BANK FOR INTERNATIONAL SETTLEMENTS

General Manager's speech

The narrow path ahead

Speech delivered by Jaime Caruana
General Manager of the BIS

Basel, 29 June 2009

Speech delivered by Jaime Caruana

General Manager of the BIS

on the occasion of the Bank's Annual General Meeting
in Basel on 29 June 2009

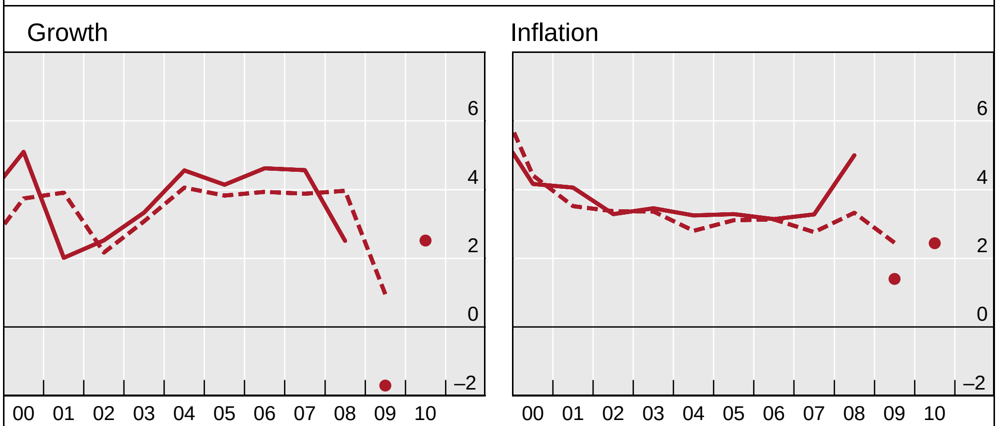
Ladies and Gentlemen

In the fourth quarter of 2008, the global economy plunged into a uniquely synchronised and deep downturn – the worst since the 1930s. The financial crisis had finally hit the macroeconomy with full force. World trade collapsed and economic weakness spread to emerging market economies. The policy response was unprecedented.

What had initially appeared as strains contained within the US subprime mortgage market spilled over in successive waves to overwhelm the interbank markets of advanced countries, undermine the soundness of major financial firms and, finally, trigger a global contraction. As events unfolded, concerns about a serious liquidity crisis escalated into concerns about solvency and then, and most worryingly, about a crisis of confidence in the economic system itself.

Now, some six months on, the sense of free fall has dissipated. While still declining, economic activity in much of the advanced world has shown signs of stabilising (Graph 1). And most emerging market economies have generally

Global growth comes to a sudden halt[1]



[1] Annual changes in real GDP and consumer prices, in per cent. Average of countries available in Consensus Economics. The dashed lines show the consensus forecasts made at the end of the preceding year; the dots show forecasts for 2009 and 2010 as of May 2009.

Sources: © Consensus Economics; national data; BIS calculations. Graph 1 proved less fragile than was feared at the peak of the turbulence. The consensus forecast is for a return to positive global growth later this year. Even so, the path to a self-sustaining recovery is fraught with risks, and the nature of the destination – the new normal – remains shrouded in thick fog. We are travelling through largely uncharted territory.

In what follows, I will argue that, to reach our destination safely, we need to strengthen the medium-term orientation of current policies and be clearer about how we will exit them. What does this imply for the journey ahead and for the destination? To understand that, let me first briefly review how we got here.

The crisis: symptoms and causes

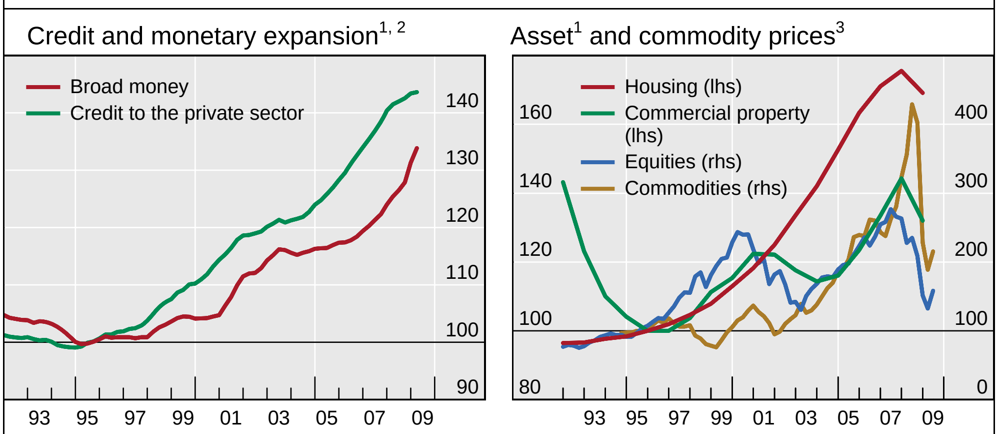
The crisis is best regarded as the steep downside of an extraordinary global financial cycle that was amplified by structural weaknesses. The financial imbalances that had built up slowly but inexorably during the boom, on the back of aggressive risk-taking and leveraging, had finally started to unwind. That the unwinding would have to happen at some point, and that it could cause financial strains, was hardly a surprise. But its timing, specific form and intensity were not anticipated.

There were signs that risks were building up. These included unusually strong increases in credit and in asset prices – especially prices of residential property (Graph 2) – and unusually low volatilities and risk premia across a broad range of asset classes (Graph 3). Could these have been signs that risk was truly low, another reflection of the Great Moderation? In hindsight, they turned out to be signs of uncharacteristically high risk-taking, complacency and leverage. Global growth was being fuelled by an unsustainable financial cycle.

Financial cycles are a natural feature of market economies. They reflect the self-reinforcing ebb and flow of risk perceptions and financing constraints that amplify expansions and contractions in real economic activity – amplification that has come to be known as procyclicality. As elaborated in the

A credit and asset price boom precedes the crisis

1995 = 100

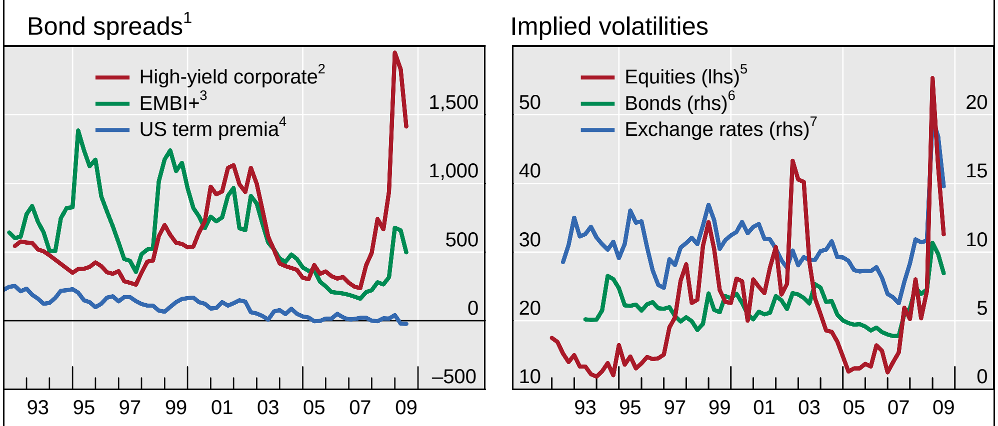


[1] Weighted average of major OECD countries, based on 2005 GDP and PPP exchange rates. [2] Relative to nominal GDP. [3] Goldman Sachs Commodity Index, in US dollar terms; quarterly averages.

Sources: IMF; OECD; Datastream; national data. Graph 2

Remarkably buoyant financial markets precede the crisis

Quarterly averages



[1] In basis points. [2] Merrill Lynch option-adjusted spreads, average for US and euro area high-yield bonds. [3] Emerging Market Bond Index Plus; stripped spread as calculated by JPMorgan. [4] Estimated for 10-year zero coupon Treasuries. [5] Simple average of the United States and Germany; derived from the price of call option contracts on stock market indices. [6] Simple average of the United States and euro area; price volatility implied by the price of call options on 10-year government bond futures contracts. [7] JPMorgan benchmark index for the level of G7 currencies' implied volatility.

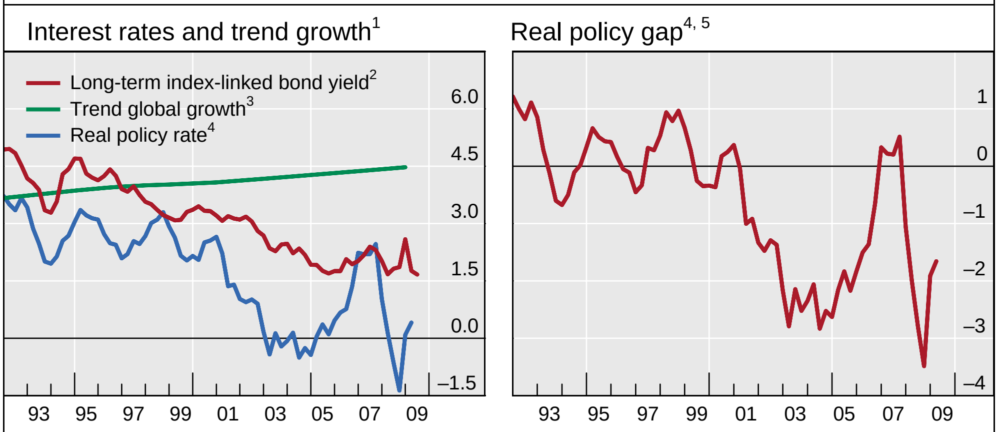
Sources: Bloomberg; Datastream; JPMorgan Chase; Merrill Lynch; US Bureau of Economic Analysis; US Bureau of Labor Statistics; national data; BIS calculations. Graph 3

BIS Annual Report, financial cycles are exacerbated by inherent difficulties in measuring risk and by distortions in incentives. Episodic financial strains cannot be eradicated entirely; the market is not fully self-correcting. But they can be mitigated or magnified by policy.

This cycle was especially severe and exceptionally costly. Risk management had improved, but neither the system's internal checks and balances nor official oversight succeeded in restraining excessive risk-taking and system-wide regulatory arbitrage. In retrospect, we clearly overestimated the diversification benefits of the originate-to-distribute model of lending and underestimated the systemic implications of thinly capitalised, liquidity-dependent off-balance sheet vehicles. Similarly, insufficient attention was paid to the tension between the unusually low policy rates in the major economies and the higher equilibrium interest rates implied by the high and rising estimates of global potential growth (Graph 4).

International monetary arrangements did not help. Several emerging market economies faced with strong gross capital inflows, and some benefiting also from higher commodity prices, resisted appreciation of their currencies. Resistance through lower policy rates in effect propagated the policy stance of core economies to the rest of the world. Resistance through unprecedented accumulation of foreign exchange reserves and their reinvestment in the core economies helped keep long-term interest rates down and boost credit expansion there. In this way, the symbiotic relationship between leverage-led growth in several industrial countries and export-led growth in other economies contributed to sustaining the unsustainable for too long (Graph 5).

Easy monetary conditions precede the crisis



[1] In per cent. [2] From 1998, simple average of Australia, France, the United Kingdom and the United States; otherwise only Australia and the United Kingdom. [3] Trend world real GDP growth as estimated by the IMF. [4] Weighted average of major OECD countries, based on 2005 GDP and PPP exchange rates. [5] Real policy rate minus natural rate. The real rate is the nominal rate adjusted for four-quarter consumer price inflation. The natural rate is defined as the average real rate in 1985–2000 (for Japan, 1985–95; for Switzerland, 2000–05) plus the four-quarter growth in potential output less its long-term average, in percentage points.

Sources: IMF; OECD; Bloomberg; national data; BIS calculations and estimates. Graph 4

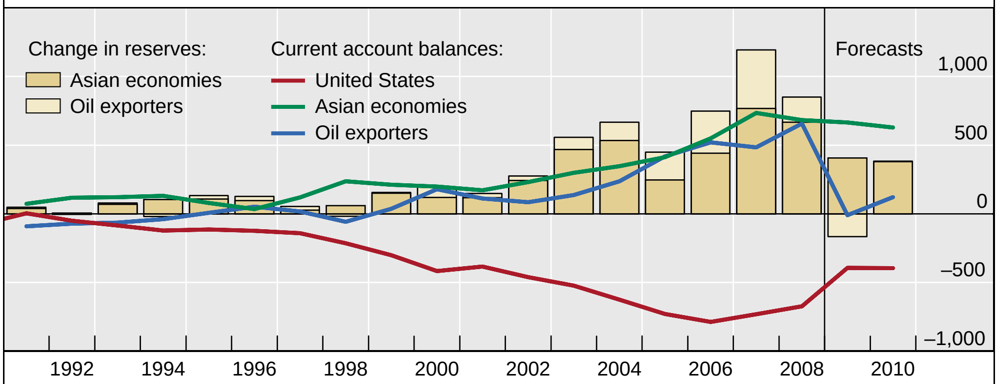
In a word, it was too easy to overestimate how much we really knew about the workings of the economy and the complex financial system that supports it. We put too much faith in the self-corrective properties of markets. And even when risks were recognised, no one was prepared to pay the price to remedy the imbalances that had been the basis for record world growth rates.

The path to a self-sustaining recovery and exit strategies

Looking forward, the path to a self-sustaining recovery is narrow and fraught with risks. This is true regardless of short-term prospects, even if we take the "green shoots" of recovery at face value. There are two simultaneous challenges. We need to facilitate the necessary adjustments in the financial system and the real economy while cushioning the impact of those adjustments on growth and employment. And we need to ensure that the short-run

Large current account imbalances and reserve accumulation

In billions of US dollars



Source: IMF. Graph 5

responses to the crisis do not mortgage the future, paying close attention to sustainability and exit strategies.

Economic adjustment is a precondition for a self-sustaining recovery. The process has started but is far from over. Our economies are still struggling with the deep-seated distortions that the unsustainable boom created in both the financial and real sectors. After all, these sectors are two sides of the same coin. The financial sector has to shrink, as it has grown too large and accumulated assets of dubious quality. New business models need to be found. In several countries, debt and leverage in both the financial and the non-financial sectors have to decline further; and household saving rates need to rise to more reasonable levels. Global excess capacity in sectors that were heavily reliant on debt financing, such as construction and automobiles, has to be worked down. And production structures have to be shifted from export- and leverage-led growth models to more balanced ones. None of this can be done overnight.

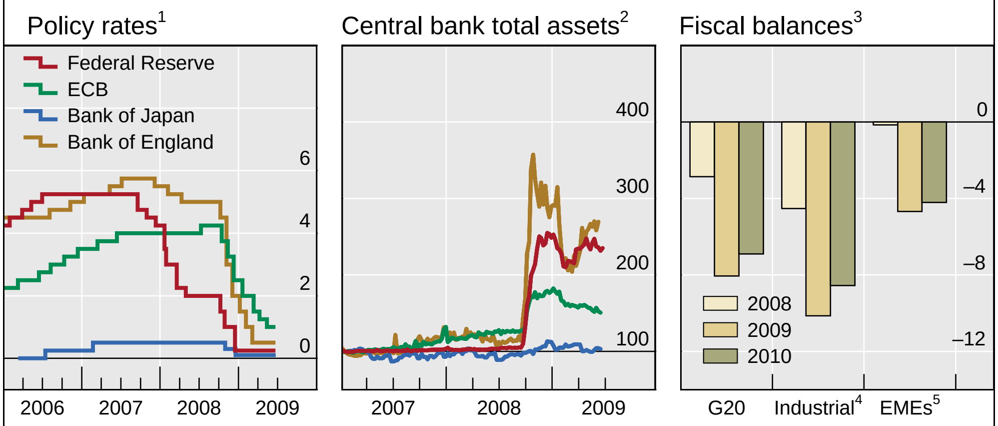
Repairing the financial system is a key priority. The authorities need to ensure that losses are booked, bad assets are disposed of, the system is recapitalised and restructured, competitive equality is restored and excess capacity is removed. These policies are necessary to allow the financial system to operate effectively and to establish the foundations for its long-term profitability. While progress has been made, perseverance and determination are essential. Full resolution of the underlying problems has been held back by several factors: the complex nature of structured products; the large cross-border operations of some of the institutions affected; the lagged recognition of the solvency crisis lurking behind the liquidity strains; and the difficulties of the political process.

Without an effective resolution of the financial system's problems, the unprecedented monetary and fiscal responses run the risk of failing to gain any appreciable traction, providing only short-term relief (Graph 6). In the main industrial economies, central banks have reduced policy rates to zero or near zero and aggressively employed their balance sheets to improve the functioning of money and credit markets as well as to influence long-term bond yields. As a result, they have reluctantly taken over part of the intermediation process normally performed by the private sector. For their part, governments have drastically relaxed fiscal positions; budget deficits and debt levels have risen sharply and are expected to rise further.

At best, a failure of these initiatives to get traction would delay the self-sustaining recovery; at worst, it could derail it. In particular, the concerns of the financial market with unsustainable fiscal positions and, by implication, with future inflation could unsettle sovereign debt markets today. This could seriously test the limits of public sector intervention and force a disorderly exit from current fiscal policies.

Once the recovery becomes evident, the stimulus will have to be withdrawn promptly and markets allowed to regain their role in allocating resources. Delaying the exit would perpetuate competitive distortions and risk generating inflationary pressures or sowing the seeds of the next imbalance.

Unprecedented monetary and fiscal stimulus



[1] For the Federal Reserve, target federal funds rate; for the ECB, interest rate on the main refinancing operations; for the Bank of Japan, target for the uncollateralised overnight call rate; for the Bank of England, Bank rate. [2] Assets in national currency, rebased to January 2007 = 100. [3] General government financial balance, as a percentage of GDP; estimates and projections published in April 2009. Aggregates are weighted averages based on 2005 GDP and PPP exchange rates. [4] Australia, Canada, France, Germany, Italy, Japan, the United Kingdom and the United States. [5] Argentina, Brazil, China, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia, South Africa and Turkey.

Sources: IMF, *World Economic Outlook*; Datastream; national data. Graph 6

Implementing a timely exit will not be easy. Some technical challenges exist. By their nature, some fiscal measures are hard to reverse. Similarly, central banks may not always find it simple to smoothly shrink their balance sheets or withdraw from their current market-making role. And even when the political support exists, it can take time for governments to lift guarantees and sell back assets. Above all, however, the challenge is to choose the proper timing and speed of the exit. True, one risk is exiting too early. But experience suggests that the bigger risk is exiting too late and too slowly or, in the case of fiscal policy, not exiting at all. The political economy pressures are overwhelmingly in this direction.

How can the risk of exiting too late and too slowly be minimised? There is no simple answer. But clarity – in the objectives of the interventions, in the respective roles of governments and central banks, and in the conditions for exit – is an important precondition. And that clarity is needed today.

Destination: the new normal

For the longer term, official authorities face the task of adjusting policy frameworks to limit the risk that any event as costly as this will ever recur. We need to edge closer to lasting financial, monetary and macroeconomic stability. Doing so calls for adjustments to both financial and macroeconomic policies. If we are to take advantage of the window of opportunity provided by the crisis, then these reforms must be pursued without delay. And they will need to be underpinned by closer international cooperation.

One key line of defence against financial instability is an improved framework of financial regulation, supervision and oversight. As elaborated in the main body of the Report, a holistic approach is necessary, covering stronger safeguards for instruments, markets and institutions. This means putting in place better mechanisms to assess the suitability and risks of new financial instruments. It means encouraging greater centralisation in clearing, settlement and, possibly, trading. It means making each institution sounder, through tighter consolidation of off-balance sheet exposures, better accounting and improved capital and liquidity standards. Above all, it calls for strengthening the macroprudential orientation of regulation and supervision – a core theme of BIS work for many years now. This means focusing firmly on system-wide risks and addressing the procyclicality of the financial system. Implementing this orientation through a rule-based approach, relying as far as possible on automatic stabilisers, would help the authorities to take restraining measures in good times. Even so, some reliance on discretion may also be inevitable.

Since the crisis, the G20, the Financial Stability Board, international standard setters and national authorities have jointly made much progress in these areas; indeed, some of the initiatives were already well in train before the turbulence. There has been a strong push towards central counterparties for the trading of derivatives. Prudential regulators have taken major steps to strengthen capital and liquidity safeguards; together with accounting standard setters, they have intensified efforts to reconcile accounting practices with sound risk management. And there are several projects under way to make the macroprudential approach operational, building on the new-found international consensus supporting it. The BIS is actively involved in all of these initiatives.

But better regulation will not be enough; complementary adjustments to macroeconomic policy frameworks are equally essential. These adjustments would call for a more symmetric response to the build-up and unwinding of financial imbalances. We will need to explore how to incorporate credit and asset price booms and the associated risk-taking more meaningfully in monetary policy frameworks. Likewise, we should give additional consideration to the possible role of fiscal policy, including that of the tax system and fiscal balances. Not least, we now know that credit and asset price booms can mask serious weakness in the fiscal accounts. They thus make fiscal prudence harder to achieve precisely when it is most needed.

At the same time, there are clear limits to what policymakers can do: the private sector has a critical role to play as well. Business models in the financial sector will have to evolve if they are to recognise the need for larger, higher-quality capital and liquidity cushions. Similarly, internal and external governance mechanisms will have to be strengthened to ensure better risk management and less risk-taking. The risk management function in financial institutions has to receive the highest priority at the highest level and not be subordinated to the business functions. Improved compensation schemes are essential.

If all these efforts are successfully completed, they will deliver a welcome new normal. Economic activity might have fewer spells of breathtaking growth but would be more sustainable – an inevitable trade-off that needs to be properly understood. The financial system would be smaller and more strongly capitalised; and return on equity would be lower but more durable. The regulatory perimeter would extend further, and systemically significant institutions, regardless of their legal form, would have less incentive to grow as large and complex as they are today. Having found ways of unwinding those institutions in an orderly fashion, policymakers would allow market discipline to have more sway and would jettison the too-big-to-fail doctrine. And international cooperation would underpin continued financial and trade openness, avoid fragmentation, and support convergence of practices.

Pursuing this agenda of rescue, recovery and reform calls for great perseverance, patience and determination. The times ahead may be particularly difficult. It is not hard to imagine a world in which overly indebted governments intervened heavily in the economy, the financial system was overregulated, the level playing field was impaired, and globalisation was reversed. Recent signs of protectionism and increased home bias – sometimes an unintended consequence of national support for the financial sector – highlight the dangers ahead. The move towards that world should be resisted, as it would usher in anaemic growth, much higher inflation risks and international tensions. Mounting that resistance puts a premium on international cooperation and a heightened sense of shared responsibility. As it has been throughout its history, the BIS is committed to playing its part in this endeavour.