



Long-term sustainability versus short-term stimulus: is there a trade-off?

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Introduction

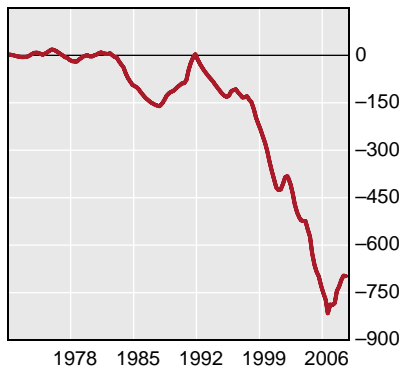
The global financial crisis and its macroeconomic fallout have dramatically changed the agenda of the central banks, fiscal authorities and supervisors and regulators. The change is illustrated by a remark surfacing repeatedly in the current economic debate: "We are all Keynesians now." In some sense, indeed we are. But history teaches us that, in designing economic policies, policymakers always need to look beyond the short time horizon that crises seem to impose on us.

In my view, current expansionary policy responses risk a failure to capture two crucial and interrelated facets of the present crisis. The first is that it is part of an underlying adjustment towards more sustainable macroeconomic conditions. The second is that it is a crisis of confidence which requires a recognition of the rational expectations of economic agents and of the behavioural effects associated with expansionary fiscal policies. To restore confidence in a sustainable way, policy actions should be credible from a medium-term perspective, address existing economic imbalances and pay attention to economic agents' expectations.

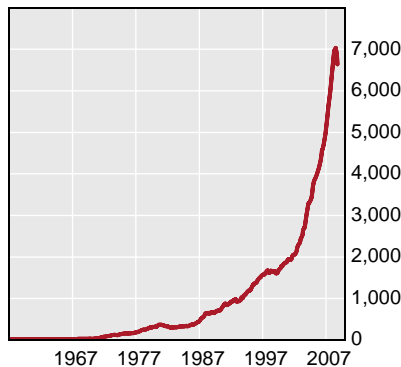
Graph 1

Global imbalances and the US housing bubble are two faces of the same reality In billions of US dollars

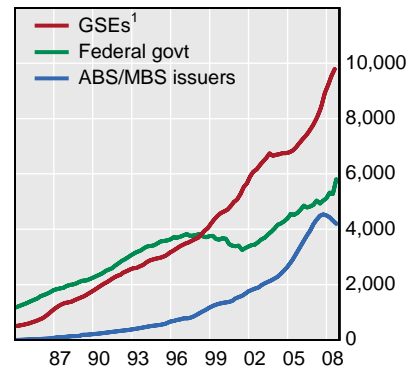
US current account deficit



Total foreign exchange reserves



US debt outstanding



¹ GSEs plus agency- and GSE-backed mortgage pools.

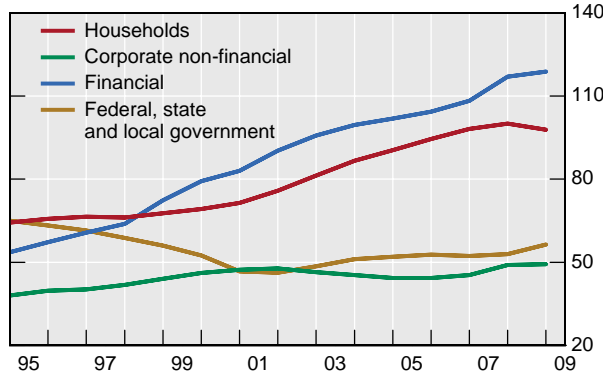
Sources: Datastream; national data.



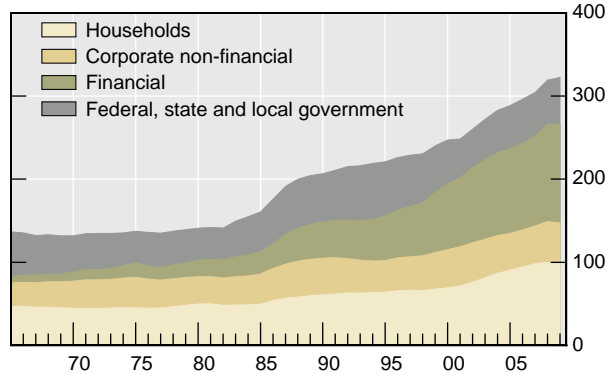
Graph 2
Debt outstanding by domestic sectors¹

United States

As a percentage of GDP



As a percentage of GDP, cumulated



¹ Data for 2008 refer to third quarter.

Source: Flow of Funds Accounts of the United States, Board of Governors of the Federal Reserve System.

You may recall the headline of last year's BIS *Annual Report*: "The unsustainable has run its course." This reflected the view that the turmoil that started in July 2007 is not only an idiosyncratic failure in the functioning of financial markets. It is also, and perhaps more fundamentally, a crisis rooted in the preceding credit boom that had fuelled financial excesses and was accompanied by large, sustained deviations of key macroeconomic variables from longer-term fundamentals. The illusion of "growth without savings" in a number of advanced economies, combined with accommodative monetary conditions – with interest rates that stayed too low for too long – and unfettered financial innovation led to the build-up of excessive debt in the global economy. The build-up is illustrated in Graph 1 on the previous page by the large widening of the US current account deficit (left-hand panel), the surge in foreign exchange reserves (centre panel) and the rise of US debt backed by mortgages (right-hand panel).

As shown in Graph 2 above, the outcome of these developments in the US credit markets has been a build-up of debt in both the household sector and the financial sector.

Policy actions around the world will be able to restore confidence only if they address existing large macroeconomic imbalances. A key issue is therefore how to reconcile short-term policy responses that mitigate the economic downturn with the need for an adjustment towards longer-term sustainability.

I. SHORT-TERM POLICY RESPONSES TO THE CRISIS: MEASURED STABILISATION OR EXCESSIVE DEMAND STIMULUS?

There are two stylised types of policy response to the global crisis: stabilisation and stimulation. A measured stabilisation policy accepts the fact that the adjustment is inescapable while it endeavours to mitigate the pain and promote an orderly adjustment. In contrast, stimulation policies, pushed to the extreme, seek a stimulus that would be large enough to, so to speak, eliminate the adjustment period – a goal that would obviously be illusory.



A. Measured stabilisation policies

So far, the policy responses to the global crisis have aimed at facilitating the adjustment in balance sheets and in the macroeconomy while at the same time avoiding a destabilising downward spiral in the global economy and in the global financial system.

Those responses have been appropriate in present circumstances. Given the magnitude of the fundamental imbalances preceding the crisis, considerable adjustments have to be made, and they are indeed being made: in the financial sector – by deleveraging, reducing overcapacities, cleaning up balance sheets and disposing of complex “toxic” financial instruments; and in the macroeconomy – by a fall in asset prices, a rise in household savings, a correction of global current account imbalances and a rise in unemployment. A legitimate objective for policymakers is to promote an orderly adjustment of these imbalances and mitigate the pain associated with the process. But we should be under no illusion that we can simply pursue pain mitigation and escape the adjustment part of the process altogether.

The consensus view, at least up to the onset of the current turmoil, has been that stabilisation policies should have three dimensions – monetary, fiscal and financial.

- Monetary policy adjusts policy rates in response to short-term business cycle developments to support sustainable economic growth and preserve price stability in the longer term.
- Fiscal policy dampens fluctuations in real income through automatic stabilisers rather than through discretionary fiscal stimulus.
- Financial sector policy uses monetary, fiscal and regulatory instruments to address the systemic threat posed by the possible failure of large financial institutions.

Let me now turn to each of these three dimensions.

On the **monetary policy** side of stabilisation, central banks have deployed unprecedented efforts (Table 1 on the next page) to offset some of the rise in the risk premia for households and firms, either through the reduction of policy rates or more directly through targeted balance sheet operations (eg US credit easing).

The lowering of policy interest rates has been appropriate in the light of the sharp downward revisions in expectations for inflation and growth. That relationship is embodied in the “Taylor rule”, by which policy interest rates evolve as a function of deviations of inflation and output from target. Recent central bank actions have in addition taken into consideration the tightening of financial conditions caused by the credit crisis. In particular, policy rates appear to have been reduced more than warranted by developments in output and inflation; the extra degree of accommodation is aiming at mitigating the rise in the cost of borrowing for those economic agents confronted with the sudden widening of credit spreads and of risk premia that has accompanied the crisis in the financial sector. In the United States, for example, the policy rate has been reduced by around 500 basis points since the summer of 2007. Over that period, the interest rate for 10-year government bonds has come down by about half, to around 2½% in January 2009; interest rates for high-grade corporate bonds have been broadly stable at around 7% (the period immediately after the collapse of Lehman Brothers being an important exception); and the rate on 30-year mortgages has come down from about 6% to around 5½%. In a nutshell, and as shown in Graph 3 on page 5, the record reduction in the Federal Reserve policy rates already seems to have been instrumental in containing the price of credit for US economic agents.



Table 1: Central banks' responses to the crisis – a simplified view

I. Action on policy interest rates since the beginning of the crisis

Policies	Federal Reserve	Eurosystem	Bank of Japan
Policy rate lowered by: ¹	500 bp	225 bp	40 bp
Change corridor around policy rate	Interest paid on bank reserves (new), then corridor narrowed	Corridor broadened, then narrowed	Interest paid on bank reserves (new)
Influence longer-term rates (communication on future rate decisions)			

II. Use of central bank's balance sheet to provide direct support to institutions and markets

	Federal Reserve	Eurosystem	Bank of Japan
Size of the balance sheet multiplied by: ²	2.5	1.75	1.25

II-1. Assets ("credit easing")

Policies	Federal Reserve	Eurosystem	Bank of Japan
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*** Liquidity provision to financial institutions**

Provide short-term liquidity, for larger amounts, at longer maturities and against broader collateral	To banks, primary dealers (incl through new facilities)	To more banks; no change in operating framework	To more banks; no change in operating framework
Foreign currency facilities	USD swap transactions with foreign central banks	Supply of USD and CHF funds (collateralised)	Supply of USD funds (collateralised)
Emergency Liquidity Assistance ³	Bear Stearns, Citi, AIG	n/a	n/a
Release more liquid securities (eg lending high-quality securities against less-liquid collateral)	yes	yes	yes

*** Liquidity provision (collateralised) to a broad group of borrowers and investors in credit markets**

Provision of liquidity	Money market mutual funds; issuers of commercial paper (incl non-financial corporates); and holders of AAA-rated ABS		Non-financial corporates
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*** Buying longer-term securities**

Purchase securities outright	GSE bonds GSE MBS Treasury notes?		JGBs Commercial paper (incl corporate financing) Corporate bonds?
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II-2. Liabilities

Policies	Federal Reserve	Eurosystem	Bank of Japan
Main sources of funding for increase in assets	Higher bank deposits Increase in Treasury account (one-off)	Higher bank deposits One-week bank deposits (new)	Issuance of BoJ bills

*** "Quantitative easing"**

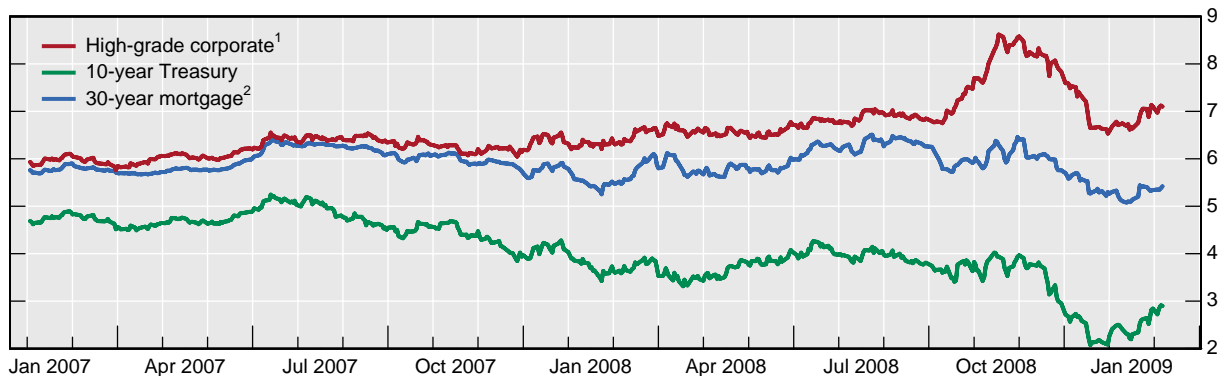
Target excess bank reserves			From 2001 to 2006
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¹ Cumulative change since end-July 2007 (August 2008 for the ECB). ² Since end-June 2007. ³ Emergency Liquidity Assistance = collateralised loan in the context of a troubled financial firm (publicly announced).



Graph 3
Mortgage, Treasury and corporate rates

In per cent



¹ JPMorgan JULI index A, 10+ yield. ² Thirty-year US fixed mortgage rate, national average.

Sources: Bloomberg; JPMorgan Chase.

However, despite strong actions taken by central banks around the world to reduce short-term interest rates, the cost of longer-term credit for financial institutions has been, if anything, rising since the beginning of the turmoil as shown in Graph 4 on the next page.

The significant widening of credit spreads for financial institutions since 2007 may reflect a more difficult transmission of policy rates to longer-term private interest rates, as shown in the top panel of Graph 5 on page 7. Since mid-2007, a negative correlation appears to have emerged in the United States between changes in short-term interest rates and corporate credit spreads: empirical estimates suggest that over this recent period the decline in policy rates has been offset by an increase in corporate bond spreads of almost the same magnitude (bottom panels of Graph 5).

In view of this unprecedented combination of close-to-zero policy rates and stubbornly high risk premia,¹ central banks have deployed a number of additional policy tools to counteract the credit crisis. Interest rate policy has been complemented by a more active balance sheet policy, including provisions to improve general market liquidity. At central banks with policy rates close to the zero bound, the complements can take the form of quantitative easing (affecting bank reserves on the liability side), as applied in Japan in response to the 1990s financial crisis; and credit easing (affecting the asset side of the balance sheet), as currently pursued by the Federal Reserve. Consequently, the balance sheets of central banks have expanded markedly (Graph 6 on page 7).

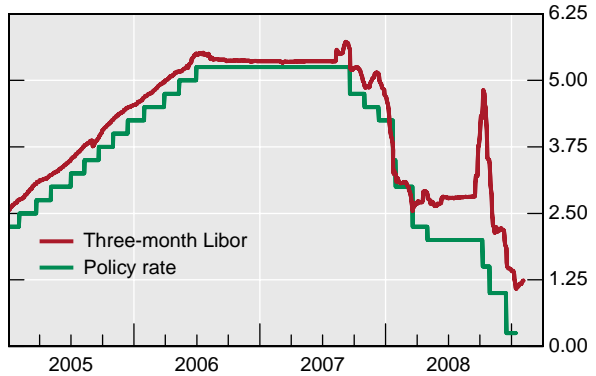
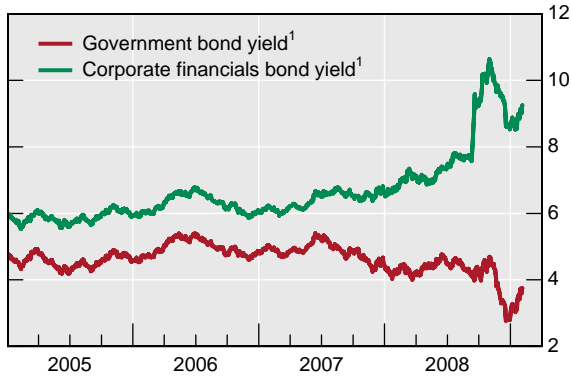
On the **fiscal side** of stabilisation, policy has consisted in allowing automatic stabilisers to play their role, resulting in a substantial increase in the cyclical component of budget deficits. In the OECD area as a whole, for instance, the general government deficit is estimated to have increased from 1.4% of GDP in 2007 to 2.5% of GDP in 2008: almost one third of that increase appears to have resulted from the deterioration of the cyclical component of these deficits.

¹ Credit spreads can be decomposed into two main components: expected losses from default and the risk premia that reflect factors such as liquidity and required compensation for bearing default risk. A main objective of central bank actions in credit markets is to counteract the impact of the latter factors on credit spreads.

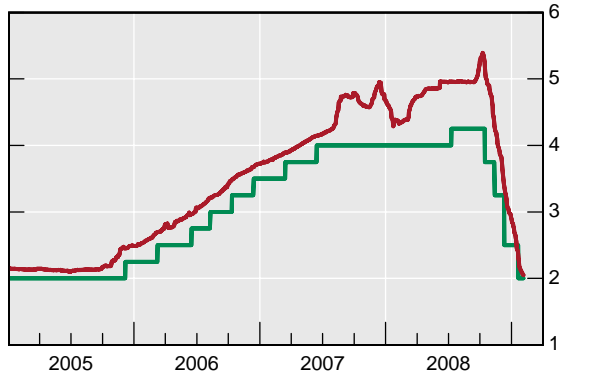


Graph 4
Indicators of long- and short-term bank funding costs (in per cent)

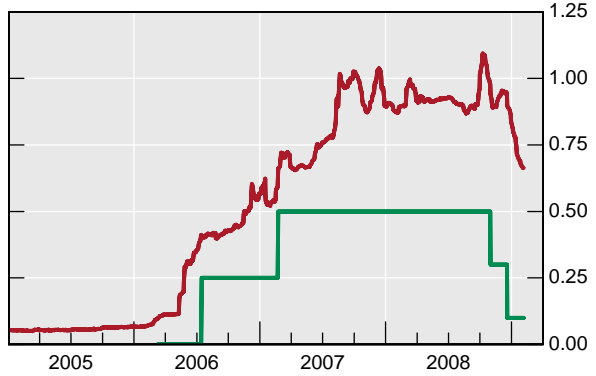
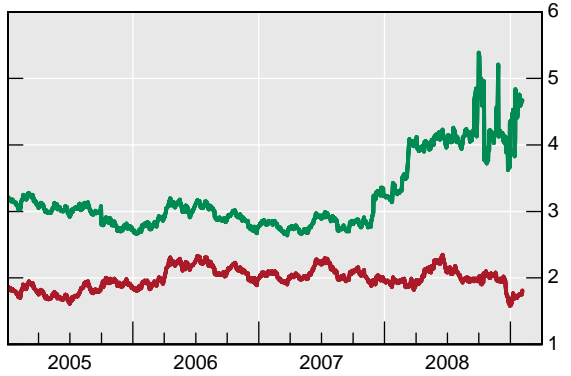
United States



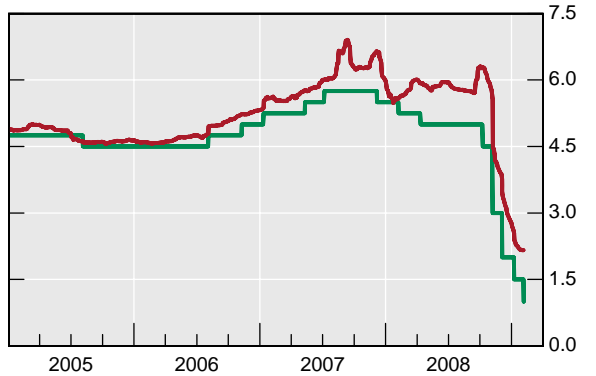
Euro area



Japan



United Kingdom



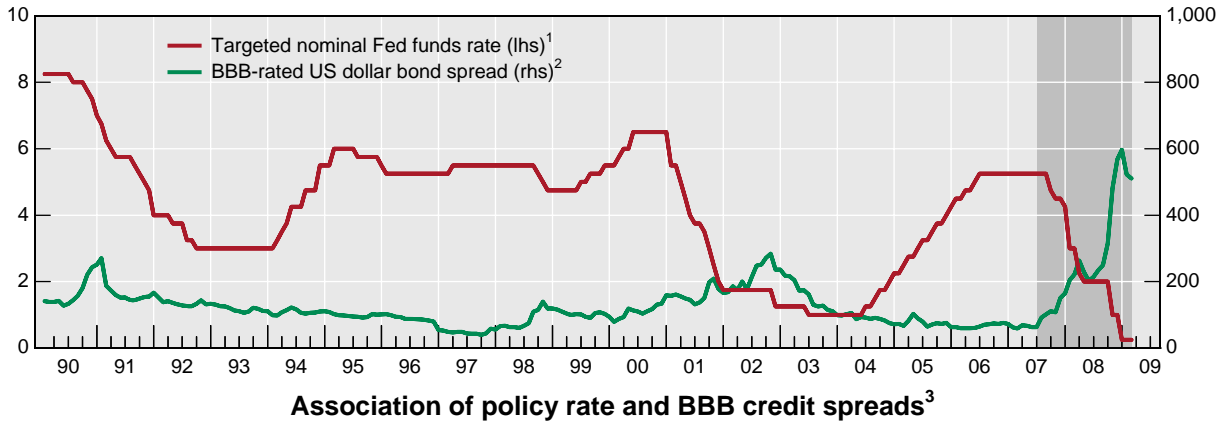
¹ Merrill Lynch index of bonds with maturities of at least 10 years.

Sources: Bloomberg; Datastream; Merrill Lynch; national data.



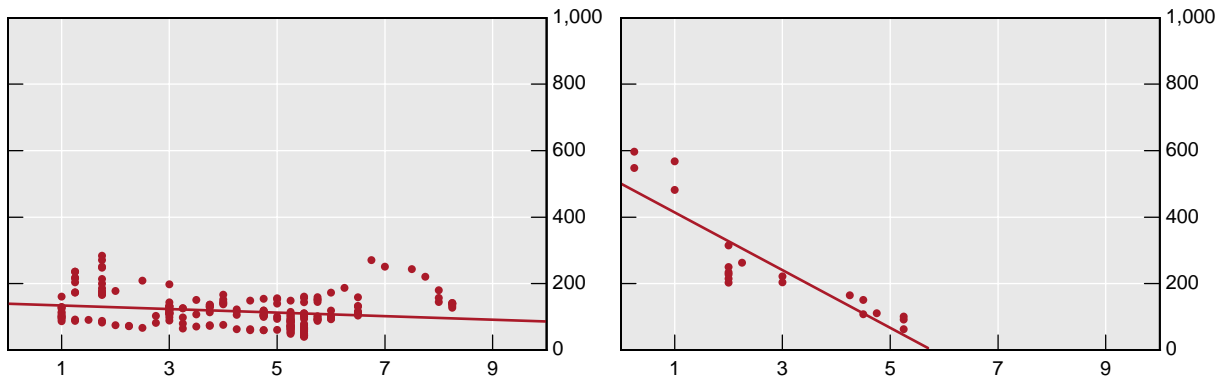
Graph 5

Corporate credit spread and Fed funds rate



January 1990–June 2007

After June 2007



¹ In per cent. ² Spread to Treasuries; month-end data; in basis points. ³ Regression of US BBB-rated corporate spreads, in basis points, on the targeted Fed funds rate, in per cent.

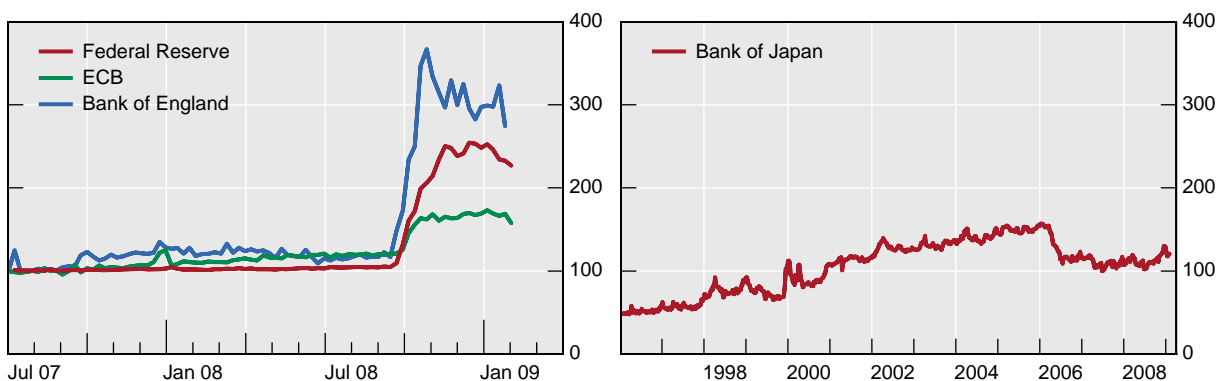
Sources: Bloomberg; Merrill Lynch; BIS calculations.

Turning lastly to **financial sector policy**, authorities have taken a number of steps to stabilise the financial system:

- providing guarantees to support credit flows, including greater coverage of retail deposit insurance and public guarantees on bank debt issuance;
- supplying emergency liquidity assistance to financial institutions via central banks;
- injecting longer-term public capital into the banking system;
- providing insurance against potential losses on bank assets.

Graph 6

Central bank total assets¹



¹ End of June 2007 = 100; weekly data in domestic currencies.

Sources: DataStream; national data.



The authorities have, however, refrained from increasing regulatory capital during the crisis. Instead, they have taken into consideration the fact that markets have effected a de facto increase in capital buffers above existing capital requirements, and regulators expect that these larger buffers will be available to cover losses over the current cycle.

The measured stabilisation policies just described are non-controversial because they have been crafted to counteract an unprecedented credit crisis rather than to have a major stimulative effect on demand.

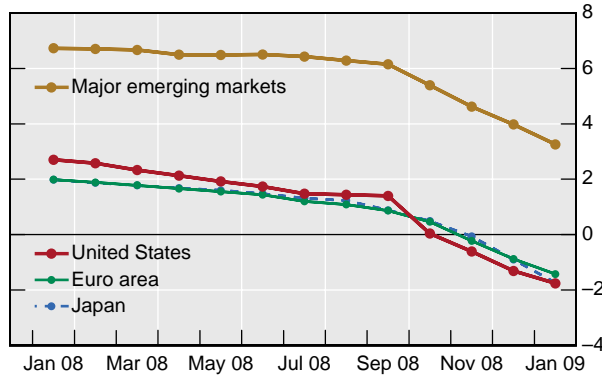
B. Large-scale policies to stimulate demand

The controversy arises in the next question: are policies to generate a major stimulus to demand warranted at the present juncture over and above the stabilisation actions just presented?

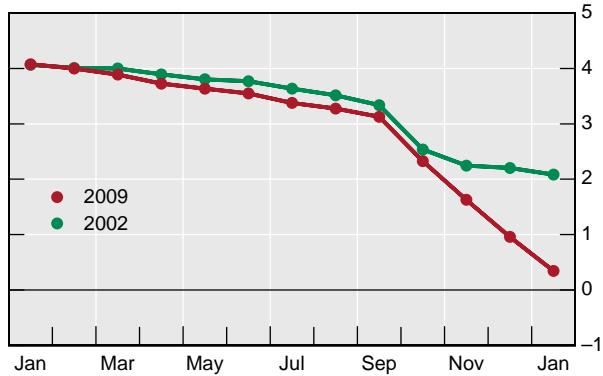
Requests have been growing recently for policies to stimulate demand on a larger scale. The requests are underpinned by two distinctive features of the current downturn that are highlighted in Graph 7 below: its simultaneity (synchronised slowdown across economies, with no “decoupling” of any large economic region); and its rapidity: in just the past year, the consensus forecast for global growth in 2009 has come down from 4.1% to only 0.3%. These two features suggest that the current recession might become the longest in the postwar era. For instance, as measured by the National Bureau of Economic Research, the average duration of US postwar recessions is 10 months, and the current postwar record is 16 months, observed for both the 1973–75 and 1981–82 contractions. The duration of the current recession, which began in December 2007, is already 14 months and counting.

Graph 7
Global growth forecasts¹

Forecasts for 2009



Forecasts of global growth for 2009 and 2002²



¹ Annual changes in real GDP, in per cent. ² Forecasts made from January of the previous year (ie for 2009, from January 2008; for 2002, from January 2001).

Source: Consensus Economics.

So, against this backdrop, I return to the question: is there scope for further larger-scale demand stimulus?

In terms of **monetary policy**, policy interest rates have already been reduced to very low levels, and it may take some time before we see their full impact on demand. For example, according to econometric estimates, whose uncertainties are compounded by the specific characteristics of the current financial crisis, the recent lowering of policy rates in major industrial countries could increase GDP by around 1 to 2 percentage points after two years, all other things being equal and depending on the country. Moreover, additional but less conventional monetary policy tools have been deployed, and their effects might still take time to be fully realised.



Turning to the **fiscal side**, there have been a lot of pressures recently for larger-scale fiscal stimulus.² The capacity for discretionary action differs from country to country, depending, for instance, on whether sufficient room for manoeuvre had been built up in good times. Moreover, automatic stabilisers tend to be weak in a number of countries where social security spending is limited (and automatic stabilisers smaller). Thus, for example, Chinese authorities have recently adopted significant stimulus measures in a context of relatively low levels of budget deficits, public debt and public spending relative to GDP.

At the global level, however, the size of the discretionary fiscal stimulus currently in train – in the form of new spending, or tax cuts, or both – already appears to be very large. For instance, the non-cyclical (structural) part of the general government budget balance is estimated to have increased by almost 1 percentage point of GDP from 2007 to 2008 for the OECD countries as a whole (2 percentage points for the United States), and recent reports point to additional significant stimulus in 2009. These developments are large by historical standards. Moreover, public programmes to rescue financial institutions are clearly unprecedented and have already led to a significant rise in the ratio of public debt to GDP in a number of large economies (Table 2 below). This should be seen in the context of the longer-term fiscal difficulties facing industrial countries as well as a number of emerging market countries due to the ageing of their populations.

In addition to fiscal stimulus, endogenous forces are at work that might support global demand in coming months. In particular, the sharp decline in the price of oil observed since its peak in summer 2008 should have significant positive effects on both inflation and output

	Budget balance			Gross public debt ²			
	2007	2008	2009	2000	2007	2008	2009
United States	-2.9	-5.3	-6.7	55	63	73	78
Germany	-0.2	-0.1	-2.9	60	65	66	70
France	-2.7	-3.2	-5.4	57	64	67	72
Italy	-1.6	-2.8	-3.8	109	104	106	109
Spain	2.2	-3.4	-6.2	59	36	40	47
United Kingdom	-2.7	-4.6	-8.8	41	44	50	63
Japan	-2.4	-1.4	-3.3	135	171	173	174
Ireland	0.2	-6.3	-11.0	38	25	41	55
Iceland	5.5	3.2	-1.9	41	24	25	122
China	1.0	0.8	-0.6	16	21	17	16
India	-5.0	-5.8	-5.6	75	79	76	73
Other emerging Asia ^{3,4}	1.5	0.0	-0.1	44	34	34	34
Latin America ^{3,5}	-1.2	-1.0	-1.5	43	50	46	44

¹ General government; as a percentage of GDP. ² For China, net debt; for Argentina, central government. ³ Weighted average of economies cited, based on 2005 GDP and PPP exchange rates. ⁴ Chinese Taipei, Hong Kong SAR, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand. ⁵ Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

Sources: European Commission, *Interim Forecast* (January 2009); IMF, *World Economic Outlook* (October 2008); OECD, *Economic Outlook* (December 2008).

² This is the most recently deployed of the four forms of fiscal action pursued in the current crisis: (1) automatic stabilisers, (2) capital injections, (3) guarantees on bank debt and (4) discretionary demand stimulus. The first and fourth affect both the deficit and the debt. The second affects the debt but not the deficit. The third has no immediate effect on the deficit or the debt, but it affects off-balance sheet contingent liabilities.



growth. According to some rough estimates, which are by nature uncertain, a sustained stabilisation of the price of oil at current levels – ie around USD 45 per barrel, compared with a 2007–08 average of around USD 85 per barrel – could raise global real GDP by perhaps 1½ percentage points after one year, all other things being equal. Such stimulus could be even larger for the industrialised countries that are mainly commodity importers.

One additional element is that, with the growing importance of the just-in-time model in production processes and inventory management, the current recession might differ from previous downturns because firms now have lower inventory levels for a given amount of output. Supporting this view is the fact that the ongoing slowdown in GDP growth in OECD countries (from 2½% in 2007 to 1½% in 2008) and the expected ½% decline in GDP in 2009 appear to have been accompanied by only a very minor correction in inventories so far, suggesting that output could respond to a demand recovery more quickly than before.

All these stimuli suggest that a scenario of a quick rebound in activity cannot be ruled out. Hence, although the economic outlook is still rather grim, the probability of a negative spiral leading to deflation and a long-lasting depression is at this stage perhaps not obviously higher than the probability of a shorter, albeit deep recession followed by a sharp rebound. The consensus view of a global recovery in 2010 is thus the median between two extremes: the downside scenario, in which current stimulus would not be enough to avoid a deeper and longer recession; and the upside scenario, featuring an earlier than expected and sharper rebound in activity.

Rigorous risk management suggests that policymakers should be symmetric in paying attention to the risks from both of these extreme scenarios, that is, the risk of “too little stimulus” and of “too much stimulus”. However, given the scale of public intervention and the fact that many commentators are focusing on “too little stimulus”, the attention in this speech will be more on the other side. If the macroeconomic stimulus currently built up is not unwound in time, it could lead to inflationary pressures that could well trigger a sharp correction in long-term interest rates (the bursting of the bond bubble?).

To summarise: what are referred to here as *measured stabilisation policies* are not controversial given the need to address current systemic threats – they help get the financial system working again and overcome the credit crunch caused by extreme and widespread “irrational” risk aversion. In contrast, there is a much larger question concerning whether *demand stimulation policies* should be activated on a larger scale. Because expectations matter, it is important to establish a reasonable calibration of current stimulus and to ensure that a concern for long-term sustainability is correctly incorporated in current short-term policy actions.

II. EMBEDDING LONG-TERM SUSTAINABILITY IN SHORT-TERM POLICY RESPONSES

Given the magnitude of the fundamental imbalances that existed before the crisis, we should be under no illusion that large-scale demand stimulus could be used to circumvent inescapable adjustments. Such a strategy would lead to a vicious circle of “serial stimulus packages” that would temporarily stimulate demand while failing to place the global economy on a sustainable path. This outcome would not be very different from the situation observed in Japan in the 1990s: the adoption of successive expansionary supplementary budgets in the early part of the 1990s was mirrored in a sharp deterioration in the underlying general government balance and by a succession of short-lived rebounds in activity. But the resulting increase in government debt limited the available room for manoeuvre when authorities wanted to address the situation in the banking sector in more depth (especially in 1998, when unviable banks were nationalised and a bank recapitalisation programme was established).



A. Medium-term risks from large-scale stimulus

From a medium-term perspective, a key risk presented by an excessive policy of demand stimulation would be to perpetuate or even exacerbate current economic imbalances.

Turning first to the **fiscal policy** dimension, too much stimulus to support consumption in low-saving countries could prevent an orderly correction in their current account deficits – leading to a further build-up of external debt (Graph 8 on the next page) – and delay the needed reconstitution of savings. At the global level, that outcome would be inconsistent with the need to rebalance demand through higher domestic demand in high-saving countries and to support net investment flows towards emerging market economies. Instead, too much stimulus would continue the past decade's accumulation of vast foreign exchange reserves, which in turn contributed to further accommodate monetary and credit conditions in low-saving mature economies.

Indeed, a key element underlined by the ongoing contagion of the financial crisis to the rest of the world is the excessive dependence of Asian economies on external demand. The resistance to exchange rate appreciation observed for many years in Asia was considered to be a way of ensuring strong, export-led growth. But the domestic side effect of this strategy has been the increasing dependence on exports and investment, demand components that are usually more volatile than domestic consumption (Graph 9 on page 13). Such excessive volatility can present a significant challenge to the long-term development of these economies.

Another risk is that medium-term fiscal sustainability could be undermined in a way that produces a “fiscal crisis”. Unless governments calibrate their fiscal stimulus in a reasonable way, excessive borrowing needs could produce disorderly movements in government bond yields and sovereign spreads. A key risk in this respect would be that markets start questioning the sustainability of fiscal positions and the credit quality of governments. Indeed, the recent widening of sovereign bond spreads may point to a greater market perception of such medium-term fiscal risks. The increase in spreads is particularly striking within the euro area, where 10-year sovereign bond spreads between Germany and a number of other countries have risen sharply to levels higher than any since the start of monetary union. Moreover, although bank rescue packages appear to have been instrumental in containing the increase in commercial bank credit default swap (CDS) spreads in recent months, the result has been achieved at the cost of higher sovereign CDS spreads in major industrial countries (Graph 10 on page 13) – one might say that, following the announcement of these government rescue packages, sovereigns appear to have been contaminated by the widening of financial spreads.

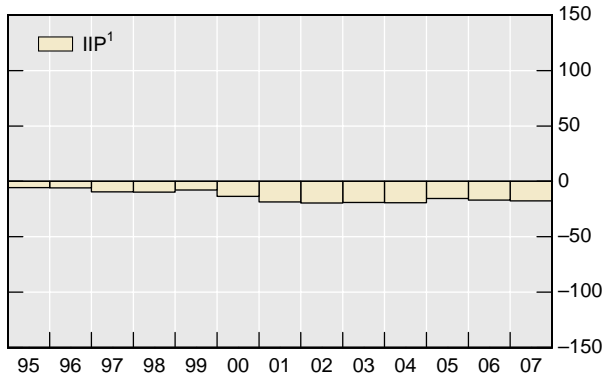
A last risk posed by excessive fiscal stimulus is that long-term inflation expectations could at some point be revised upwards should economic agents come to the conclusion that governments will not be able to deal with future debt burdens without allowing higher inflation. In this respect, recent developments in inflation-linked bonds shown in Graph 11 on page 14 suggest that financial market participants might, indeed, start to again revise their longer-term inflation expectations; if so, that would explain a substantial part of the rebound in sovereign bond rates observed in the past few weeks.

On the **monetary policy** side, another well known risk is the “liquidity trap”: the longer that financial markets function with close to zero interest rates, the less effective the market liquidity created by these low interest rates can be in stimulating activity, as borrowers prefer to keep assets in short-term cash accounts rather than make long-term investments. Moreover, maintaining the cost of credit too low for too long would distort both the allocation of savings and risk-taking behaviour (for instance, by triggering an excessive search for yield). Such a period of excessively low credit costs could hamper the needed restoration of savings and the needed correction in asset prices – the right way to deal with a collapsed housing bubble is not to reflate it – and would also sow the seeds of the next boom and bust cycle.

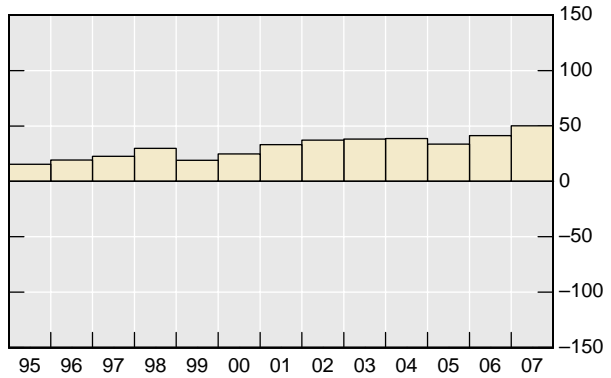


Graph 8
Net external debt
As a percentage of GDP

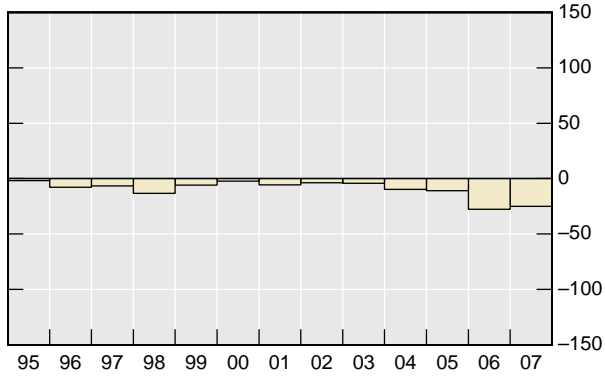
United States



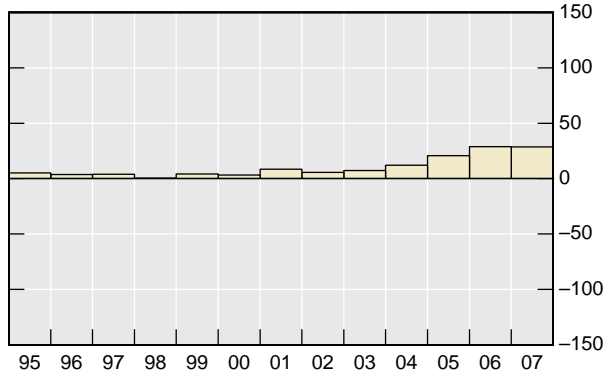
Japan



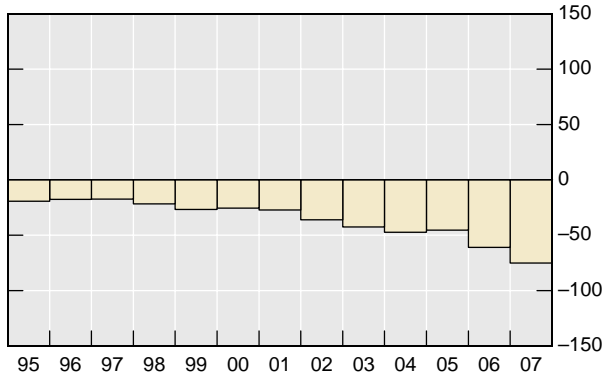
United Kingdom



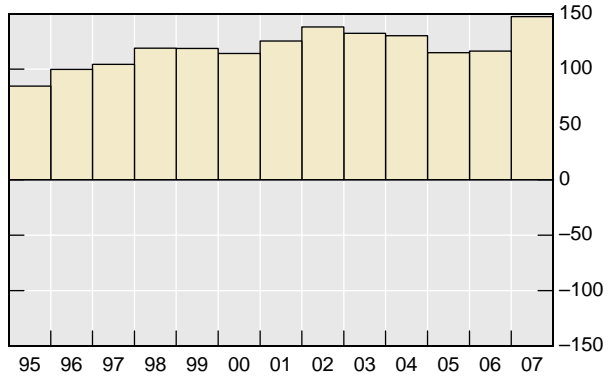
Germany



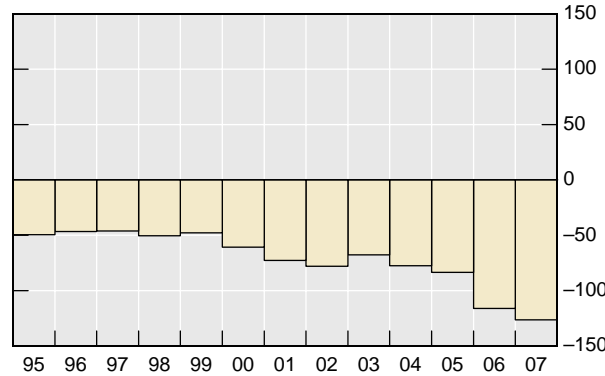
Spain



Switzerland



Iceland



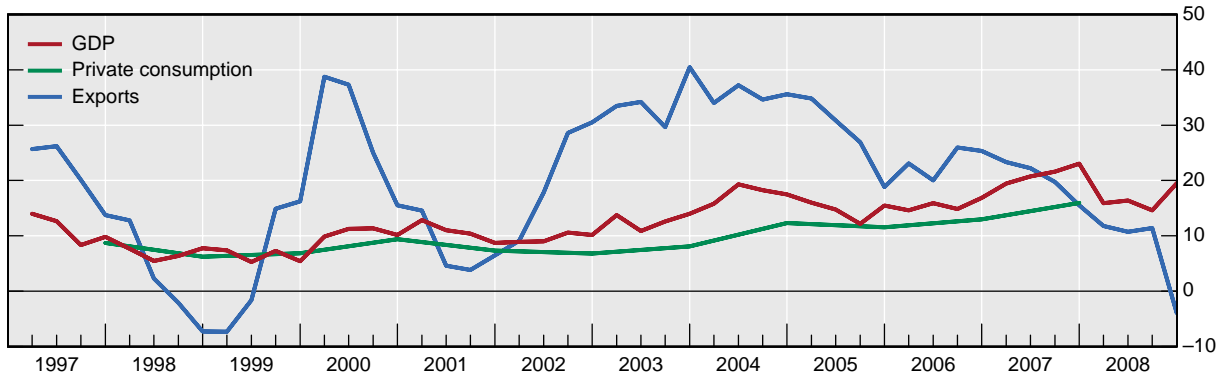
¹ Net international investment position (countries' assets minus countries' liabilities).

Source: IMF, International Financial Statistics.



Graph 9
China

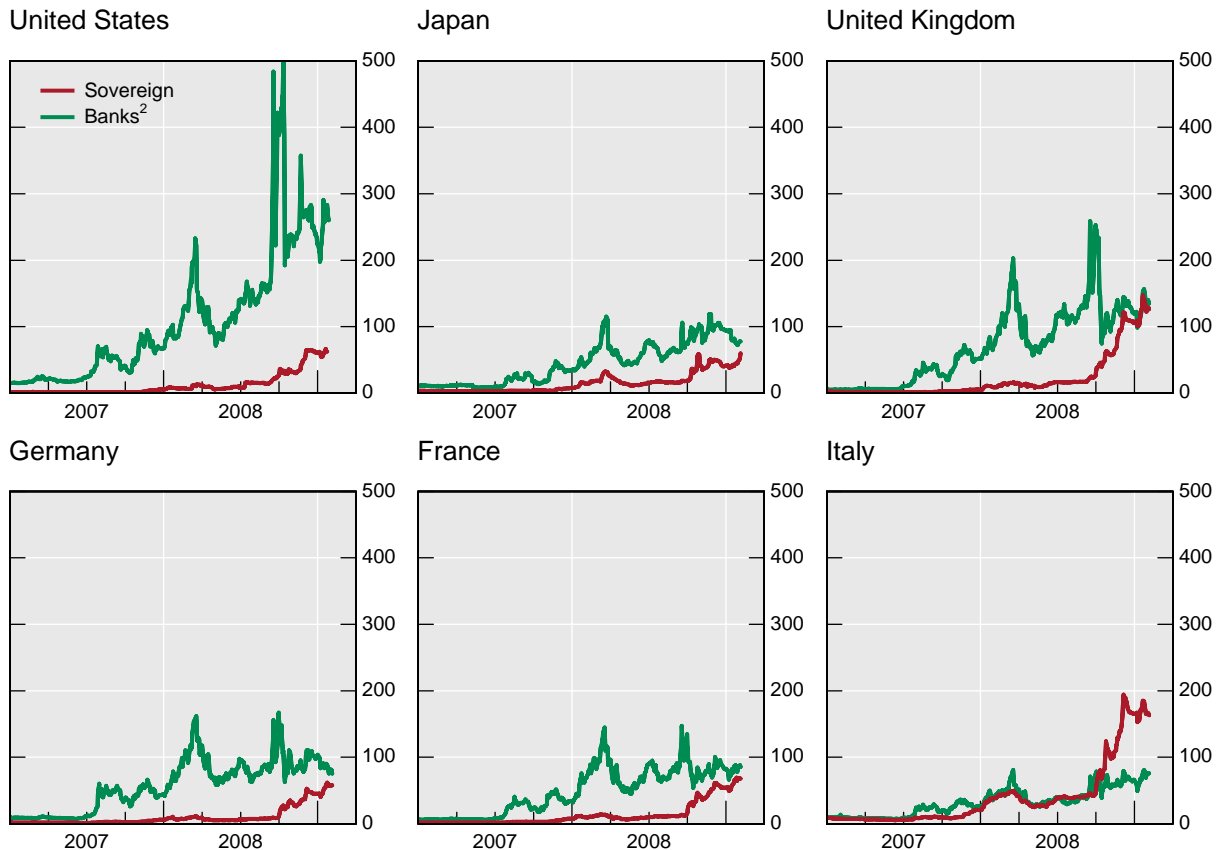
Annual nominal changes, in per cent



Source: Datastream.

Turning to **financial sector policy**, recent rescue packages for banks have been associated with government requests for commercial banks to lend more. One obvious risk is to end up with a combination of only modest deleveraging in the financial sector and a massive leveraging in the public sector without achieving the needed reduction of debt at the global level.

Graph 10
CDS premia¹



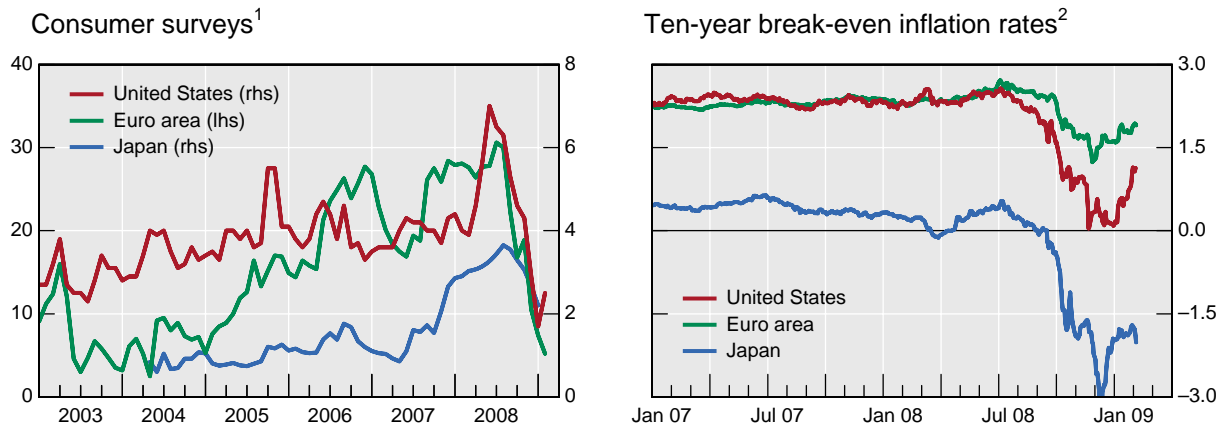
¹ Five-year on-the-run CDS spreads. ² Simple average over sample of major banks – for the United States: Bank of America, Citigroup, Goldman Sachs, JPMorgan and Morgan Stanley; for Japan: Mitsubishi UFJ, Mizuho FG and Sumitomo Mitsui FG; for the United Kingdom, Barclays, HBOS, HSBC and RBS; for Germany: Commerzbank, Deutsche Bank and Dresdner Bank; for France: BNP Paribas, Crédit Agricole and Société Générale; and for Italy: Intesa Sanpaolo and Unicredit..

Sources: Datastream; Markit.



A perhaps even more fundamental risk relates to market distortions. Government decisions to provide financial support to banks can have negative side effects on the provision of credit to the economy and on competition. In particular, public guarantees potentially raise financing costs for borrowers not covered by the scheme and may crowd out demand for non-guaranteed debt instruments, including top-rated debt securities (see, for example, the recent widening of spreads on covered bonds). More generally, the apparent willingness of authorities to extend support to banks could distort the evaluation and pricing of different risks, especially if a growing variety of liabilities is perceived to be covered by an implicit government guarantee. In this context, some observers have raised concerns of a possible “new mercantilism”: competing national responses to the financial crisis may undermine the benefits of global capital markets, raising competition issues and hindering the restructuring of the global financial sector. And, indeed, it is fair to say that the coordination of central bank policy responses to the crisis has been more effective than the coordination of the various bank rescue packages initiated by governments.

Graph 11
Inflation expectations



¹ Based on consumer surveys for one-year-ahead inflation; for the United States: University of Michigan consumer sentiment – median expected inflation, in per cent; for the euro area: European Commission consumer survey diffusion index; for Japan, figures are calculated from shares of ranges in the Monthly Consumer Confidence Survey, in per cent. ² Difference between 10-year nominal and index-linked yields, in per cent.

Sources: ECB; Cabinet Office, Government of Japan; Datastream; national data; BIS calculations.

Lastly, another key risk is that the resources available for stabilising the financial system might become insufficient. Excessively large fiscal measures to stimulate demand in the short term would constrain the amount of public resources available for banking resolution and balance sheet cleaning, which is ultimately the key to ensuring a sustainable recovery. The total fiscal cost of some past banking crises – the direct cost as well as the indirect cost due to lost output – has been quite high, according to recent OECD estimates, ranging from 18% of GDP in Japan for the 1990s crisis to 30% of GDP in Korea following the 1997 crisis. The recent turmoil in Iceland has shown that the failure of a banking system may overwhelm the nation’s resources.

Because expectations are key, the feedback of such medium-term concerns to the expectations of economic agents might well counteract policy: to be effective, even in the short run, policies must have a clearly stated medium-term anchor.



B. Policy framework for medium-term sustainability: how can medium-term risks be mitigated?

Current policy actions have to be embedded in properly designed medium-term policy frameworks, and there is a trade-off between short-term stimulus and long-term sustainability. One way of addressing this trade-off is to design exit strategies well in advance, ideally at the same time as policy actions are set up.

A number of the recently announced actions in the three realms of monetary, fiscal and financial sector policy have been designed from such a medium-term perspective, and that represents a positive development:

- In the monetary policy dimension, the Federal Reserve has recently communicated a possible exit strategy based on an appropriate pricing of its facilities and on a timely unwinding of its interventions. An important element is that a number of the monetary policy tools recently deployed to address the financial crisis have been designed to allow a rapid shrinking of the central bank balance sheet when the situation in credit markets normalises.
- Regarding fiscal policy, the most recent German short-term fiscal package included a medium-term consolidation mechanism.
- In the financial sector – more precisely, regarding prudential policy – the Basel Committee on Banking Supervision is working on ways to mitigate procyclicality in bank regulation by building capital buffers above the regulatory minimum in good times; then, in times of stress, they could be drawn down to absorb losses and sustain the flow of credit to the economy.

Yet developing the consistent medium-term policy frameworks described above is not sufficient. Also necessary is a broad macrofinancial stability framework to ensure that individual policy frameworks are compatible with each other and contribute in a coherent way to the overarching goal of maintaining financial stability and prevent the repetition of the serious financial excesses that we have seen.

Looking ahead, a key challenge is to design preventive measures that will ensure financial stability in the medium term. You are well aware that there are different schools of thought on the crucial question of what is “preventable”:³ one radical view is that it is illusory to “lean against the wind” and that, instead, policymakers should limit themselves to “cleaning up the mess” when bubbles burst; an opposite view is that all public policies – especially monetary, fiscal and prudential policies – should be used in a consistent macrofinancial stability framework so as to pre-empt financial excesses and serial boom and bust cycles.

Which approach would have been the most effective is almost impossible to judge after the fact, not least because of the impossibility of knowing the outcome of the counterfactual scenario. But what is clear is that having a macrofinancial stability framework guiding policymakers would certainly help embed concern for medium-term sustainability into short-term stabilisation and stimulation actions and thereby restore confidence in periods of stress.

- In this conception, monetary policy has an important role to play. The recent financial turmoil suggests that monetary policy may have to counteract excessive credit expansion and asset price booms even if price stability is achieved.⁴

³ See Hervé Hannoun, “Policy lessons from the recent financial market turmoil”, speech at the XLV Meeting of Central Bank Governors of the American Continent, Ottawa, 8–9 May 2008.

⁴ See William White, “Is price stability enough?”, *BIS Working Papers*, no 205, 2006.



- On the fiscal policy side, a properly designed framework would stress the importance of countercyclical fiscal restraint to moderate booms and reduce outstanding public debt in good times; that would ensure sufficient room for fiscal policy to take financial stabilisation measures in times of stress.
- Regarding prudential policy, the suggestion of developing a macroprudential framework for addressing risks at the system-wide level has been advocated since the early 2000s by the BIS, and we are continuing to work on this crucial issue.

One key objective of the macrofinancial stability approach would be to limit the “serial” bubbles that can result from short-sighted policy reactions to asset price crashes. We have seen a succession of such bubbles and reactions in the past decade (the dotcom bubble, the housing bubble, the credit bubble, the commodity bubble and, perhaps what will prove to be the next one, the bond bubble). An essential element of this framework is to ensure that buffers are built up in good times at both the micro and macro levels that can help contain episodes of financial stress: at the micro level, capital buffers sufficient for banks to ride out losses; at the macro level, foreign exchange reserves sufficient to resist sudden stops in international capital flows and adequate fiscal buffers to give governments some room for manoeuvre in a downturn.

Summary

Let me conclude. Policymakers may be taking actions that will slow, or possibly prevent, necessary adjustments. Most informed observers agree that the capital structures of the US and European economies need to change. That is, there is too much debt relative to equity. What has been commonly called “deleveraging” is the process of converting debt into equity. Some of the economies that are in trouble clearly also need to make big adjustments in their industrial structure. For one example, the global financial system is almost surely too big. And in some countries the residential construction industry is unsustainably large. The point is that fiscal policymakers must take care that their expansionary policies do not simply delay needed adjustments. If there is such a delay, we could be in for a very long haul.

It is a legitimate goal of policy to mitigate the macroeconomic recession and slow the spin of the negative feedback loop. However, expansionary policies that fail to take the crisis of confidence sufficiently into account run the risk of becoming ineffective beyond the very short term. To restore confidence in a sustainable way, policy actions should be embedded in a credible longer-term perspective and pay due attention to their effects on the expectations of economic agents.

Policymakers have therefore to be aware of the risk of providing “too much” demand stimulus and should not exclusively focus their attention on the risk of “not doing enough”.

The crucial actions are to develop consistent medium-term policy frameworks (and, in particular, preserve fiscal discipline), plan sufficiently in advance for how current policies will be unwound when normal conditions return, and develop a consistent approach to macrofinancial stability. Together, these measures would ensure that short-term policy actions do not sow the seeds of tomorrow’s boom and bust episodes.