BANK FOR INTERNATIONAL SETTLEMENTS

General Manager's speech

It's time to address the root causes

Speech delivered by Jaime Caruana
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General Manager of the BIS

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Good afternoon, ladies and gentlemen.

Five years after the start of the financial crisis, the world economy is still in a fragile state. This fragility is not primarily cyclical – rather, it reflects fundamental weaknesses shared by many countries. There has been progress in addressing these long-standing problems, but more remains to be done. This is why output in the advanced economies has barely returned to the levels reached at the outset of the crisis.

Confidence in the global recovery has eroded further over the past few months. Markets are jittery. Growth prospects in the advanced economies remain modest. European financial markets are under stress, and a number of European countries are in recession.

Emerging market economies are growing more strongly than the advanced economies. Over the past five years, their expansion has accounted for three fourths of global growth. It was thanks to earlier reforms – often pursued when domestic demand was contracting – that many returned to strong growth and were able to pursue countercyclical policies during this crisis. But emerging markets have recently felt increasing strains from unbalanced growth, and some are struggling with inflation pressures. They are not immune to the global slowdown.

In these difficult circumstances, calls for further economic stimulus are not surprising. Some advocate additional monetary accommodation; others suggest a softening of the new financial regulatory regime; and still others recommend postponing fiscal consolidation and structural adjustment in the private sector until happier times. The common basis for all of these proposals is that, if only policymakers were less rigorous and stimulated more now, growth would eventually come to the rescue. If only it were that simple!

The main roadblock to sustained growth is not a lack of economic stimulus. Instead, it is a vicious cycle of adverse feedbacks between three fundamental weaknesses, all related to balance sheets:

- First, the financial sector is still fragile. Despite some progress, many banks remain overleveraged, and uncertainty about the quality of their assets prevents many banks from borrowing in unsecured markets.

Government bond yields have soared for some sovereign borrowers in Europe as they have found it harder to attract foreign investors. The fragmentation of bank and bond markets along national lines is a cause of deep concern.

- Second, large structural imbalances that existed well before the crisis still weigh on households and firms. In many advanced economies, their debt burdens remain too high. In some countries, the real estate sector is still adjusting; and in some others, growth remains too dependent on exports.
- And third, government debt is unsustainably high in most industrial countries.

Central banks find themselves caught in the middle, forced to be the policymakers of last resort. They are providing monetary stimulus on a massive scale. They are supplying liquidity support to banks unable to fund themselves in private markets. And they are easing government financing burdens by keeping interest rates low far out along the yield curve. These emergency measures could have undesirable side effects if continued for too long. A worry is that monetary policy would be pressured to do still more because not enough action has been taken in other areas. While central bank actions can buy time, they cannot substitute for balance sheet repair or reforms to raise productivity and growth. Central banks cannot solve the problems neglected by other policies.

Three fundamental weaknesses

The overriding need is to strike at the root causes of the crisis by strengthening bank balance sheets, reducing leverage, rebalancing economic activity and putting fiscal positions on a sustainable path. We have made progress in these areas. But restoring confidence demands that we complete the job with clarity and determination. Let me elaborate.

Take first the weakness in the financial system. Banks know they need more and better capital. They know they need more liquid balance sheets. They know they need to avoid business strategies based on excessive leverage. Here the authorities and the private sector have made progress. Most banks are better capitalised than they were before the crisis. The Basel III framework provides a credible path forward. Effective implementation of the financial reform agenda is essential.[1]

Bank recapitalisation needs to be complemented with earlier loan-loss recognition and more realistic asset valuation. One symptom of doubts about the quality of bank assets has been the low price-to-book ratios of banks (Graph 1). In many major jurisdictions, these ratios have actually dropped further over the past year! The authorities and the banks will therefore require great determination in quickly improving the transparency and strength of bank balance sheets.

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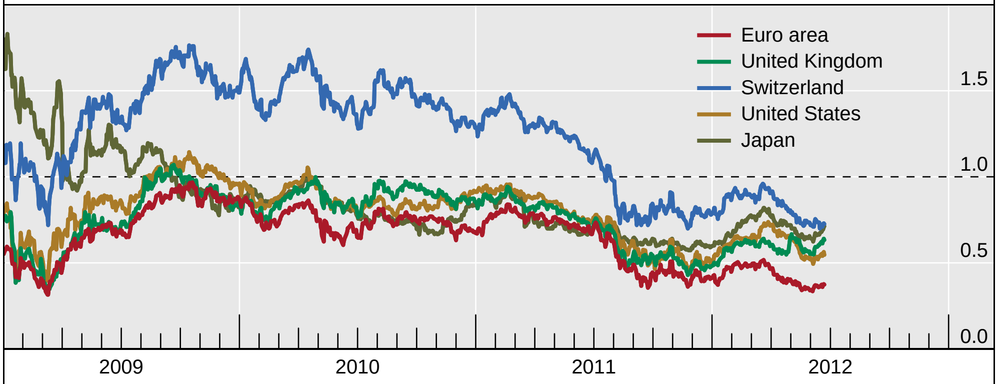
[1] "Progress and challenges in financial reform", speech by Jaime Caruana at the XXI International Banking Congress, *Banking business and banking regulation: strategies, results, prospects*, St Petersburg, 6 June 2012, www.bis.org/speeches/sp120612.htm.

Price-to-book ratios of major banks[1]



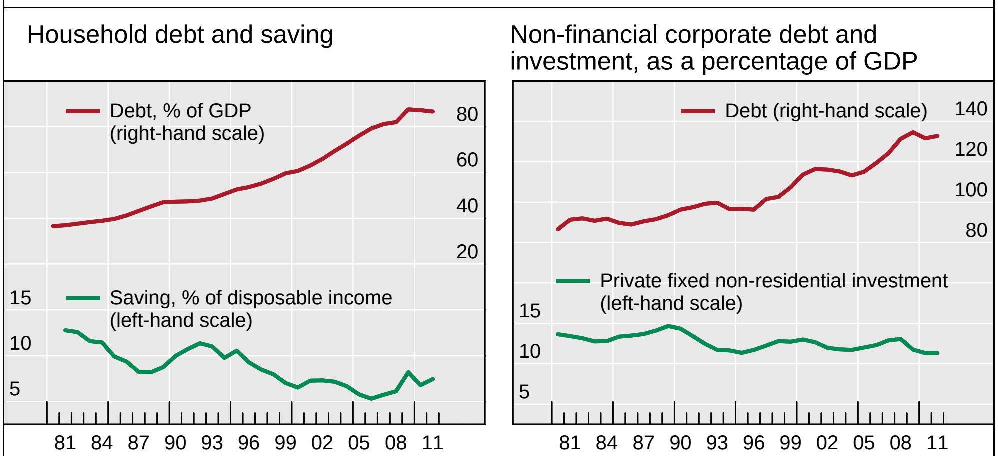
[1] Simple average across major banks: for the United States, Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase and Morgan Stanley; for the euro area, Banco Santander, BNP Paribas, Crédit Agricole, Deutsche Bank, ING Group, Société Générale and UniCredit SpA; for the United Kingdom, Barclays, Lloyds, HSBC and RBS; for Switzerland, Credit Suisse and UBS; for Japan, Mitsubishi UFJ, Mizuho and Sumitomo Mitsui.

Source: Datastream. Graph 1

The second weakness is significant structural imbalances and rigidities. The boom in credit caused a substantial misallocation of resources. Construction, the financial industry and other credit driven sectors grew out of proportion, especially in those countries that went through the sharpest boom bust cycles in house prices. Property booms also made households complacent about their future wealth, lowering their saving rate. Even in the face of population ageing and high public debt, households were borrowing more and more and saving less and less (Graph 2, left-hand panel). And non-financial corporations added to the problem by piling up debt without increasing real fixed investment (Graph 2, right-hand panel).

The credit boom also masked structural inefficiencies and rigidities that largely pre-date the start of the financial crisis. Booming credit and rising asset prices boosted income, lowered unemployment and improved fiscal positions,

Private sector debt, saving and investment in advanced economies[1]



[1] Simple average across Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Italy, Japan, the Netherlands, Norway, Portugal, Spain, Sweden, the United Kingdom and the United States.

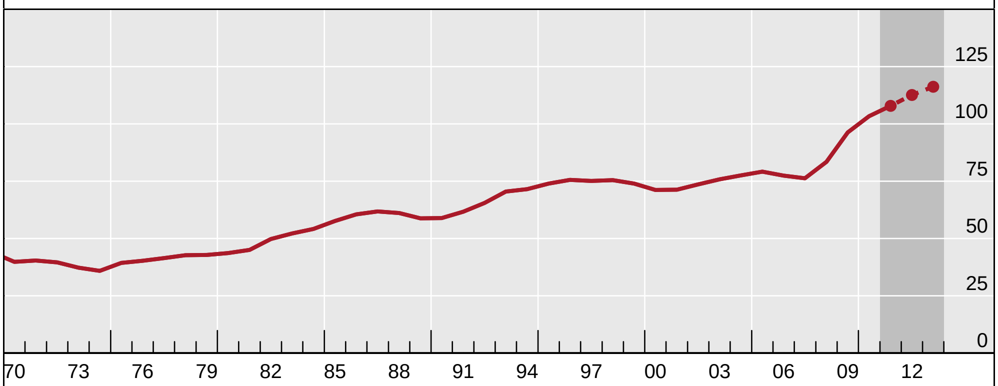
Sources: OECD Economic Outlook 90 database; national data; BIS calculations. Graph 2 making it seem less urgent to address the structural issues. The slow, uneven progress in solving the long-standing structural problems is retarding growth. The markets for some specific goods and services are still uncompetitive. In some countries, for instance, many markets for services are still over-regulated. Labour markets remain too rigid, often protecting those with jobs but putting potential new entrants – especially the young – at a disadvantage. Choices about taxation and public spending are still frequently driven by short term considerations. Research, training and education continue to receive too few resources. And tax inefficiencies remain. Such limited progress in structural reform is making it harder to correct the large imbalances revealed by the most severe financial busts.

The third weakness is the unsustainability of public debt. Since the onset of the crisis in 2007, public debt in the advanced economies as a whole has risen from about 75% of GDP to more than 110% this year. However, public debt in the major industrial countries has been rising more or less steadily since the 1970s – therefore high debt levels are not solely the result of the financial crisis (Graph 3). In the years before the crisis, governments did make periodic efforts to consolidate their public finances. But such restraint was rarely sustained and debt continued to rise. Making matters worse, increased government spending typically went into greater public consumption and transfers. Public investment as a share of GDP actually fell. Population ageing, which will put additional pressure on public finances, might well depress potential growth rates. These elements together will surely make it increasingly difficult to service high levels of public debt.

Given current deficits and future age-related spending, fiscal trajectories are unsustainable in most industrial countries. The surpluses required to bring debt down to the levels immediately preceding the start of the crisis are substantial and will need to be maintained for many years. Governments in several countries – including some in the euro area – have made progress.

General government debt in advanced economies[1]

As a percentage of GDP



[1] Weighted average of the economies listed, based on 2005 GDP and PPP exchange rates and available data. Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom and the United States. Estimate for 2011 and projections for 2012 and 2013 are shown as dots.

Sources: European Commission AMECO database; IMF, *World Economic Outlook*, April 2012; OECD Economic Outlook 90 database.

Graph 3

They have not only cut current budget deficits, but they have also introduced reforms that should improve the medium-term management of public finances. Nevertheless, few governments have done enough to correct the deficit bias evident in many countries since the mid-1970s. Removing that bias will require a more fundamental examination of both the efficiency of the public sector and the structure of taxes and expenditure.

The limits of central bank policies

Central banks have a role to play in supporting these adjustments. And they have indeed taken exceptional measures on a large scale. Central banks kept policy rates at near zero, and they extended loans on a large scale to counter a liquidity freeze and ease bank funding strains. These measures forestalled a collapse of the financial system and prevented the world economy from plunging into a global depression.

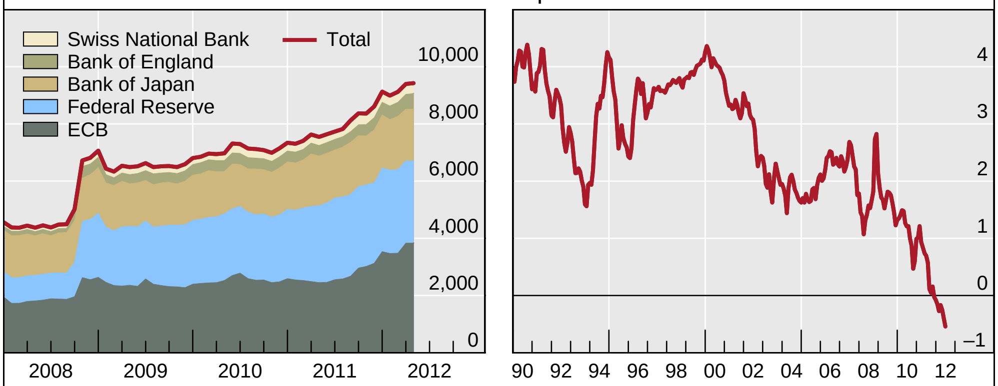
But faced with continuing threats to financial stability and growth, central banks have repeatedly launched new programmes to provide still further support to their economies. Some have done this by purchasing a large quantity of assets, generally government bonds; others by signalling their intention to keep policy interest rates low for a longer period; and still others by buying private assets in order to narrow credit spreads. In the process, some central banks have also provided a large amount of liquidity to the banking system – sometimes while relaxing the quality of acceptable collateral; and authorities in a number of countries have intervened directly in foreign exchange markets and built up reserves.

One simple measure of these efforts is the rise in central bank balance sheets. Since the start of this crisis, the total assets of five major central banks in the advanced economies have grown to more than $9 trillion (Graph 4, left-hand panel), or over 13% of world GDP, and now stand at more than double the pre-crisis average of almost $4 trillion. The composition of their assets has

Central bank balance sheets and real interest rates

Total assets of five central banks[1], in billions of US dollars

Ten-year real bond yields for the US[2], in per cent



[1] Valued at end-2011 exchange rates. [2] From 1997 onwards, monthly averages of inflation-indexed US Treasuries; before 1997, nominal government bond yields deflated by CPI inflation forecasts six to 10 years ahead.

Sources: Bloomberg; © Consensus Economics; Datastream; national data; BIS calculations. Graph 4 also changed dramatically, with several central banks holding a significant proportion of domestic bonds or providing, as in the euro area, a sizeable proportion of funding to commercial banks. For example, the Federal Reserve now holds 11% of total outstanding US public debt, and the Bank of England holds more than 18% of the United Kingdom's public debt.

Central bank actions helped drive down long-term interest rates, which have fallen remarkably even in the face of a sharp increase in government bond issuance. Benchmark real long term interest rates are extremely low or negative in major currencies – for example, the yield on 10-year inflation-adjusted US Treasuries is at present negative (Graph 4, right-hand panel). In addition, central bank actions mitigated liquidity and credit strains in private markets.

But such results can create unrealistic expectations about the power of central banks. Monetary policy cannot resolve the fundamental problems that hold back sustainable growth. The root causes of the crisis are structural and fiscal, and only structural and fiscal reforms can bring the global economy back to sustainable growth. Monetary policy can buy time needed for other policies to correct fundamental balance sheet problems. But even in this transitory role, monetary policy is not without limits or risks. Under current circumstances, the benefits of continued monetary easing cannot be taken for granted.

As the benefits of extraordinary monetary easing shrink and become less certain, the risks of expanding central bank balance sheets are likely to grow. Such hazards may materialise in ways that are not completely clear today. I would underline three major risks.

The first is that prolonged monetary stimulus makes the necessary fiscal and structural adjustments seem less urgent. With cheap funding from the central bank, market signals may be obscured. Borrowers may overestimate their repayment capacity. Commercial banks find it easier not to adjust. The fiscal authorities may be tempted to delay consolidation. The absence of adjustment could increase dependence on central banks and accentuate the pressure on central banks to do ever more.

Second, the financial stability risks of protracted low interest rates could be significant. Earning capacity in the financial sector may be undermined, and financial firms, squeezed by low returns, may place riskier bets but not necessarily where credit is most needed. Large interest rate exposures in the financial industry may, one day, be used as an argument for holding interest rates down.

A third risk is that policy could be mis-calibrated or mis-communicated. The unprecedented size of their balance sheets has brought central banks into uncharted territory. With no history to rely on, they will find it difficult to calibrate and implement the tightening of monetary policy that will inevitably be required. Excess bank reserves could translate into a significant, sudden and unanticipated expansion of bank credit. Central banks have the technical tools to withdraw excess reserves. But there is always the risk of pressure to keep interest rates low or of a simple failure to see in time the need to tighten. Even if these dangers are successfully avoided, communicating with the public in a convincing way will still be very challenging in such unprecedented circumstances.

Finally, if markets come to see monetary policy decisions as constrained by the growing financing needs of government, the ability of central banks to control inflation would, at some point, be seriously compromised. Fiscal consolidation is therefore essential not only to restore fiscal sustainability, but also to preserve the credibility of monetary policy. This credibility, built up over the past two decades, has proved its worth during the crisis. It must not be squandered.

So it is reassuring that central banks have continued to emphasise that their exceptional measures have not weakened their commitment to price stability. The vital importance of this core mandate means that central banks cannot assume the responsibility for all economic goals.

The euro area crisis

Nowhere are the damaging feedbacks between financial fragility, heavy private and public sector indebtedness and structural imbalances more apparent today than in the euro area. In some countries, the combination of high leverage among households and firms, incomplete repair of the financial sector and sovereign over-indebtedness has created a variety of vicious cycles. In such stressful circumstances, the lack of a common risk free asset – such an asset need not imply fiscal transfers – and the absence of a unified banking system tend to segment financial markets. As a consequence, the Eurosystem had to take a disproportionate role in the euro area financial system.

Eliminating these weaknesses jointly and credibly is a precondition for restoring confidence in governments, in banks and in the common currency. It is a precondition for securing access to funding markets for weaker sovereigns; for reviving interbank lending; and for reducing incentives for depositors to move funds across borders – more generally, acquiring safe assets should not require crossing borders. Finally, it is a precondition for easing the central bank out of its uncomfortable role as a financial intermediary.

There has been some progress at national and European levels. Structural reforms are moving forward, including in labour markets and pension systems. These efforts, combined with the adoption of the fiscal compact, have created a better framework for putting fiscal trajectories on a sustainable path. Acting in accordance with the fiscal compact will substantially enhance the credibility of sovereigns.

But persistent fragilities suggest that more needs to be done at both the national and European levels. In several respects, institutional development has not kept up with the needs of the monetary union.

It is therefore welcome that these sensitive topics are now on the political agenda. A currency union that centralises the provision of liquidity may conflict with banking systems that are fragmented along national lines. Recent proposals for movement on the banking front are promising because, first, the banking rules would be unified across the euro area. Second, with common banking rules must come common frameworks for supervision, deposit insurance and resolution. Such ambitious changes will take time. But setting out a common vision, an agreed objective and a clear mandate could help to break some of the adverse links that are making the euro area crisis so severe.

It would be a mistake to think that the euro area is unique. The potential for perverse interactions between weaknesses also exists elsewhere. If not addressed in time, these weaknesses – in particular on the fiscal side – could lead to a crisis even in those countries that have so far been spared. Such a failure would make the goal of achieving sustainable growth in the global economy even more elusive.

The way forward

Let me conclude. The current difficulties of the world economy have deep roots and will require fundamental solutions. Fiscal adjustment, the repair of banks' balance sheets and other reforms cannot be put off in the hope of better times. Relying only on central banks but failing to act on other fronts would ultimately damage confidence and increase the risks to macroeconomic and financial stability.

The pace at which countries close fiscal deficits, and phase in reforms, depends on their individual circumstances. Those with the weakest fiscal positions and highest dependence on foreign funding will have to move quickly. Most advanced economies do not have the luxury of waiting. Fundamental fiscal reforms are needed at all levels of government.

Simultaneous fiscal adjustment across many countries would impose special responsibilities on countries that have a current account surplus and are too dependent on exports. Through structural and other reforms, they can re-orient their economies to increase domestic absorption and achieve more sustainable growth in the long run. This would help other countries reduce their unsustainable current account deficits.

Strong demand in several emerging economies has helped support global demand in this crisis. But even these dynamic economies cannot always rely on further macroeconomic stimulus. Some are also exposed to the kind of credit-driven expansion that did so much damage in advanced economies. Finally, some remain vulnerable to sudden reversals of external financing.

Achieving strong and sustainable growth also depends on strong international cooperation. In tackling the root causes of the crisis, implementing reforms and resisting national bias is essential. Although the progress already achieved – including in those countries now under stress – should not be underestimated, it will take time for the benefits to materialise. In the meantime, we must build on this progress and complete the job if we are to restore confidence and reinforce the basis for sustainable growth.