BANK FOR INTERNATIONAL SETTLEMENTS

General Manager's speech

Building a lasting foundation for sustainable growth

Speech delivered by Jaime Caruana
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Good afternoon, ladies and gentlemen.

In a number of crucial respects, the picture today is better than it was a year ago, and much better than it was in June 2009. While serious vulnerabilities remain and hard work lies ahead, it is important that we don't lose sight of how far we have come.

Taking the global economy as a whole, the gap between world demand and productive capacity is closing. And the world economy is growing at a historically respectable rate of around 4 per cent. The recovery, although slow and uneven, has raised output to its pre-crisis levels in some of the countries hardest hit. The resurgence of demand has put concerns about deflation behind us. Accordingly, the need for continued extraordinary monetary accommodation has faded.

The financial reform agenda has moved forward rapidly with the agreement reached on Basel III. Banks have already increased their capital base significantly. A macroprudential approach that focuses on systemic risk forms a fundamental part of the new framework and internationally agreed standards. These are no small achievements, and not one of them was assured a year ago.

After four years, however, the financial crisis and the ensuing policy responses continue to cast long shadows. Economies and financial systems are still vulnerable to even modest shocks, and the likelihood of severely adverse developments has not decreased. The global recovery remains uneven, and global headline inflation has risen a full percentage point, to 3.6 per cent, since April of last year.

In the advanced economies at the centre of the crisis, overall deleveraging and structural adjustment is still incomplete. Excess capacity remains in the financial and construction sectors. The repair of private balance sheets still has some way to go. And the threats posed by public sector debt have materialised, reaching a crisis point in some countries. There are still substantial risks of contagion between sovereign and financial sector fragilities.

Some emerging market economies exhibit the all-too-familiar signs of rising financial vulnerabilities, as domestic credit and asset prices surge.

Sizeable current account imbalances are very much with us, and gross capital flows pose risks even to economies running current account surpluses. As these developments unfold, global monetary and financial conditions remain unusually accommodative.

In the remainder of my remarks, I will describe these legacies of the crisis, and then turn to the policies – fiscal, monetary, structural and prudential – that can contribute to the lasting foundation for robust, stable and sustainable growth. Those policies, in turn, need to be part of a broader, integrated framework in which policymakers act promptly both with a long-term perspective – paying modest costs today to avoid larger costs tomorrow – and with attention to the global repercussions of their policies. In the end, cooperation will make everyone better off.

Challenges and policies for stable and sustainable growth

As we leave the crisis behind us, it is important to understand the underlying source of the challenges it has left. We experienced the bust of a global financial cycle. During the preceding boom, there was a tendency not only to underestimate financial risk, but to overestimate the economy's potential growth rate and its capacity to generate sustainable tax revenue. And associated with this was a failure to recognise emerging structural imbalances that would ultimately damage the foundations of sustainable long-run growth.

I will highlight four challenges that were left by the crisis: fiscal reckoning; inflation; excess capacity together with the unfinished adjustment of private sector balance sheets; and financial vulnerabilities.

Fiscal reckoning

The economic downturn, the tax cuts and expenditure increases in response to the crisis, and the cost of recapitalising the financial sector have all brought forward the *fiscal reckoning*. In countries that experienced credit booms, policymakers have come to recognise the significant hole left by the collapse in tax revenues that had been only temporarily boosted by the boom. The aftermath is a sovereign debt crisis.

In many cases, recent events simply brought forward an approaching problem. Without corrective measures, the fiscal trajectories of some of the world's largest advanced economies are unsustainable. This is not news. Rising dependency ratios, expensive publicly funded programmes for retirement and health care and the like put future commitments well in excess of future revenues. Financial market participants can ignore such looming problems for a long time until, suddenly, they enforce changes that are swift and painful.

Thus, the need for *fiscal consolidation* is even more urgent than when I spoke a year ago. According to the OECD, the average OECD country must improve its primary balance by nearly 7 per cent of GDP just to stabilise its debt-to-GDP ratio by 2026.

We will not have lasting macroeconomic and financial stability until we have taken decisive measures to put public finances on a sound and credible path. The creditworthiness of the sovereign is a prerequisite for a well-functioning economy. The default of the sovereign breaks the social contract and undermines the trust that is essential to the smooth running of both the state and the economy. No economy – no matter how large, rich and powerful – is immune to the risks posed by fiscal incoherence.

Nowhere is the link between fiscal sustainability and financial health more apparent than in parts of Europe today. In some European countries, vulnerabilities in the financial sector weakened the state; in others, public sector weakness has infected the banks; in all, the resulting fragilities now jeopardise the benefits of economic and financial integration. There is no easy way out, no shortcut, no painless solution – that is, no alternative to the rigorous implementation of comprehensive country packages including strict fiscal consolidation and structural reforms. The design of the euro area's fiscal and competitiveness arrangements must lead to predictable, reliable and less discretionary early corrective action in good times.

Unfortunately, Europe does not have a monopoly on urgent fiscal challenges. The big economies also need to manage their situations carefully and make efforts to consolidate fiscal positions quickly, not least because they have a big impact on global financial conditions.

Inflation, side-effects and low interest rates

The welcome recovery and absorption of spare resources have brought with them the less welcome spectre of *inflation*. As they did in the early 1970s, booming commodity prices may point to a more serious problem. Prices of food, energy, metals and the like are more sensitive to shifts in supply and demand than are the prices of either manufactured goods or services. And, unlike in the past two decades, prices of internationally traded manufactured goods look to provide little inflation offset, as wages and prices are rising in emerging markets. Despite the apparent persistence of slack in some parts of the world, there are risks of second-round effects and of rising inflation expectations.

Very accommodative monetary policy conditions in the economic regions most affected by the turmoil have been transmitted globally through bond and equity markets and bank credit. Double-digit growth in US dollar loans to non-US residents is just one example of how borrowing in major currencies is providing cheap credit even where central banks have tightened.

Extraordinarily loose financial conditions may have undesirable side-effects. We are all familiar with the list. Low interest rates can delay balance-sheet repair, encourage dangerous risk-taking in segments of financial markets and, in the process, make the eventual exit from official support more hazardous. They can intensify investors' eagerness to place funds in booming emerging market economies, encouraging the build-up of financial imbalances there. The more active deployment of macroprudential tools in emerging market economies is welcome, but cannot substitute for monetary tightening. The longer that interest rates are low, the more severe these side-effects and the greater the risk of a disruption when yields inevitably rise.

There is a need to *normalise monetary policy*. The prevailing, extraordinarily accommodative policy rates will not deliver lasting monetary and financial stability. Real short-term interest rates have actually fallen in the past year, from minus 0.6 per cent to minus 1.3 per cent globally.

History teaches us that recoveries from financial crises are slower and less robust than those after ordinary recessions. After a financial crisis, it takes longer for debt burdens to fall, balance sheets to be repaired, unproductive capital to be scrapped, and labour to be reallocated. Policymakers should not hinder this inevitable adjustment. Normalising policy too late and too slowly may undermine inflation-fighting credibility as well as risk further damage from the delay of structural and balance-sheet adjustments. More normal interest rates lessen the temptation to muddle through, and they place the focus squarely on the needed adjustments.

Monetary policy tightening can also aid the adjustment in current account imbalances. By encouraging currency appreciation in countries that are growing more quickly, it will contribute to correcting imbalances there. It can also complement the structural policies needed to rebalance growth patterns globally, moving us away from the unsustainable combination of leverage-led and export-led growth.

Excess capacity and unfinished balance-sheet adjustments

Excess capacity in finance and real estate points to unfinished adjustments in the crisis-stricken economies. The financial industry has built capital buffers, but overall leverage in the economy – private and public – remains too high. The simple mean of household debt-to-GDP for the US, the UK and Spain declined by only 2 percentage points from 2007 to the end of 2010, while over the same period for the same countries, government debt-to-GDP rose 30 percentage points.

Until losses are revealed and balance sheets repaired, funding problems and distortions will persist. This is an important feature of economies after the bust of a credit boom. In particular, the post-crisis financial system remains large relative to the economy as a whole: excess leverage and excess capacity have not been shed.

Policymakers must intensify their efforts to promote the repair of financial sector balance sheets and to set the conditions for banks' long-term profitability. The macroeconomic road is likely to be at least as bumpy next year as it has been this year. This means making sure that banks are ready when the next shock inevitably comes. Tough stress tests, supported by recapitalisation measures, are essential.

Moreover, without a stronger and leaner financial system, it will be impossible to withdraw the extensive public support that is still in place. No financial system can operate safely and effectively under conditions that are creating both moral hazard and the resource misallocations that come with it.

Financial vulnerabilities

Despite efforts to date, sovereign and financial sector risks continue to feed on each other. Short-term bank funding needs remain high, and the risks of interest rate surprises continue to be elevated. Elements of global finance are prolonging financial fragilities: these include not only low policy rates and expectations of continued official support, but also high expectations of returns on bank equity. Investors need to lower their expectations of such returns in accord with lower bank leverage.

At the same time, there are signs of a return to *excessive risk-taking*. While encouraging investors to take some risk was part of crisis management, there are signs that, in some areas, investors may be going too far again.

Moreover, several of the more vibrant economies of the world are exhibiting signs of an *unsustainable credit boom*. Credit levels and asset prices have moved outside their historical ranges, signalling the emergence of financial vulnerabilities. History may never actually repeat itself, but it does have a recurring tempo and tone. These developments portend yet another damaging financial cycle.

We should not underestimate the work required to complete financial reform. Basel III needs full and consistent implementation worldwide. We need to demand higher standards for systemically important financial institutions and credible mechanisms for their orderly resolution. The risks posed by shadow banking systems must be monitored and reduced. Improvements are needed in the statistics and processes for monitoring systemic risks, nationally and globally. Where credit booms and output are advancing strongly, authorities should consider imposing the Basel III countercyclical buffer to make banks more resilient. And throughout all this, we need to make the arrangements flexible enough to keep pace with the rapidly evolving financial system and the incentives to arbitrage restrictions away.

To sum up, early action is needed. The question is not whether to consolidate fiscal policy. It is not whether to normalise monetary policy. And it is not whether to accelerate structural adjustment. It is when and how each of these will happen.

Fiscal trajectories must be put on sustainable paths, monetary conditions should be normalised, and adjustments in the real economy and balance sheets should be accelerated. Early action will reduce vulnerabilities, lower repair costs and strengthen resistance to unexpected events. This is particularly true for the resilience of financial firms. Where possible, we should *build strength now*. Instead of taking the maximum time to reach the minimum standards, there is a good case for going faster and going further. Perhaps this time we will see a virtuous race to the top.

Policy frameworks

The more enduring lessons of the crisis, however, are not just about policy actions, but about policy frameworks. A lasting foundation for monetary and financial stability requires regulation and supervision with a strong macroprudential orientation; monetary policy that plays an active role in supporting financial stability; and fiscal policy that amasses the buffers required for effective crisis management.

These policies share two features. One rejects short-termism in favour of a long-term view. The other frees us from home bias in policymaking, allowing us to do more than just “keep our own house in order”.

The first feature requires policymakers to keep an eye on the long-term horizon if they are to pre-empt the slow build-up of financial imbalances that can derail growth, cripple monetary policy and trigger sovereign crises.

The governance of macroprudential policy must encourage decision-makers to take a long view based on the principles of independence, clarity and accountability. This suggests that central banks should play a key role.

Fiscal policy also needs to take a long-term view. Governments, like financial firms, must build up buffers. Fiscal policy should aim at maintaining a very low level of debt during normal times so that governments are ready for the next, inevitable shocks. And policymakers should recognise that the level of revenue collected in the midst of a credit boom is unsustainable.

The second feature tells policymakers that, in an integrated global economy, keeping their own house in order is not enough. No individual economy is safe unless the global economy is safe. The fortunes of individual countries and the adequacy of their policies can be accurately assessed only as part of the global conditions that, collectively, they help to shape. For instance, if every central bank views commodity price movements as outside its control, then global monetary policy can be too loose. Just as each big private bank generates systemic effects that it must internalise, so too each country’s policies create international spillovers that it must take on board.

Building a lasting foundation for low inflation, robust growth and a stable financial system requires early action in the face of uncertainty. It will require not only good ideas, hard work and difficult adjustments but also collaboration, cooperation and coordination both nationally and internationally. Developing a shared understanding of the challenges, and working towards common solutions, is what international cooperation is all about. As it has throughout its history, the BIS will continue to pursue this core mission.