanced economies at the heart of the crisis, some private sector deleveraging has taken place, although public sector debt has grown steadily. But the most worrying development has been the steep rise in private sector debt elsewhere, especially in several emerging market economies (EMEs), including the largest – the main engines of global growth post-crisis. The increase has been strongest among corporates, whose profitability has been declining, and among commodity exporters. Often, as indicated by our latest statistical release, this has gone hand in hand with strong property price booms on the back of aggressive risk-taking – all eerily reminiscent of the financial booms seen pre-crisis in the economies subsequently hit by it.

Debt continues to rise



The global sample of countries comprises: Argentina, Australia, Brazil, Canada, China, the Czech Republic, Denmark, Germany, France, Greece, Hong Kong SAR, Hungary, India, Indonesia, Ireland, Italy, Japan, Korea, Malaysia, Mexico, the Netherlands, Norway, Poland, Portugal, Russia, Saudi Arabia, Singapore, Spain, South Africa, Turkey, the United Kingdom and the United States. AEs = advanced economies; EMEs = emerging market economies.

Sources: IMF; OECD; national data; BIS total credit statistics.

Debt denominated in foreign currency has played a prominent role, with the US dollar portion for EMEs doubling since 2009 to some USD 3.3 trillion. Our global liquidity indicators now suggest that the growth in this component came to a halt in the third quarter of 2015. And the international debt securities statistics confirm that EME borrowers have been cutting back on issuance since then – in China, they have been paying back foreign currency debt, partly explaining the rapid fall of foreign exchange reserves. Alongside the changes in credit spreads and the depreciation of many currencies vis-à-vis the dollar, these are the telltale signs that external financial conditions have been tightening for EMEs. And this has been happening as domestic financial cycles have been maturing or turning. It is as if two waves with different frequencies came together to form a bigger and more destructive one.

Debt, therefore, is what helps understand apparently unrelated developments. It sheds light on the slowdown in EMEs. It provides clues about the worrying vicious cycle between US dollar appreciation and tightening financial conditions for firms or countries that have heavily borrowed in dollars. It gives a hint about the reason for the weakness in oil prices, as countries such as China demand less and highly indebted oil-producing firms come under pressure to keep the spigots open to meet their service burdens. And it may even illuminate the puzzling slowdown in productivity growth: recent BIS research finds evidence that credit booms sap productivity growth as they gather pace, largely by allocating resources to the wrong sectors. The impact of these misallocations lingers on and becomes more powerful if a financial crisis subsequently erupts. In turn, weaker productivity makes it harder to sustain debt burdens. Put differently, we may not be seeing isolated bolts from the blue, but the signs of a gathering storm that has been building for a long time.

And then we have the narrowing room for policy manoeuvre. The latest turbulence has hammered home the message that central banks have been overburdened for far too long post-crisis, even as fiscal space has been dwindling and structural measures lacking. Despite exceptionally easy monetary conditions, in key jurisdictions growth has been disappointing and inflation has remained stubbornly low. Market participants have taken notice. And their confidence in central banks' healing powers has – probably for the first time – been faltering. Policymakers too would do well to take notice.

Hyun Song Shin

The debate about economic and financial vulnerabilities arising from the extended period of central bank stimulus has taken on an air of urgency as signs mount of a turning point in global liquidity conditions. Discussions at the Shanghai G20 meeting underscored this point.

This issue of the Quarterly Review presents recent BIS research and analysis that address key aspects of the reversal of global liquidity. A box on capital outflows from China, by Bob McCauley and Chang Shu, shows the importance of renminbi bank deposits outside China in explaining recent currency moves. Talk of "capital outflows" gives the impression that only financial flows that cross the border actually matter. But flows across currencies are often more illuminating in helping us understand currency market stresses whether or not money actually crosses the border. For many months following the global financial crisis, the renminbi appreciated steadily against the dollar. This is the kind of environment that is conducive to "carry trades", where firms with access to dollar credit can borrow dollars offshore and convert them into renminbi. They seek to profit from the steady appreciation of the renminbi as well as the higher interest rate on renminbi deposits. Depositing the funds offshore in a bank would be one way to hold the proceeds.

But notice that both the dollar borrowing and the renminbi deposits are outside China. There is little or no cross-border dollar lending. However, a strengthening dollar pushes borrowers to repay their dollar debt, so when that carry trade is reversed, renminbi deposits will fall in lockstep. The box by McCauley and Shu provides estimates of these shifts across currencies by drawing on the BIS banking statistics. The combination of reduced offshore renminbi deposits and Chinese firms' paydown of foreign currency debt reflects the unwinding of carry trades and explains the downward pressure on China's currency. It also shows why the offshore renminbi rate trades at a discount to the onshore rate during periods of stress.

Just as offshore dollar borrowing increased during the period of easy monetary policy in the United States, we are now seeing an increase in borrowing in euros outside the euro area. Graph 2 of the Highlights chapter shows that the fastest-growing component of euro-denominated credit is that to non-residents, especially the euro-denominated bonds issued by non-financial companies outside the euro area. This has been growing at 15% a year. The euro-denominated bond issued by US non-financial companies has been so prominent that it has acquired its own name – the “reverse yankee”. In contrast, euro-denominated credit to borrowers within the euro area has been growing more slowly, at an annual rate of 2.1%. That’s in spite of the monetary policy actions of the ECB, including negative policy rates, intended to stimulate lending within the euro area.

Speaking of negative policy rates, one special feature in this issue of the Quarterly Review tackles below-zero interest rates – a topic that has received much attention recently.

Morten Bech and Aytek Malkhozov discuss the nuts and bolts of central banks’ implementation of negative policy rates. They look at the four central banks which had at least one policy rate below zero at the end of 2015: the ECB and the central banks of Denmark, Sweden and Switzerland (the Bank of Japan of course adopted a negative rate for a portion of bank reserves in January this year). As the authors make clear, they leave broader questions of the *desirability* of negative rates aside and focus on whether (and how) negative policy rates have been transmitted to other interest rates in the economy.

In implementing negative rates, central banks have attempted to introduce them in ways that mitigate the burden on banks. For example, three of the four (all except Sweden’s Riksbank) applied negative rates only to bank reserves at the central bank that exceeded given thresholds.

One consistent finding across all cases is that moderately negative rates passed through to money market rates and further along the yield curve. But their impact on other rates, especially bank rates, has been much less evident. Crucially, rates on bank deposits of retail customers have not been cut below zero. And mortgage rates in Switzerland have actually increased in recent months as banks have attempted to protect their profits. This raises questions about how the monetary transmission mechanism has changed in these countries, how it will change and, more generally, how the financial system would function if benchmark borrowing costs went further into negative territory or remained negative for a prolonged period.

Another feature, by Dietrich Domanski, Michela Scatigna and Anna Zabai, looks at the possible impact of monetary policy on wealth inequality since the financial crisis, joining a topical debate among economists and policymakers.

We don’t have good international data yet on how inequality has evolved since the crisis. So the authors perform a simulation which estimates how household wealth has changed by using changes in the value of assets assuming a constant portfolio composition. They conclude that inequality is likely to have increased in most countries. This reflects the rapid recovery of share prices (which helps those at the top), the slower recovery of housing prices (which would have helped those at the bottom), and the high degree of household debt (which hurts those at the bottom more).

It is an open question whether central bank actions fanned inequality or not, but there are some useful insights. Typically, monetary policy tends to increase inequality by boosting equity prices and to reduce it by boosting house prices. This relative impact and portfolio composition are key. By contrast, the impact on bond prices is less important. In any case, the lessons do not conform to a simplistic generalisation. But these issues will continue to merit close attention.

Pat McGuire and Goetz von Peter have written about the drivers of the contraction of bank credit during and after the financial crisis. They use a unique data set, based on the BIS banking statistics, which captures the positions of groups of banks of a given nationality in a given location – for example, German banks in the UK.

The special feature largely confirms earlier findings, especially that foreign banks which are funded locally tend to maintain more stable lending relationships than those that are funded across borders. But it provides a richer description of how these effects played out during the crisis.

Finally, Morten Bech, Anamaria Illes, Ulf Lewrick and Andreas Schrimpf look at the recent rise in electronic trading and automatic trading in fixed income markets. They draw on recent reports by the Markets Committee and the Committee on the Global Financial System.

While indicators of “market quality” – liquidity and trading costs – have generally remained strong, market conditions remain susceptible to a sudden evaporation of liquidity. More work is needed to understand the impact of electronic trading on the robustness of these markets, particularly under stressful conditions.