# Norman T L Chan: Can central banks save the world?

Keynote address by Mr Norman T L Chan, Chief Executive of the Hong Kong Monetary Authority, at the 19th Annual Hong Kong Business Summit Luncheon, Hong Kong, 25 November 2013.

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C K (Chow), Stephen (Yiu), distinguished guests, ladies and gentlemen, good afternoon.

1. It has been five years since the onset of the Global Financial Crisis in 2008. The Crisis – followed three years later by the European Sovereign Debt Crisis – exposed the weaknesses of the global financial system and the vulnerabilities of the global economy. Today, peripheral countries in Europe are suffering a sharp contraction in their economies, and major advanced economies are experiencing very weak growth, if any at all. The economic output of several European countries, including the UK and France, is still below the levels prior to the Global Financial Crisis. The US, which seems to be the only bright spot among the advanced economies, still hasn't recovered in full the 8.7 million jobs it lost following the Crisis.

2. Confronted by this extremely difficult environment, it was not surprising that central banks in the advanced economies began taking unprecedented steps to lower interest rates as far as possible. And, once the rates hit rock bottom, they began introducing different forms of very aggressive quantitative or credit easing. For example, in the US, the Fed introduced QE1, QE2 and unlimited QE3, which inflated the Fed's balance from US$900 billion in 2008 to US$3.7 trillion now. Separately, in the past five years, the balance sheets of the ECB and the Bank of England have expanded, almost two-fold for the ECB and over four times for the Bank of England. And, the Bank of Japan, the forerunner of QE, has embarked on what is called Qualitative and Quantitative Easing (QQE).

3. Today, the big question is: will the unconventional monetary policies undertaken by these central banks actually work? Put another way: can central banks save the world?

### Is the World Worth Saving?

4. But before I try to address the question of whether central banks can save the world, I would like to digress a little by raising a deliberately provocative question: Is the World Worth Saving? You may think it a little odd that I should ask this question, as the answer must surely be an emphatic "Yes". Indeed, the commonly shared desire is that we must do whatever it takes to bring the world back to the path of economic recovery, to enable more jobs to be created and to improve people's welfare and livelihood. So, why do I ask this seemingly superfluous question? Let me explain.

5. On a number of occasions in recent years I have expressed the view that although there were many factors leading to the Global Financial Crisis and the European Debt Crisis, the root cause of our present predicament is the excessive leverage and indebtedness built up over the past two to three decades in the household, corporate and government sectors in the advanced economies. During this period, the indebtedness of many industrial economies, such as the US, the UK, France and Germany increased steadily from 160% or 1.6 times of GDP to over 320% of GDP. Japan, of course, ranked the highest in this "league table" with over 450% of GDP. This is alarming not just because the stock of debt was rising, but the speed of the increase outpaced the economic or income growth of these economies by 100% over this period. What is even more depressing is that the aggregate public and

private sector indebtedness ratios actually increased even further after the financial crisis in most advanced economies except for Germany.

6. The increases were mostly due to a sharp pick up in public debt in most advanced economies after the Global Financial Crisis, as substantial amounts of public funds were deployed by the crisis-hit countries to salvage their financial systems, while the real economies were suffering from falling fiscal revenues with slow growth and rising public spending. In the US, for example, public debt increased by US$6 trillion from the end of 2008, with the ratio of public debt to GDP rising from about 74% to the current 100%. Another striking example was Japan where the public-debt-to-GDP ratio surged from an already precarious level of around 190% in 2008 to almost 240% in 2012, and is expected to rise even further to over 250% by 2020 along with still more fiscal stimulus under "Abenomics". In terms of private-sector debt, while the US and the UK underwent more significant private-sector deleveraging, most European countries showed little progress on the reduction in private-sector indebtedness. The weak peripheral countries aside, even in core countries like France, the private non-financial sector debt ratio increased sharply from about 200% of GDP at the end of 2008 to 230% of late.

7. There are many narratives on why this trend of rising indebtedness has occurred. Perhaps the financial "deepening" had made credit much easier and cheaper for many households and corporates to obtain. Or, financial innovation in the form of securitisation and financial derivatives, such as CDS and CDOs, enabled leverage to be amplified and distributed throughout the financial system and beyond. But, the cause of this alarming trend is not the issue. The point I wish to make is that most people had become insensitive to the excessive levels of indebtedness and leveraging, and the resulting imbalances and vulnerabilities that had built up prior to the Global Financial Crisis and the European Sovereign Debt Crisis. Clearly, many people would now question the validity of this mindset. But have we learnt our lessons? Unfortunately, I'm not so sure we have. While most people would agree with the view that excessive debt and leveraging was a major factor leading to the crises in the US and Europe, many would still think it is possible to overcome the problems without having to deleverage or somehow avoid the pain arising from the deleveraging process.

8. On the subject of pain, most of us understand what happens when we live beyond our means through borrowings at the individual, household or corporate level. Without any increase in productivity or income, excessive levels of debt can lead to insolvency or bankruptcy, which entails very serious and unpleasant consequences. However, the situation is a lot less clear when it comes to a country incurring excessive debt because the usual bankruptcy rules do not apply. Indeed, when compared to households or corporates, there are two significant problems relating to governments spending beyond their means. First, there is the temptation for governments to continue to incur deficits as the market seems to be quite willing, at least for a while, to finance such deficits. In this context, Greece is a good recent example. Secondly, there is the usual political pressure for governments to spend and borrow now, and worry about repayment later. Unlike an individual borrowing money, government borrowing can be rolled over and increased over such an extended period that repayment becomes a problem for the next generation not the present one. Sadly, this kind of behaviour is rather common and widespread. It is hard to imagine a reasonable person wanting to maintain a good lifestyle now by borrowing huge amounts of money which can only be repaid by his or her children or grandchildren. In other words, allowing or asking governments to spend beyond their means for an extended period of time is tantamount to society mortgaging the income and livelihood of our future generations. Such action is irrational and irresponsible, but it's happening all over the world. No wonder some people have

posed the question – if this is the kind of world we're living in, is it really worth saving?

## Can central banks save the world? "Yes and no"

9. Rather than trying to answer this metaphysical and provocative question, let me quickly return to the subject of my remarks today: can central banks save the world? The short answer is "yes and no".

10. When a financial crisis occurs and the financial system is facing imminent meltdown, as happened in the wake of the collapse of Lehman Brothers in 2008, shockwaves in the form of a severe credit crunch normally follow as banks and other financial firms lose confidence in each other and hold on to whatever liquidity they can. The breakdown in the collateral and credit supply chain can lead to the failure of not only illiquid or poorly managed firms, but also otherwise sound and healthy firms. However, central banks, playing the role of lender of last resort, can and should step in to inject the necessary liquidity to allow the financial system to continue to function. If not, illiquidity can quickly turn into insolvency on a systemic scale. Given the ability of central banks to create money by expanding their balance sheets, the Fed and the world's central banks did exactly that during the latest Global Financial Crisis. This action helped prevent a global financial system meltdown. Therefore, we can say central banks can and do save the world during a financial crisis.

11. Nevertheless, the ability of central banks to reflate the economy or boost employment during the post crisis recovery is not as clear cut. After the 2008 Global Financial Crisis, the US, followed by Europe and Japan, reduced interest rates to a very low level. And, when they hit the near zero lower bound, the major central banks embarked on unconventional monetary policies of quantitative or credit easing. So far, the US has created and injected US$2.8 trillion into the banking system and is currently pursuing a monthly US$85 billion asset purchase programme. Mainstream thinking supports the use of this unconventional monetary easing on the grounds that weak growth post-crisis is mainly the result of a lack of aggregate demand and thus the solution is to boost demand generally by reducing the cost of borrowing and inducing investors to shift from low-yielding government bonds to riskier assets in search of yields.

12. While there was general agreement on the need and efficacy of action taken by central banks during the crisis period to stabilise the markets, the same cannot be said for using the extremely accommodative monetary easing by the advanced economies to support economic growth and job creation. Looking beyond mainstream thinking, there are some sound analyses by renowned economists, such as Bill White of the OECD and Dr Rajan, the former IMF Chief Economist and newly appointed Governor of the Reserve Bank of India, that suggest these unconventional monetary policies are now in "uncharted waters" and may create unintended consequences and risks to the global financial system. At this point, I will mention three key costs or risks of these unconventional monetary policies.

    (a) First, these policies punish the savers and pensioners: The suppression of interest rates at close to zero is helpful to debtors, but I should hasten to add that only those debtors who can refinance themselves at the lower rates can benefit. So, most of the US home owners in negative equity or with low credit scores have not been able to benefit from the all-time-low mortgage rates (which once dropped to as low as 3.55%). At the same time, the low interest rates cause a great deal of harm to savers, whose deposits have been earning virtually no interest at all. There are millions of savers, including households, pensioners, corporates and investment funds that have remained prudent and have avoided falling into the excessive leverage trap. These prudent savers have been punished badly in the past four

years under the "low-for-very-long" policies. With a sharp drop in recurrent interest income, the behaviour of this group may have changed by scaling down their consumption or investment. This offset, at least partially, the potency of low interest rates and QEs.

(b) Secondly, these policies create moral hazard: The suppression of interest rates and the injection of huge amounts of liquidity through QEs create considerable moral hazard in several ways. It delays the necessary adjustments in the debt overhang through deleveraging by households, corporates and governments. If one agrees that excessive leverage is the root cause of the latest crises, deleveraging across the board is the only way to escape the trap. It is hard to imagine why the problem of excessive leverage can be overcome by adding more debt to the system. As QEs can reduce the short term pain and pressure brought by adjustments, there is a real risk the implementation of the much needed reforms in the private sector and the fiscal reform in the public sector could be delayed, or dropped altogether. This means the fundamental cause of the imbalances in the global financial system is not being addressed at all. The problem is particularly acute in the fiscal positions of many advanced economies that have built up high levels of public debt. According to the "Ricardian Equivalence" theory, when people believe the fiscal positions of their governments are unsustainable and that at some future stage the governments have no choice but to raise taxes to pay back the debt, this will materially curtail the citizens' desire to spend and invest now because they need to save more to prepare for the "rainy" days ahead.

(c) Finally, the third important cost or risk factor is the misallocation of resources and investments: Given the near zero interest rates and abundant liquidity in the financial system, it is to be expected that the asset markets, especially the stock and housing markets, will benefit. With US stock markets continually reaching historical highs and with a strong rebound in the housing market, the positive wealth effects should help boost consumption and investment. So, this must be good news – apart from the inconvenient questions one asks from time to time about "How long will it last?" or "Is it sustainable?" For Emerging Market Economies, we have all witnessed the inflow of capital at the initial stages of the QEs, which drove up asset prices and inflationary pressure. This is not surprising as investors have no choice but to take aggressive steps to search for yields globally. This results in a misallocation of resources, as the abnormally low interest rates distort investment decisions by allocating capital away from productive real investment into risky assets that yield higher returns. The lack of real investment in turn reduces medium-term potential growth. Indeed, business investment growth in the US has been lacklustre since the economy recovered from the global financial crisis. The misallocation of resources aside, the search for yield behaviour also leads to a mispricing of risks across a wide spectrum of asset classes. In the US, junk bond issuance has risen sharply in the past few years, accounting for about 24% of all bond issuances so far in 2013, while the average high-yield spread has fallen below 5%. While the buoyancy in the asset markets helps support the economy in the short term, imbalances could build up in the economy and the financial system that may pose a threat to systemic stability when the unconventional monetary policies begin to unwind.

13. Ladies and gentlemen, before moving on to what lies ahead, let me briefly summarise my key message – excessive leverage is the root cause of the global financial crisis, but surprisingly, not much has changed. Many have still not learnt the lesson, and think the problems can be solved by further leveraging. And policymakers advocating extremely accommodative monetary easing still believe liquidity-driven growth is the answer. Indeed, it's ironic that low interest rates, mispricing of risk and excessive debt levels, which contributed to the crisis in the first place, are now considered the "solution".

**What lies ahead?**

14. So, we have now entered "uncharted waters" or the "world of the unknown". It has often been argued that the Global Financial Crisis was unprecedented and one which demanded unprecedented policy action. As most of the advanced economies have very little, if any, fiscal headroom to support growth and job creation, the use of zero interest rates and QE, and leveraging on central banks' seemingly limitless ability to expand their balance sheets, appears to be "The Only Game in Town". Presumably, this means the situation has become so bad, we may as well try these unconventional policies to see if they work. However, as I outlined earlier, the efficacy or potency of these policies has not been as strong as first thought. In the US, the pace of economic recovery has been rather moderate, if not disappointing, despite the unprecedented fiscal and monetary support packages launched since 2009. In Europe, the situation is even more disheartening, given the fact the output of many peripheral countries and the UK and France is not yet back to pre-crisis levels. Again, when faced with criticisms that the central banks had gone beyond their remit and capabilities by taking up the role of supporting economic growth, mainstream thinking argued that, even though QE was not as potent as it was hoped, the economic conditions post-crisis would have been a lot worse without these unconventional monetary policies. At this juncture, based on the empirical evidence available so far, it is hard to judge one way or the other whether the unconventional monetary policies have worked, or will work.

15. However, it should not take long to find out the answer. This is the fifth year of QE in the US; and the main issue now is not to what extent QE has helped economic recovery since 2009, but what happens when the Fed actually exits from these accommodative policies. Of course we don't know exactly when the Fed will exit, which entails three stages: tapering in the asset purchase programme, ending the purchase programme and eventually raising policy rates. Chairman Bernanke and some FOMC members have made it clear the timing of these stages is still uncertain as it will depend on the actual pace of economic recovery and improvement in the job market. The three stages have long been known to the markets and are nothing new. However, when Chairman Bernanke talked about a possible timeline for tapering in May and June, the US and global asset markets reacted strongly with both bond and stock prices taking a beating. It is particularly noteworthy that Chairman Bernanke's remarks triggered selling off in many emerging market economies, especially those with weak current account positions. As a result, it took the Chairman and his FOMC members considerable time and effort to clarify that tapering was not "tightening" and there was still a long way to go before US interest rates would rise. Lately, there has also been some rather strange market behaviour, with the markets going down when the economic or employment data showed some improvement, which in theory should have been good news; and markets rising when jobs or employment data showed signs of softening. This pattern is quite different to what conventional wisdom would suggest. It also highlights the uncertainty and risk that when asset markets have been supported by low interest rates and high liquidity for a prolonged period, the normalisation of the interest rate and liquidity conditions could create the kind of market dynamics that may destabilise the financial system and dislocate the recovery path of the real economy.

16. Nevertheless, we don't know how long these perverse market dynamics will persist and how they may impact on the Fed's exit. We certainly hope the world will benefit from an orderly exit from the QE and zero interest rate policies. As we don't have a crystal ball, we can only wait and see what will happen in the re-pricing of assets across the globe as and when interest rates begin to normalise. In the meantime, it is crucial we are well-prepared for possible turbulence and shockwaves.

17. But, I believe Hong Kong is on the right track. While we have been at the receiving end of massive international capital flows for several years, prompting a rise in inflationary pressure and overheating in the property market, we have acted swiftly to contain the adverse impact of such unprecedented monetary easing policies. Since 2009, the HKMA has undertaken six rounds of countercyclical prudential measures on mortgage lending, coupled with other supervisory action on bank capital and liquidity, to enhance the resilience of the banking system so it is better equipped to cope with future shocks. We have also launched a series of measures to contain credit growth, and recently we have further required banks with relatively fast credit growth to ensure they have stable funding sources to support that growth.

18. The prospect of a tapering in quantitative easing in the US has already caused jitters on global financial markets, including fund flows and exchange rates in some regional economies. Such volatility may continue, if not magnify, in the next couple of years. Therefore, we must remain vigilant against the possible spillover effects from other economies, as well as any other emerging risks. We will continue to take proactive steps to ensure our banking system is resilient to a possible reversal of the credit cycle, and to enhance banks' liquidity planning and management in anticipation of any sudden outflow of funds.

19. In conclusion, ladies and gentlemen, we will keep reminding and warning the public not to allow ourselves to incur excessive debt simply because interest rates are currently at very low levels. We don't know whether and when these shocks will materialise, but we must stand ready to face them and be able to emerge from the next crisis relatively unscathed, as we have done in the past.

20. Thank you very much.