Looking beyond the here and now

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Ladies and gentlemen, it is my pleasure to welcome you to the presentation of this year's BIS Annual Report.

With this Report, we aim to contribute to the debate on the global economy among policymakers, the private sector and academics. The nature of this debate has changed a lot over the last year. The criticism of globalisation seems to have gained prominence.

This year's Annual Report reflects this shift. We devote a whole chapter to the economics of globalisation. This global focus complements the long-term perspective that we have emphasised in past Annual Reports: that looking beyond the here and now helps us to understand the underlying drivers, strengths and weaknesses of the global economy.

What I would like to highlight in my presentation today is the opportunities that the current global economic upswing provides. Stronger growth creates tailwinds that allow us to marshal support for economic openness and pay more attention to long-term developments. In other words, to pursue policies that build economic resilience, so as to be better prepared for the next "shock" or downturn.

After my presentation, Claudio Borio, Head of the Monetary and Economic Department, and Hyun Shin, Economic Adviser and Head of Research, will each elaborate on specific analytical aspects.

A stronger global upswing as an opportunity

Global growth has broadened and strengthened during the past year. By early 2017, virtually all major economies were expanding. Unemployment in a number of major economies has fallen to levels consistent with full employment. Inflation has moved closer to central bank objectives.

The near-term outlook appears the best in a long while. Consensus and international organisation forecasts point to further gradual improvement this year. Global growth is projected to reach 3.5% – in line with the long-term historical average, and less than half a percentage point below the level observed in the decade before the global financial crisis. The sentiment in financial markets is broadly consistent with this positive scenario: equity prices have risen globally and volatility is low.

How sustainable is this momentum? The Annual Report discusses four risks that could undermine the current expansion.

- The first one is a flare-up of inflation. Economic slack is vanishing in several countries, typically a sign of growing upside risks to inflation. But a number of factors – including globalisation and technological change – may mitigate the risk of a substantial, generalised and lasting rise in inflation. The Annual Report analyses how changes in the global economy may have put a lid on inflation pressures. Claudio Borio will talk more about what we know (and do not know) about changes in the inflation process in his presentation later.

- A second risk is maturing financial cycles and high debt. In a number of smaller advanced economies and emerging market economies, long financial booms have moderated or turned into downswings. And globally, debt is at record levels: in 2016, the stock of non-financial sector debt in the G20 economies stood at around 220% of GDP, almost 40 percentage points higher than in 2007.[1] High debt might become a significant drag on demand as interest rates normalise.
- A third risk is lagging corporate investment. The recent expansion has been consumption-led. BIS research shows that such expansions tend to be less durable. The flip side has been rather weak investment, at least in advanced economies. True, the outlook for corporate profits has improved. And some indicators point to a pickup in business investment. But persistent political uncertainty and high corporate debt could weigh on investment.
- Last but not least, there is the threat of protectionism. Arguments against international integration have gained attention in recent years. And there seems to be a greater willingness to resort to protectionist measures. Non-tariff barriers, such as regulations and subsidies, have risen fourfold since end-2010. Protectionism could hurt growth and welfare through various channels: weaker productivity, less international division of labour, and rising production costs as foreign inputs become more expensive.

Bearing these risks in mind, what can be done to turn the current momentum into a lasting period of robust global growth? As the Annual Report explains, we believe that the most promising policy strategy is to take advantage of the tailwinds to build greater economic resilience, nationally and globally.

Economic resilience is more than just the capacity to withstand "shocks". It also reduces the likelihood that "shocks" will materialise in the first place. And it helps us cope with adverse long-term trends, such as ageing populations or slowing productivity.

At the current juncture, building resilience has two important angles. One is to preserve the benefits of trade and financial openness. The other is to adopt a longer-term perspective in policymaking. Let me discuss these two aspects in turn.

Preserving the benefits of globalisation

Globalisation has slowed since the global financial crisis, but it is not in retreat. Trade in relation to world GDP has plateaued at a level of about 60%. Similarly, the share of global value chains in trade has stagnated at around 60%.

Financial integration has also moderated. In 2015, external financial assets and liabilities stood at 400% of world GDP, somewhat below the peak in 2007. Behind this development stand two broadly offsetting trends, as BIS statistics show: European banks pulled back from international lending, but banks from Asia and elsewhere have taken their place. As a result, overall integration has not flagged. Moreover, securities issuance has outpaced bank lending, in line with the rise of capital markets, institutional investors and asset managers.

The special chapter on globalisation shows that trade and financial openness are deeply intertwined. One can think of globalisation as consisting of three layers. In the first layer, cross-border

[1] The aggregate debt ratio cited is based on conversion to US dollars at PPP exchange rates. Based on market exchange rates, the aggregate ratio in 2016 was close to 250%.

payments and credit are needed to facilitate trade of commodities and finished goods. Here, it is obvious that real and financial globalisation go hand in hand.

But this is also true for the second layer, which involves more complex international trade. Financial openness allows the financing of cross-border investments and whole global value chains that distribute production across countries. It also allows hedging of the corresponding financial risks.

It is only in the third layer that financial links are established mainly for financial purposes – for instance, to diversify portfolios or to take and manage complex financial risks. Hyun Shin will elaborate on how to think about the link between trade and financial globalisation in his presentation shortly.

Together, trade and financial openness have been instrumental in raising living standards and have helped lift large parts of the world population out of poverty. Trade openness has made production much more efficient and vastly improved consumption opportunities. Financial openness has supported trade and made funding more easily available. By the same token, globalisation has also contributed to economic resilience. Just recall that globalisation has spread productivity gains and provided greater scope for diversifying risk.

But what about the criticism that globalisation is contributing to economic instability, rather than strengthening resilience? The special chapter discusses two arguments.

One is that globalisation is responsible for growing inequality within advanced economies. Empirical studies seem to indicate that other factors, technological change in particular, have played a bigger role. But it is true that the gains of trade are not equally distributed, and the adjustment burden is often concentrated in specific sectors or regions. This adjustment cost is one side of the coin. The other is lasting overall gains in income and welfare. Just as there is no suggestion to wind back technology, reversing globalisation would be greatly detrimental to living standards. Rather, the process of globalisation should be properly governed and managed. This requires paying proper attention to its distributional effects.

The other argument is that financial openness brings instability. Again, it is true that access to global funding also exposes economies to external developments that may be destabilising. For instance, we document in the Annual Report the procyclical nature of credit flows. But the risks are not fundamentally different from those of domestic financial liberalisation. The best policy approach is therefore not to reduce financial openness, but rather to carefully address the risks associated with procyclicality and excesses in finance. I will come back to this point later.

A longer-term perspective in policy

The emphasis on resilience recognises the boundaries of policymaking. One is the limited capacity to fine-tune the economy. The post-crisis period has shown how hard it is to boost growth and inflation despite unprecedented measures. Another is insufficient attention to longer-term developments and slow-moving trends.

Financial market pressures or political cycles may favour policy decisions that focus on the near term. But slow-moving trends and short-term decisions may have lasting cumulative effects. For instance, a sequence of macroeconomic stimulus measures may have a lasting effect on the stock of debt or the room for policy manoeuvre. These long-term, cumulative effects make it harder to deal with the next unexpected shock or eventual downturn.

How could the current tailwinds be used to build resilience? Let me highlight two main areas: one is to enhance policy space so as to be better prepared for future adverse events; and the other is to enhance the capacity of the economy to adapt to long-term trends.

For monetary policy, replenishing policy space would suggest normalising policies, which means reducing dependence on the extraordinary measures adopted in the aftermath of the crisis. While the timing and pace of such policy normalisation depend on domestic circumstances, there are some common challenges. Debt levels have continued to rise globally, and the valuation of several assets looks rich. The configuration of low levels of market volatility and low bond yields may point to snapback risks. Spillovers may create global repercussions. All this highlights the importance of gradual and steady monetary policy normalisation, but also the risk of waiting too long to normalise.

For fiscal policy, building resilience means first of all a prudent assessment of fiscal space, recognising the lack of precision in these estimations. It also entails the need to take into account fiscal risks, including financial market responses to higher sovereign risks, and the burden of ageing populations. If there is space, fiscal measures can be used to support other policies. This includes growth-friendly structural reforms. It also includes targeted measures to alleviate the adjustment costs of globalisation and technological change – for instance, by promoting retraining, education and the flexible reallocation of resources.

Last but not least, structural policies are essential for building resilience through greater flexibility and stronger growth. The specific types of structural reforms that are needed are largely country-specific. But a common denominator is fostering the rapid take-up of innovation, entrepreneurship and the flexible reallocation of resources. Steps in that direction not only help economies adjust to trends such as technological change and globalisation, they in fact enhance the gains from such trends. Unfortunately, far from speeding up, implementation of structural reforms has been slowing down.

From a longer-term perspective, these policies should, along with macroprudential policies, be part of a policy framework designed to address the risks associated with the financial cycle in an integrated manner. Tackling the financial cycle would call for a more symmetrical approach: policy should not just respond to financial busts, but also proactively constrain the build-up of financial imbalances. Otherwise, over long horizons, the result could be a sequence of financial booms and busts, a progressive loss of policy ammunition and a debt trap.

The role of international cooperation

I would like to end with some observations on how international cooperation can support policies to strengthen resilience. In many respects, building resilience is first and foremost a domestic task. But certain challenges call for a global response and require international cooperation within a consistent multilateral framework.

Managing the risks associated with financial openness is a prime example. The financial system is truly global. Many financial institutions are active around the globe, facilitating funding and managing financial risks across many jurisdictions. And there are global currencies. As the dominant global currency, the US dollar is the currency of choice not only for around half of all trade, but also for roughly half of global cross-border bank claims and more than 60% of central banks' foreign exchange assets. Efforts to build resilience globally have to take these features into account.

A priority is therefore to finalise the financial reforms under way. Completing Basel III is especially important, given the role banks play in the global financial system. This is no time to weaken safeguards or add another source of uncertainty that would hinder the necessary adjustments in the financial industry.

In addition, it is worthwhile exploring ways to advance cooperation in the area of monetary policy. As discussed in detail in previous Annual Reports, the reason is significant monetary spillovers from jurisdictions that are home to international currencies, together with limited insulation properties of exchange rates. Cooperation would help limit the disruptive build-up and unwinding of financial imbalances. Deepening the dialogue to reach a better agreement on diagnosis and remedies is a precondition for further progress.

Let me conclude. The current growth tailwinds provide an opportunity for policymakers to pursue a policy agenda that strengthens the resilience of their domestic economy. International cooperation can support these efforts, and help to ensure that they add to resilience at the global level. This is the most promising way to achieve sustained growth and lasting economic prosperity.