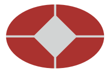
BANK FOR INTERNATIONAL SETTLEMENTS

Shelter from the storm

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Introduction

Good afternoon! I am very happy to be here in Luxembourg at the European Stability Mechanism (ESM). I believe that institutions such as the ESM are incredibly important. Of course, we should do everything possible to avoid needing them in the first place. Getting one's house in order, building a resilient and flexible economy, and reducing vulnerabilities – all these things are clearly of first-order importance. But we should not be naive and believe we will be able to avoid all future crises. And when they do occur, having a shelter from the storm is *very* important.

In my talk, I would like to review some of the achievements and unintended consequences of the policy response to the Global Financial Crisis (GFC) and the subsequent European debt crisis. I will then sketch some of the challenges authorities might face in the years to come and discuss what we can do to safeguard economic and financial stability. Let me be clear from the outset as to what I take away from these considerations.

First, we have made a lot of progress in making the global financial system more stable.

Second, vulnerabilities nevertheless remain. Some are long-standing – for instance, the high levels of debt in many economies. Others are more recent, such as those related to the shift in financial intermediation from banks to markets.

Third, our ability to manage future financial crises has not improved as much as it should have. Progress in Europe – and, to a lesser extent, Asia – has not found parallel advances elsewhere. At the same time, the International Monetary Fund (IMF) might not have sufficient resources to deal with large crises. As a result, many countries do not have sufficient, reliable access to a lender of last resort, which could result in spillovers and spillbacks around the globe.

Policy responses: achievements and unintended consequences

We have achieved a lot in the 10 years since the GFC and the five years since the European sovereign debt crisis. The effective management by central banks of the fallout played a critical role in halting the crises; additional monetary stimulus in subsequent years helped nurture the recovery. Central banks slashed policy rates and kept them at very low levels for many years, in some cases right up to the present day. In addition, they developed new tools such as quantitative easing, forward guidance and negative interest rates. These decisive actions avoided a financial meltdown and economic depression.

Authorities also took decisive actions on the regulatory and supervisory front, which helped restore trust in the financial system and build resilience for the future. In particular, banking authorities

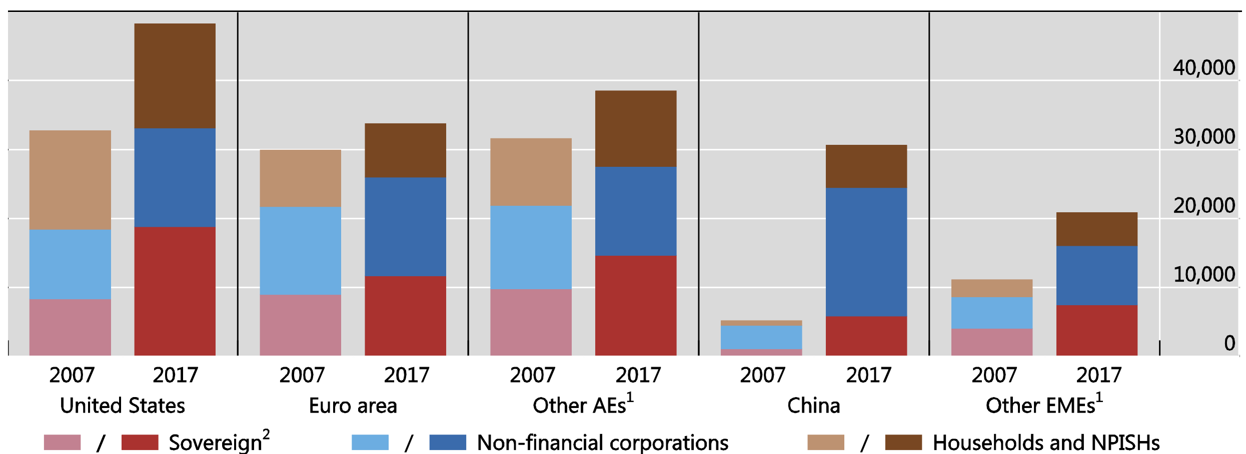
overhauled the regulatory framework and delivered Basel III. Moreover, in order to orient financial regulation and supervision towards systemic stability, many countries developed or enhanced macroprudential policy frameworks that complemented the established microprudential ones.

The monetary and fiscal response to the crisis gave rise to a number of unintended side effects that may pose challenges going forward.

Persistently low interest rates facilitated deleveraging in those countries and sectors that were at the epicentre of the crisis – in particular, household and banking sectors in major advanced economies. But easy financing conditions also fostered further debt accumulation in countries and sectors outside that epicentre. This includes some smaller advanced economies (AEs) and many emerging market economies (EMEs) (Graph 1).

Debt levels continue to rise

End-year figures, in billions of US dollars | Graph 1



[1] Sum of nine advanced economies and 19 EMEs. [2] General (if not available, central) government core debt at nominal (if not available, market) value.

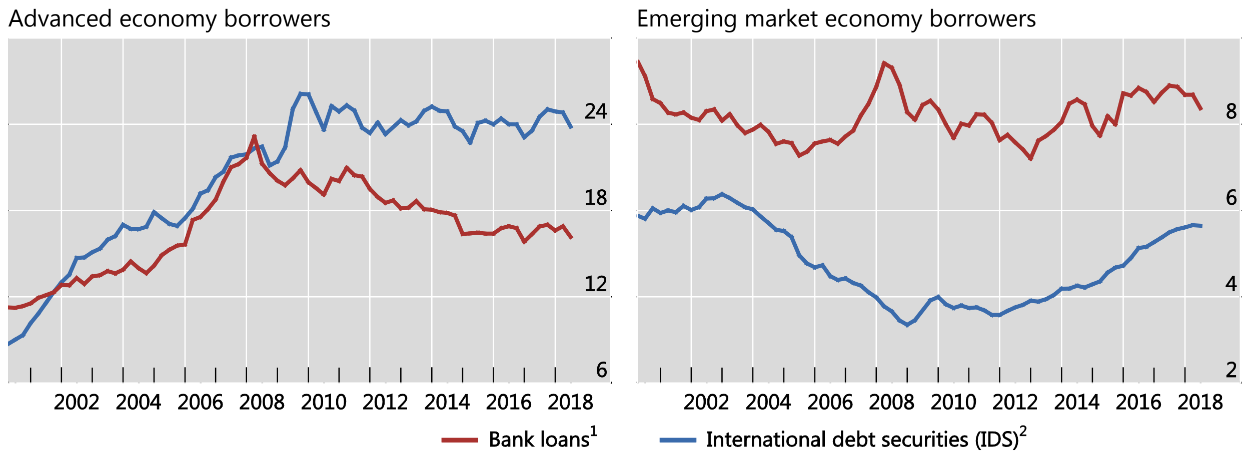
Sources: BIS total credit statistics; BIS calculations.

The policy response also contributed to a shift in the supply of credit from bank financing to bond financing (Graph 2). Low interest rates induced search for yield in bond markets; and regulatory tightening together with post-crisis deleveraging led to a retrenchment in bank intermediation globally. As a result, in particular in EMEs, an increased share of financial intermediation was conducted through bond markets rather than banks (Graph 2, right-hand panel).

The greater share of bond markets in global financial intermediation has meant a more prominent role for asset managers, which affects market dynamics and markets' potential behaviour in response to shocks.

Bonds take on larger role

Amounts outstanding, as a percentage of regional GDP — Graph 2



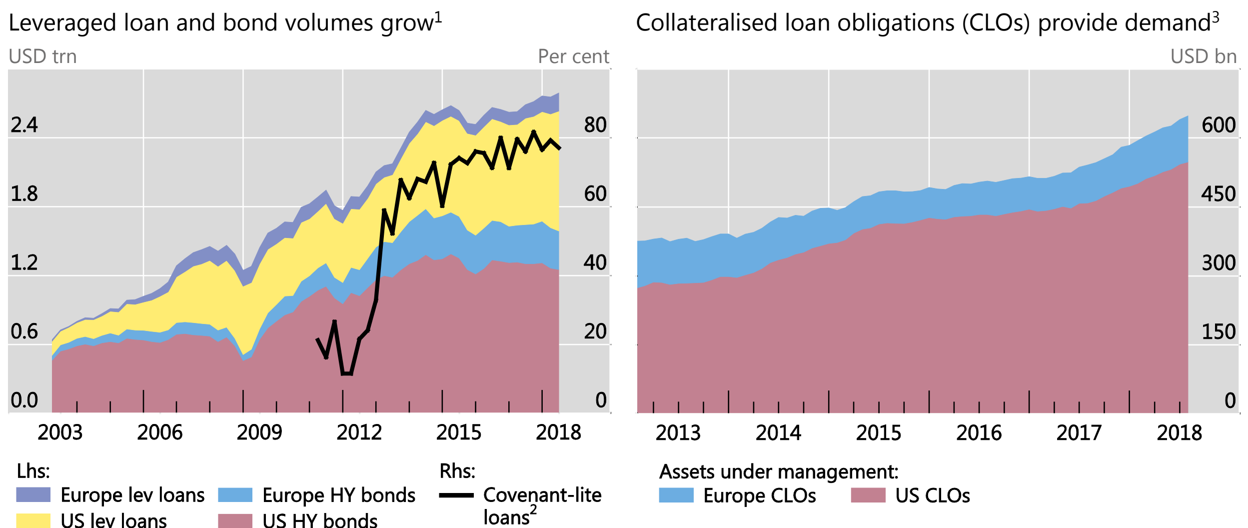
[1] Cross-border loans and local loans in foreign currency to non-bank borrowers. [2] By residence and immediate sector of issuer; all instruments; all maturities; non-bank issuers.

Sources: Dealogic; Euroclear; Thomson Reuters; Xtrakter Ltd; BIS locational banking statistics; BIS calculations.

Over the past decade, we have seen intense search for yield, both nationally and internationally, often reflecting excessive risk-taking by investors. This has dramatically compressed risk premia, including term premia and credit risk premia in corporate and EME sovereign yields. In the United States and Europe, the volume of high-yield bonds and leveraged lending has picked up in recent years, and leveraged loans tend to have fewer covenants (Graph 3, left-hand panel). One driver of this surge is the revival of collateralised loan obligations, which have grown steadily in volume (Graph 3, right-hand panel).

Risk-taking picks up

Graph 3



[1] For institutional leveraged loans (lev loans), outstanding amounts are based on S&P/LSTA leveraged loan index (LLI) for the US, and S&P European leveraged loan index for Europe, where LSTA = Loan Syndications and Trading Association; for high-yield (HY) bonds, outstanding amounts are based on the USD high-yield ICE BofAML index for the US and the EUR high-yield ICE BofAML index for Europe. [2] Based on US market deals. [3] "US CLOs" covers USD-denominated issuances and "Europe CLOs" EUR-denominated issuances.

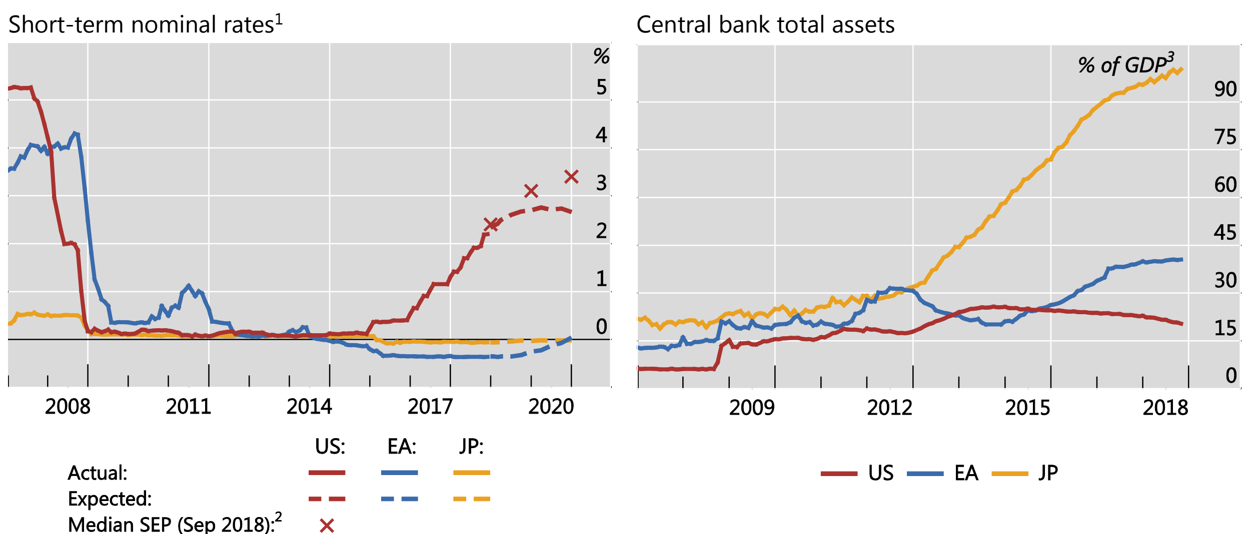
Sources: ICE BofAML indices; Thomson Reuters Loan Pricing Corporation; BIS calculations.

The most damaging unintended consequence of the crisis response has probably been the postponement of the implementation of pro-growth structural reforms. Accommodative financial conditions can boost the economy temporarily and reverse crisis-related output and employment losses. But they cannot boost long-run growth potential. Significant structural impediments to growth clog both product and labour markets in many countries. Implementing growth-friendly structural reforms will become harder as monetary accommodation is withdrawn. Therefore, now is the time to speed up the implementation of such reforms.

Challenges going forward

Monetary policy normalisation in the major advanced economies is making uneven progress, reflecting different stages of recovery from the GFC (Graph 4). The Federal Reserve is unwinding its asset holdings by capping reinvestments and is increasing policy rates. The ECB has scaled back its large-scale asset purchases, with a likely halt of net purchases by end-year. Meanwhile, the Bank of Japan is continuing its yield curve control via its purchases and has not communicated any plan for exiting.

Policy rates remain low and central bank assets large 10 years after Lehman — Graph 4



[1] For actual: effective federal funds rate (US); EONIA (EA); one-month OIS rate (JP); monthly averages. For expected: OIS forward rates. As of 26 November 2018. [2] Summary of Economic Projections (SEP) of the US Federal Reserve Board members and US Federal Reserve Bank presidents. [3] For the last period, latest available GDP.

Sources: Bloomberg; national data; BIS calculations.

The ongoing unwinding of accommodative monetary policy in core advanced economies is a welcome step. It is a sign of success, reflecting the fact that economies have been brought back to growth and inflation rates back towards target levels. Monetary policy normalisation is essential for rebuilding policy space and creating room for countercyclical policy. Moreover, it can help reduce the risk of financial vulnerabilities and contribute to restraining debt accumulation.

But there are also significant challenges. The ongoing normalisation starts from an unprecedented point and involves extreme uncertainties. For central banks, the path ahead is quite narrow, with pitfalls on either side. They will need to strike a delicate balance between competing considerations. This includes, in particular, the challenge of achieving their inflation objectives while avoiding the risk of encouraging the further build-up of financial vulnerabilities.

Central banks have prepared and implemented normalisation steps very carefully. They have been very gradual and highly predictable. Central banks have placed great emphasis on telegraphing their policy steps through extensive use of forward guidance. As a consequence, major financial and economic ructions have been avoided thus far. In this regard, the increased resilience of the financial sector as a consequence of the profound regulatory and supervisory financial reforms undertaken since 2009 has also helped.

That said, there are still plenty of risks out there.

First, central banks do not control the entire yield curve and the behaviour of risk premia. There is much uncertainty as to how investors will react to monetary policy normalisation. An abrupt repricing in financial markets may prompt an outsize revision of the expected level of risk-free interest rates or a decompression in risk premia. Such a snapback could be amplified by market dynamics and feed back to the macroeconomy in adverse fashion. It could also be accompanied by sudden sharp exchange rate moves and spillover across borders, with broader repercussions globally.

Second, as I mentioned a moment ago, financial intermediation has changed and the response of some players to "live fire" has not yet been tested. Low fees and the promise of liquidity on an intraday basis have boosted the popularity of exchange-traded funds (ETFs). But the promise of intraday liquidity is a double-edged sword. As soon as ETF investors are confronted with negative news or observe an unexpected fall in the underlying asset price, they can run – that is, sell their ETF shares anytime – which will add to the downward pressure on market prices. This could be the case particularly in asset classes where retail investors traditionally did not participate but now do, thanks to the convenience of ETFs. As securities markets become choppier, we will need to be on the lookout for ETFs possibly accentuating the volatility of the underlying asset market or its surrogates. If the underlying asset market is not liquid enough, then asset managers could be forced to offload other liquid assets, which would give rise to contagion. Moreover, ETFs have yet to be tested in periods of high interest rates.

More generally, the growing size of the asset management industry may have increased the risk of liquidity illusion: market liquidity seems to be ample in normal times, but dries up quickly during market stress. Moreover, precisely when asset prices fall, asset managers often face redemptions by investors, in particular by retail investors. This is especially true for bond funds investing in relatively illiquid corporate or EME bonds. Therefore, when market sentiment shifts adversely, investors may find it more difficult than in the past to liquidate bond holdings.

A related development has been a shift in the provision of liquidity. In the past, large systemically important banks used to act as market-makers. But given regulatory strengthening, they no longer play this role. Central banks' asset purchase programmes may also have contributed to liquidity illusion. As central banks unwind their asset purchase programmes and increase policy rates, investors may choose to rebalance from riskier bonds back to safe government bonds. This can widen spreads of corporate and EME bonds. Another concern is herding and "benchmark hugging" by asset managers, which can amplify financial market volatility.

Third, the fundamentals of many economies are not what they should be. At the same time, there seems to be less political appetite for conservative macro policies. High and rising sovereign debt relative to GDP in many advanced economies has increased the sensitivity of investors to the perceived ability and willingness of governments to ensure debt sustainability. A recent example is the sensitivity of the spread on Italian government bonds to the government's recent budget plans.

Corporate and household debt is high and rising in many economies. In addition, as a large amount of EME foreign currency debt matures over the next few years, large current account and fiscal deficits in some EMEs could induce global investors to take a more cautious stance. Tightening global financial conditions and EME currency depreciation may increase the sensitivity of investors to these vulnerabilities.

Fourth, other factors may amplify the spillover effects from unwinding unconventional monetary policy. Expansionary fiscal policy in some core advanced economies may push up interest rates further, by increasing government bond supply and aggregate demand in already overheating economies. Trade tensions have started to affect global growth prospects. Such tensions also weigh on exchange rates and perceptions of corporate debt sustainability. Heightened geopolitical risks should not be ignored. The sharp corrections in AE and EME equity markets alike during the last months are generally attributed to both cumulating trade tensions and geopolitical risks.

Preventing and managing crises

So, despite the significant advances over the last 10 years, various things could go wrong.

The first line of defence should be a resilient and flexible economy. Growth-enhancing structural policies could facilitate the treatment of overindebtedness. In contrast to expansionary monetary and fiscal policies, they boost output without boosting debt, thus reducing debt burdens. And, if sufficiently broad in scope, they would have positive distributional effects, reducing income inequality.

Financial reforms should be fully implemented. If enforced in a timely and consistent manner, these reforms will contribute to a much stronger banking system. Indeed, the Basel Committee's Regulatory Consistency Assessment Programme has found that its members have put in place most of the major elements of Basel III. But there are also implementation delays. It is important to attain full, timely and consistent implementation of all the rules, including the reforms that were agreed last year. This would improve the resilience of banks and the banking system. It is also necessary for attaining a level playing field and limiting the opportunities for regulatory arbitrage.

Policymakers need to better understand asset managers' behaviour in stress scenarios and to develop policy responses. One key question for policymakers is how to dispel liquidity illusion and support robust market liquidity. Asset managers need to take steps to strengthen their liquidity risk management. Policymakers can also prod them to maintain robust liquidity during normal times to weather liquidity strains in bad times – for example, by encouraging regular liquidity stress tests.

While everybody agrees that prevention is better than cure, it would be foolish to neglect crisis management. Among other things, this requires a strong safety net. A natural starting point is international reserves that could be deployed to smooth the impact of external shocks. But international reserve accumulation tends to be very expensive. Therefore, reserves should be complemented by regional and global arrangements.

Europe is the region that has made the most significant progress in setting up a regional safety net. The ESM has been up and running for over five years and has already assisted five countries. The ESM's toolkit is in fact larger than that of the IMF, as demonstrated by the programme for the recapitalisation of Spanish banks. In addition to lending in crises, it can extend precautionary credit lines, although these have not yet been extended. But even in Europe, there are open issues. For instance, there is as yet no unified European deposit insurance scheme, and a veto by a single country can derail ESM lending.

In East Asia, central banks have multilateralised the network of Chiang Mai swaps among ASEAN central banks and China, Japan and Korea. Unlike the ESM in Europe, this multilateralised swap has not been drawn upon. In addition, central banks worldwide have established standing bilateral swap arrangements.

The existing regional and bilateral arrangements have large gaps and do not cover many countries in Africa, Latin America and elsewhere in Asia and Europe. There is thus a strong need for the global safety net meant to be provided by the IMF, on top of national and regional arrangements.

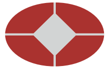
Unfortunately, the IMF's resources are limited. Taking all the sources together, the IMF has access today to resources of SDR 975 billion or about €1.2 trillion. This is larger than the ESM's maximum lending capacity of €500 billion, but it is actually only around 1% of global external liabilities (Graph 5). But about one half of current IMF lending capacity, SDR 480 billion, is temporary, coming as it does from bilateral borrowing arrangements and New Agreements to Borrow (NAB), all of which expire in the coming years. If these facilities are not renewed, then the IMF's fire power could be severely curtailed.

IMF quotas as a percentage of global gross external liabilities — Graph 5

Sources: P Lane and G Milesi-Ferretti, "International financial integration in the aftermath of the global financial crisis", *IMF Working Papers*, 17/115, 2017; IMF, *International Financial Statistics*; BIS calculations.

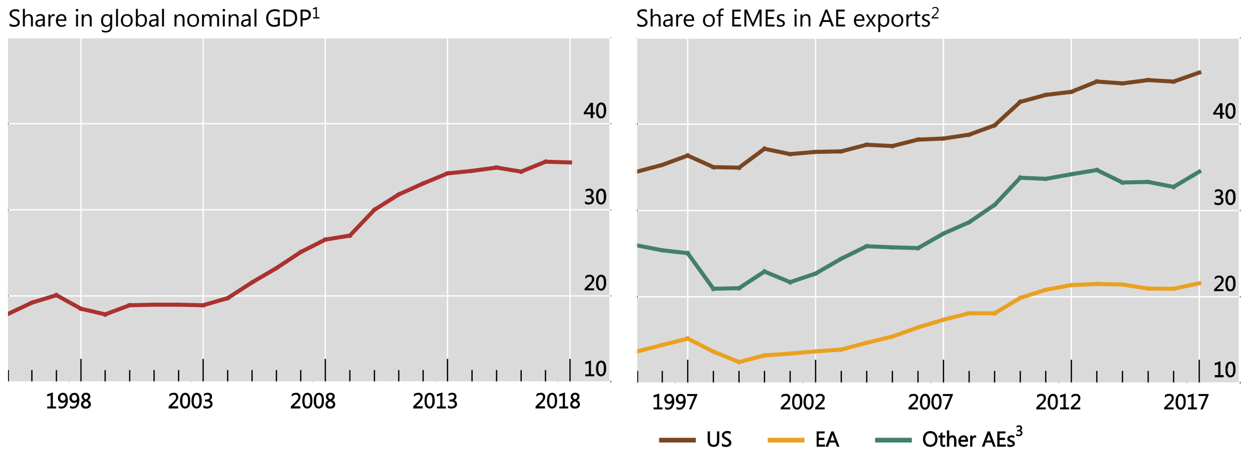
Traditionally, the IMF has been a quota-based institution. Regretfully, IMF quotas have not kept up with financial globalisation. IMF quotas amount to less than 0.5% of global gross external liabilities, down from over 4% in the early 1970s. The last quota increase, agreed in 2010, took effect only in 2016. It is therefore urgent that IMF member countries conclude as soon as possible the 15th General Review of Quotas.

So why does this matter for Europe? First of all, crises today can be far more disruptive than in the past. And in an integrated global financial system, they can easily spread from one part of the world to another. In addition, the combined weight of EMEs in the global economy is much larger than a few decades ago (Graph 6, left-hand panel). EMEs now account for more than one third of global GDP at market prices, up from less than one fifth only 20 years ago. And well over 20% of the euro area's exports go to EMEs. For the United States, share of EME export destinations is even approaching 50% (Graph 6, right-hand panel). Last but not least, any stress in EMEs will result in migration to AEs.



EMEs play a much bigger role in global economy than before

In per cent Graph 6



[1] Share of 23 major EMEs; IMF estimates for 2018. [2] Exports of goods; share of 23 major EMEs in total exports. [3] Nine advanced economies.

Sources: IMF, *Direction of Trade Statistics* and *World Economic Outlook*; BIS calculations.

Concluding remarks

We have made great progress over the past 10 years in overcoming the GFC and the European sovereign debt crisis. But it would be naive to assume that we have eliminated all risks. We therefore need to be prepared. First of all, this means putting one's house in order: undertaking structural reforms to make the economy more flexible and resilient; reducing vulnerabilities such as large fiscal deficits; and following sound macroeconomic policies.

But we also need to improve our ability to manage crises. In Europe, the GFC created the political will for further progress in financial integration, including banking union. There is a lender of last resort, the ESM, with an innovative toolkit. However, we also need an effective lender of last resort with global reach. Unfortunately, there has been limited progress in scaling up the IMF's core resources. Without this, the global safety net remains incomplete.