BANK FOR INTERNATIONAL SETTLEMENTS

Making the most of borrowed time

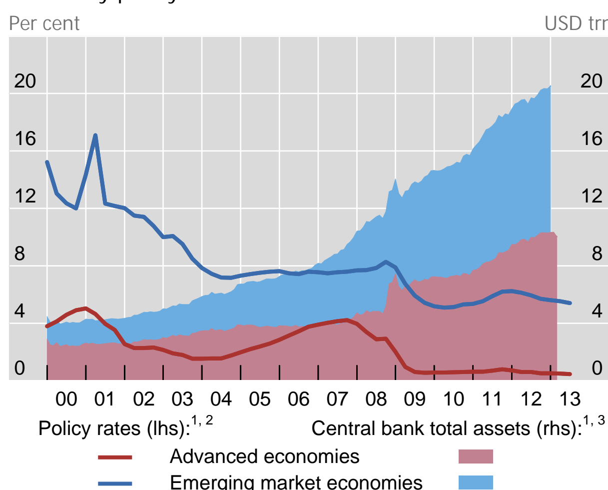
Jaime Caruana, General Manager of the BIS

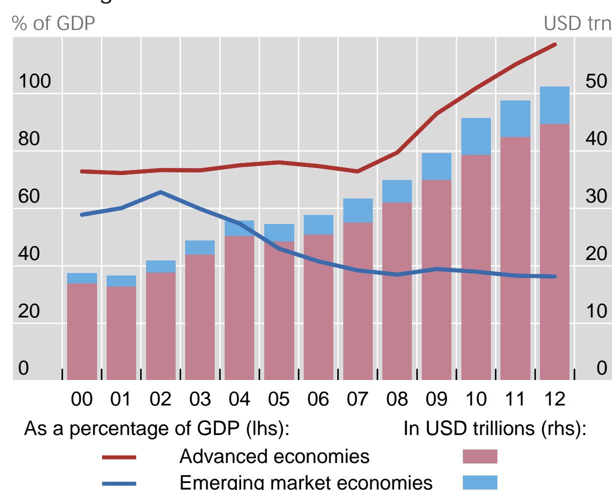
on the occasion of the Bank's Annual General Meeting
in Basel on 23 June 2013

Good afternoon, ladies and gentlemen.

Since the beginning of the financial crisis almost six years ago, central banks and fiscal authorities have supported the global economy with unprecedented measures. Policy rates have been kept near zero in the largest advanced economies. Central bank balance sheets have doubled from $10 trillion to more than $20 trillion. And fiscal authorities almost everywhere have been piling up debt, which has risen by $23 trillion since 2007. In emerging market economies, public debt has grown more slowly than GDP; but in advanced economies, it has grown much faster, so that it now exceeds one year's GDP. These trends can be seen in Graph 1.

Monetary policy stance and public debt — Graph 1





[1] Advanced economies: Australia, Canada, Denmark, the euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom and the United States; emerging market economies: Argentina, Brazil, Chile, China, Chinese Taipei, Colombia, the Czech Republic, Hong Kong SAR, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, the Philippines, Poland, Russia, Saudi Arabia, Singapore, South Africa, Thailand and Turkey. [2] Weighted average based on 2005 GDP and PPP exchange rates. [3] Sum across the economies listed.

Sources: IMF, *International Financial Statistics* and *World Economic Outlook*; OECD, *Economic Outlook*; Bloomberg; Datastream; Global Financial Data; national data.

Without these forceful and determined policy responses, the global financial system could easily have collapsed, bringing the world economy down with it. But the subsequent global recovery has remained halting, fragile and uneven. In the United States, the expansion continues, albeit at a moderate pace. In major emerging market economies, growth is losing momentum. Most of Europe has fallen back into recession. At the same time, the general downward trend in productivity growth has not been receiving enough attention from policymakers.

As the risks mounted around mid-2012, central banks rode to the rescue yet again. The ECB addressed market fears with the promise that it would do "whatever it takes" within its mandate to save the euro. It followed up with a conditional programme to buy sovereign debt of troubled euro area countries. The Federal Reserve, the Bank of England and the Bank of Japan likewise pushed forward with additional expansionary measures.

And while large advanced economies were expanding their unconventional policies, central banks in many emerging market economies lowered their target policy rates, in some cases reducing them to their 2009 levels.

As global financing conditions eased further, private credit continued to grow at a rapid pace in some countries, lending standards weakened, equity prices reached record highs worldwide, long-term yields hit record lows and credit spreads compressed. Even highly leveraged firms could borrow at long-term rates far below the rates they had to pay before the crisis.

But easy financial conditions can do only so much to revitalise long-term growth when balance sheets are impaired and resources are misallocated on a large scale. In many advanced economies, household debt remains very high, as does non-financial corporate debt. With households and firms focused on reducing their debt, a low price for new credit is not terribly relevant for spending. Indeed, many large corporations are using cheap bond funding to lengthen the duration of their liabilities instead of investing in new production capacity. It does not matter how attractive the authorities make it to lend and borrow – households and firms focused on balance sheet repair will not add to their debt, nor should they.

And, most of all, more stimulus cannot revive productivity growth or remove the impediments that block a worker from shifting into a promising sector. Debt-financed growth masked the downward trend in labour productivity and the large-scale distortion of resource allocation in many economies. Adding more debt will not strengthen the financial sector nor will it reallocate resources needed to return economies to the real growth that authorities and the public both want and expect.

Central banks have borrowed the time that the private and public sectors need for adjustment, but they cannot substitute for it. Moreover, such borrowing has costs. As the stimulus is sustained, it magnifies the challenges of normalising monetary policy; it increases financial stability risks; and it worsens the misallocation of capital.

Finally, prolonging the period of very low interest rates further exposes open economies to spillovers that are now widely recognised. The challenges are particularly severe for the emerging market economies and smaller advanced economies where credit and property prices have been rapidly growing. The risks from such a domestic credit boom at a late stage of the economic cycle are hard enough to manage. Strong capital inflows exacerbate such risks and challenges for market participants and authorities; and they expose economies to large sudden reversals if markets expect an exit from unconventional policies, as volatility during the past few weeks seems to indicate.

In short, the balance of costs and benefits entailed by continued monetary easing has been deteriorating. Borrowed time should be used to restore the foundations of solid long-term growth. This includes ending the dependence on debt; improving economic flexibility to strengthen productivity growth; completing regulatory reform; and recognising the limits of what central banks can and should do.

Ending the dependence on debt

Extending monetary stimulus is taking the pressure off those who need to act. Ultra-low interest rates encourage the build-up of even more debt. In fact, despite some household

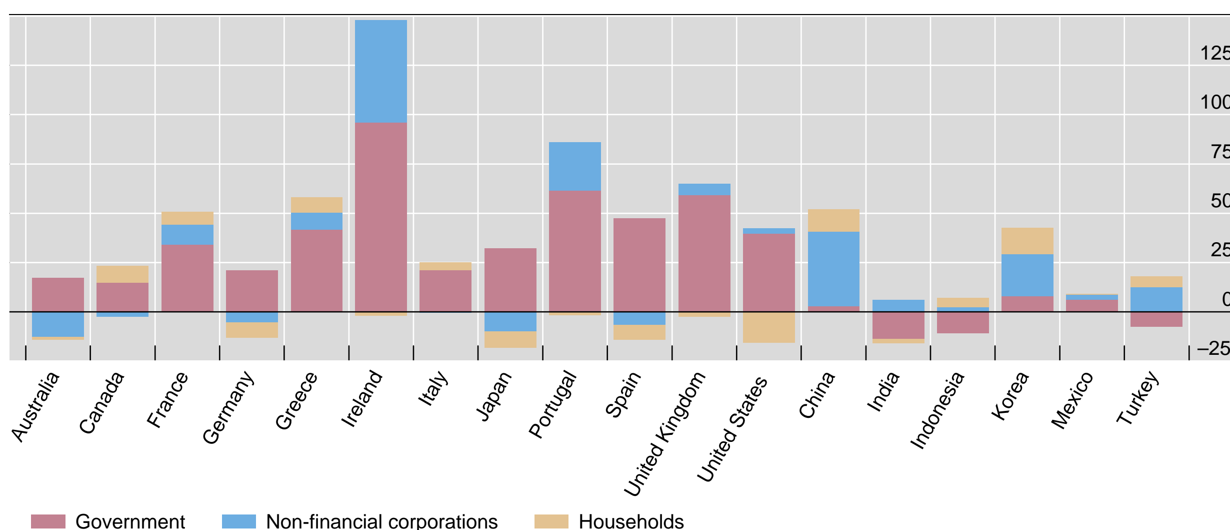
deleveraging in some countries, total debt, private and public, has generally increased as a share of GDP since 2007. For the advanced and emerging market economies shown in Graph 2, it has risen by about 20 percentage points of GDP, or by $33 trillion – and rising government debt has been the main driver. This is clearly not sustainable.

Low rates have allowed the public sector to postpone consolidation at the risk of a further deterioration in sovereign credit quality and damage to longer-term growth. There is plenty of evidence that as public debt surpasses about 80% of GDP, it becomes a drag on growth – because it raises debt servicing costs (and uncertainty about the future tax burden); it increases sovereign risk premia; and it reduces the room available for countercyclical policy.

Change in debt, 2007–12

In percentage points of GDP

Graph 2



Sources: IMF, *World Economic Outlook*; OECD; BIS; national data.

Government attempts at fiscal consolidation need to be more ambitious. Average headline deficits in the major advanced economies have narrowed by about 3½ percentage points. This is broadly in line with previous episodes of fiscal adjustment, but it is not sufficient to bring public debt back to a sustainable path. In many cases, government debt is rising further, notwithstanding record low servicing costs. Very low long-term interest rates are making government spending look cheap. But the belief that governments do not face a solvency constraint is a dangerous illusion. Bond investors can and do punish governments hard and fast when they believe that fiscal trajectories have become unsustainable.

The need for fiscal adjustment is especially large for governments that currently enjoy the lowest funding costs. Our calculations show that, when taking into account rising spending for health care and pensions, some countries – for example, the United Kingdom or the United States – would have to improve their primary fiscal balance by more than 10 percentage points in order to reduce public debt to 60% by 2040. These are huge adjustments. And the numbers for many other advanced economies are not much smaller.

When growth is strong, reducing deficits and debt relative to GDP is less painful – some believe even painless. And the adoption of plans for future consolidation could reap immediate

benefits by boosting confidence. Hence, some ask: Why not announce consolidation plans now but act later, when times are better?

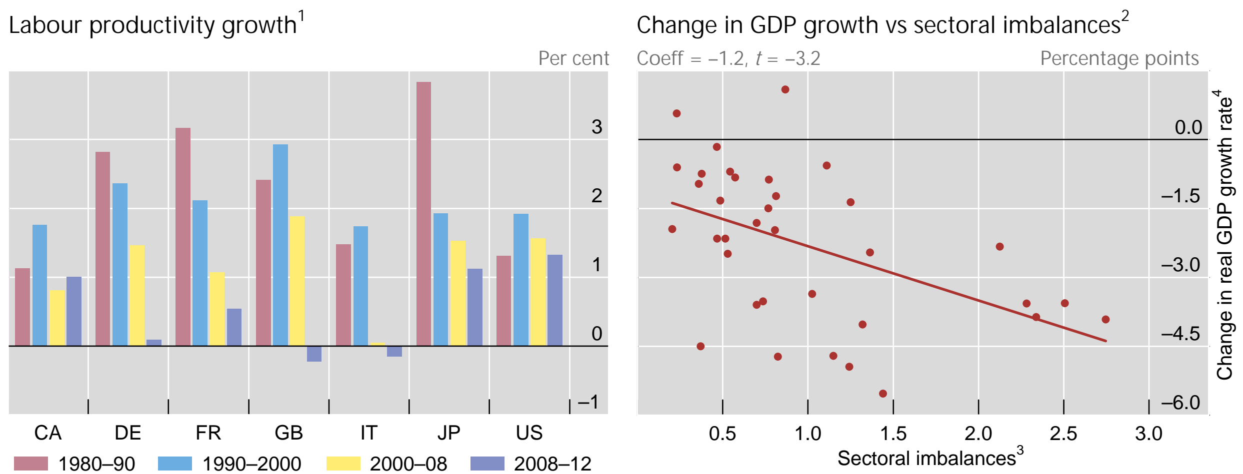
The answer is that, without strong action now to tackle the root of the problem, credibility will be low and the repeated growth disappointments of the past few years are likely to continue. It is very difficult to credibly tie the hands of future governments. Instead, consolidation is postponed indefinitely, or at least until bond investors decree otherwise. And then the pain will be large indeed, and the consolidation will tend to be very unfriendly to growth.

Rather than debating *when* to consolidate, we should be discussing *how*. Policymakers should be carefully choosing the composition of adjustment that will minimise the short-term costs of fiscal consolidation and maximise the boost to potential output. Successful consolidations tend to focus on cuts, especially in government consumption and transfers, rather than on tax increases. Proposals to raise revenues should consider taxes that are less distortionary than those on labour and capital.

Strengthening productivity growth

Debt-financed growth has made it easier for authorities to delay the contentious work of removing labour and product market rigidities. The boom masked the need to reform economies even as resource allocation became less and less efficient. And the crisis-motivated macroeconomic stimulus of the past few years has exacerbated these distortions. Hence, progress in labour and product market reforms has been slow.

Productivity growth and sectoral imbalances — Graph 3



CA = Canada; DE = Germany; FR = France; GB = United Kingdom; IT = Italy; JP = Japan; US = United States.

[1] Average annual real GDP per hour worked. [2] The scatter plot represents a number of advanced and emerging market economies, but does not include Greece, which had a change in GDP growth of –11% and a sectoral imbalance index of 0.3. With Greece included in the sample, the regression coefficient becomes –0.8, t = –1.4. [3] Defined as average absolute changes in the sectoral employment share between the beginning and end of the Great Recession, ie from 2007 to 2009. [4] Average annual growth rate between 2010 and 2012 minus average annual growth rate between 2001 and 2007.

Sources: European Commission; IMF, *World Economic Outlook*; OECD; BIS calculations.

Strong and sustainable growth requires speeding up reforms that enhance economic flexibility. As Graph 3 shows, labour productivity growth has been declining in major advanced economies. And the accumulation of large sectoral imbalances – especially the outsized property and financial sectors – has also held back growth. The imbalances have also hindered the creation of new jobs – imposing huge costs on many individuals and the economy as a whole. These developments call for measures that enhance economic flexibility, allowing labour to be employed where it is most productive and allowing ideas to generate new products and markets.

Pushing through reforms and changing behaviour are always difficult because the costs are paid upfront while the benefits accrue only over long periods. But reforms now also face economic and financial headwinds, while near-zero interest rates and forceful central bank action reduce the urgency to act.

Difficult as they may be, however, the reforms are critical to attaining and preserving confidence. And they are critical to limiting the human suffering and economic damage imposed by long-term unemployment. Notably, progress in these areas has been most visible in the countries where market pressure has been the most severe, but much remains to be done.

Completing financial sector reform

A healthy financial system is the backbone of a vibrant economy. Growth, innovation and job creation require sound financing. Banks are making uneven progress in rebuilding their balance sheets. Progress is visible in the evolution of bank capital and in spreads on credit default swaps (CDS). But more is needed by banks in some countries to recognise bad assets and make funding more stable, thus regaining investors' confidence.

The CDS spreads in the left-hand panel of Graph 4 suggest that more needs to be done in the euro area in particular. Banks there have made progress in strengthening their capital buffers, but uncertainties remain, not least about the link between the health of banks and sovereigns. Breaking this link requires continued consolidation of public finances and, importantly, further determined steps to complete a full European banking union, including not only a single rulebook and single supervisory mechanism, but also a single resolution mechanism and common deposit insurance.

The foundations for a much healthier system have been put in place, in a process that started with the implementation of the Basel III capital and liquidity standards, continues with the work on resolution regimes, and is proceeding with reforms of over-the-counter derivatives markets and shadow banking.

Restoring confidence in the resilience of financial markets and institutions will require transparent and consistent implementation of the new rules. But consistency does not mean uniformity – diversity is necessary if we are going to have dynamic and stable markets. The issue is how to best counteract banks' incentives to maximise reported regulatory capital.

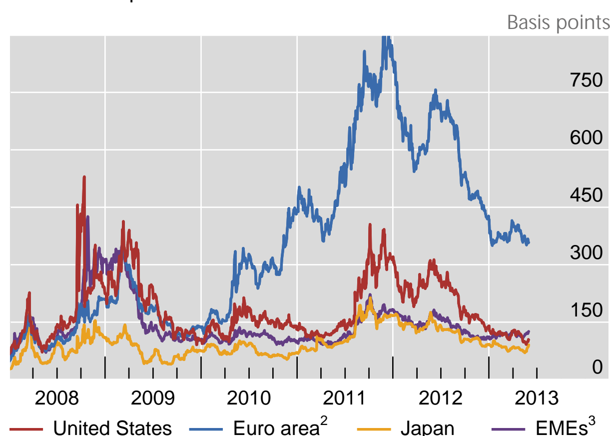
An effective regulatory framework must be risk-sensitive and provide market participants with comparable and reliable information about banks' risk-taking. But the framework must also be robust to the inherent uncertainties in risk measurement. Does that mean that a simple ratio for gauging risk can provide the answer? Probably not. Even the simplest ratio or rule

becomes complex when expressed in regulations. However, a combination of risk-sensitive balance sheet measures and a simpler leverage ratio can make for a framework that is more robust to the complexity and uncertainties that are inherent to any risk assessment in a complex financial system.

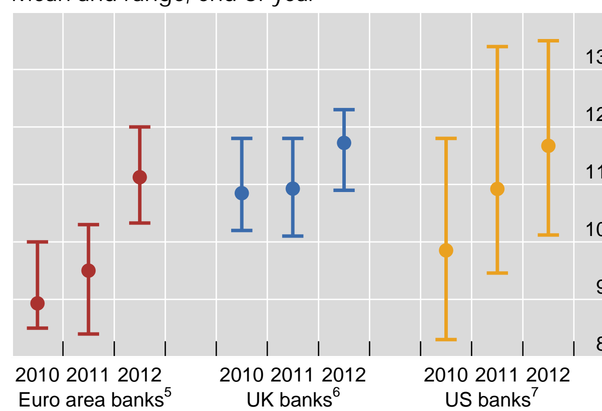
More generally, mechanisms within and across borders that can resolve any failing financial institution without public funds will further boost confidence in the financial system. Those mechanisms are essential to remove the implicit public subsidies and moral hazard that come with being too big to fail.

Bank CDS spreads and capital — Graph 4

Bank CDS spreads[1]



Core Tier 1 ratio
Mean and range, end of year[4]



[1] Five-year on-the-run CDS spreads in US dollars; simple average across selected banks. [2] Belgium, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal and Spain. [3] Brazil, China and Singapore. [4] Means are simple averages across selected banks. [5] Banco Bilbao Vizcaya Argentaria, Banco Santander, BNP Paribas, Commerzbank, Deutsche Bank, Société Générale, UniCredit. [6] Barclays, HSBC, Lloyds TSB Group, Standard Chartered. [7] Bank of America, Bank of New York Mellon, Citigroup, JPMorgan Chase and Wells Fargo.

Sources: Bankscope; Markit; BIS calculations.

Recognising the limits of what central banks can and should do

Three trends stand out as central banks moved to provide further stimulus over the past year:

- First, they stepped up interventions in government bond markets. The Federal Reserve and the Bank of England now hold sizeable shares of the outstanding stock of their respective government issues. Including the bonds acquired by foreign central banks in their currency interventions, central banks hold about one third of all US Treasuries outstanding.
- Second, central banks targeted specific parts of the monetary transmission mechanism for repair. They used tools that included specific lending programmes, such as the Bank of England's Funding for Lending Scheme; purchases of government bonds of specific countries, such as the ECB's Securities Markets Programme; the Federal Reserve's continued purchases of mortgage-backed securities; and the Bank of Japan's subsidising of lending, entitled Measures to Support Strengthening the Foundations for Economic Growth.

- Third, central banks made forward commitments. Most were conditional, such as the Federal Reserve's pledge to continue its balance sheet expansion at least until unemployment reaches a certain threshold and the ECB's assurance that, through its Outright Monetary Transactions programme, it will buy government bonds of countries that fulfil certain conditions.

Half a decade ago, most, if not all, of these measures were unthinkable. Their emergence shows how much responsibility and burden central banks have taken on.

But this overdependence on central banks poses significant challenges for the economy as a whole. Progress with repairs and reforms would make it easier for central banks to normalise monetary policy.

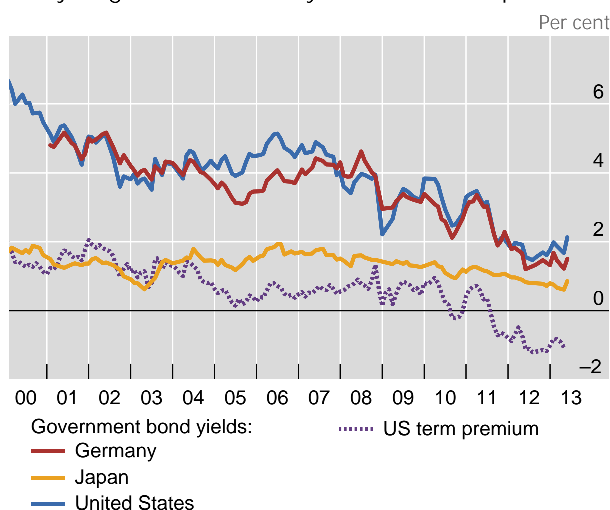
A rise in long-term interest rates from the abnormally low levels shown in the left-hand panel of Graph 5 will of course have an economic and financial impact. How severe it will be crucially depends on the dynamics of the rate increase process. Experience suggests that the upward trajectory of long-term rates could be abrupt and volatile – and the complexity of the global financial system makes it impossible to predict what the adjustment will look like.

Emerging market economies could be particularly exposed to a spike in market volatility and a reversal of the recent strong capital inflows that are evident in the right-hand panel of Graph 5. The recent volatility in emerging market interest rates, equity markets and exchange rates confirms this view.

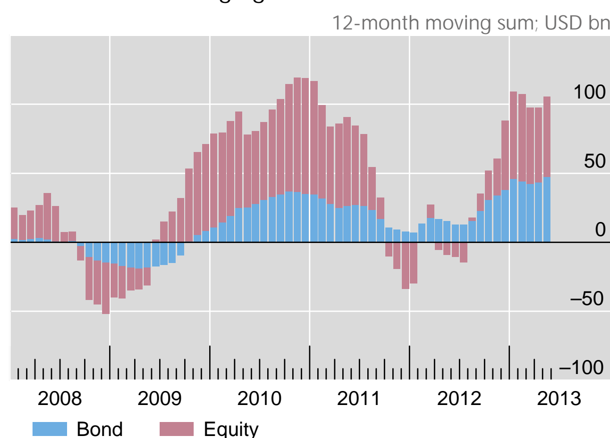
Nobody knows exactly how central banks will exit, or what they will exit into. In any event, they will need to employ great skill in both implementation and communication. Central banks have more tools now than six years ago. But when the time comes, they will need the flexibility to use these tools as needed. And they will have to take decisions with much less certainty than they would probably like – waiting for irrefutable evidence may complicate exit and prove costly. The bigger the scale and scope of their interventions, the more difficult it will be to reduce them.

Long-term interest rates and capital flows — Graph 5

Ten-year government bond yield and US term premium



Net flows into emerging market funds



Sources: Bloomberg; EPFR; BIS calculations.

Beyond the issues surrounding exit, the role of central banks is changing. A monetary policy framework anchored to price stability remains the foundation for strong, sustainable growth, but as the crisis has taught us, the goal of near-term price stability must be augmented with financial stability considerations – including how to deal with financial booms and busts in a more symmetric way and how to factor international spillovers into decisions. Dealing with those challenges requires understanding and accepting the limits of what central banks can and should do.

A shared responsibility

On all reform fronts there has been progress. But everyone has to make the most of the borrowed time that policy accommodation has provided.

Is this a call for undifferentiated, simultaneous and comprehensive tightening of all policies? The short answer is no. Concrete measures need to be tailored to country-specific circumstances and needs. And the timing need not be simultaneous, although in some places it may be difficult to avoid an overall reduction in accommodation because some policies have clearly hit their limits.

Ours is a call for acting responsibly now to strengthen growth and avoid even costlier adjustment down the road. And it is a call for recognising that returning to stability and prosperity is a shared responsibility. Monetary policy has done its part. Recovery now calls for a different policy mix – with more emphasis on strengthening economic flexibility and dynamism and stabilising public finances.

Finally, today's large flows of goods, services and capital across borders make economic and financial stability a shared international responsibility. Cross-border effects of domestic policy action are intrinsic to globalisation. Understanding spillovers and finding ways to avoid the unintended effects is central to the work of the BIS. And continued discussions among central banks and supervisors – discussions that the BIS facilitates and promotes – are essential for avoiding national biases in policymaking. Such national bias runs the risk of undermining globalisation and thus blocking the road to sustained growth for the global economy.