BANK FOR INTERNATIONAL SETTLEMENTS

Time to ignite all engines

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Ladies and gentlemen

It is my pleasure to present to you this year's BIS Annual Economic Report. Our central theme is how to chart a course to clear economic skies. My remarks will focus on the current state of the global economy, the outlook, the risks, and, above all, the need for a better balance in policies.

Following the gains from a decade of extraordinary monetary policies that helped to restore global growth, we have seen a slowdown in the pace of expansion since last year. While the near-term outlook is still good, there are many vulnerabilities further out. For the global economy to remain on course towards clear skies, other policies need to play a bigger role and policymakers must take a longer-term perspective. In particular, a better mix is required between monetary policy, fiscal policy, macroprudential measures and structural reforms. And navigating the way to clear skies also means balancing speed with stability as well as conserving some fuel to cope with possible headwinds. This matters all the more given the many uncertainties and risks we face today.

A growing global economy, but risks and vulnerabilities remain

Let me summarise how we assess economic developments over the last year and how we see the outlook.

The global economy clearly slowed in the past 12 months. Some of this slowdown was to be expected. Global growth was well above potential in 2017, and the economy was bound to decelerate from its above-normal speed. However, some of the slowdown was unexpected, and was due to several headwinds that have contributed to a much weaker performance of trade and the manufacturing sector.

One headwind has been the ongoing trade tensions and related uncertainties about the future of the multilateral trading system, which exercise a powerful drag on the global economy. As well as clouding future demand and affecting investment prospects, the trade tensions bring up questions about the viability of existing supply chain structures and the very future of the global trading system. It bears repeating: trade wars have no winners, only losers.

Another headwind involves developments in China, where the authorities have sought to bring about the much needed deleveraging of the economy to make growth more sustainable. Given China's heft and tight interconnections in the global economy, the slowdown quickly spread around the world. Here too, global value chains acted as a powerful transmission channel.

Some signs still augur relatively well for the near-term outlook. Services have held up, while continued strong employment growth and solid wage increases have underpinned consumption. In many large economies at the heart of the Great Financial Crisis, credit and financial conditions are still supporting economic activity, most notably in the United States. And thanks to the post-crisis reforms, the majority of global banks are much better capitalised.

Central banks have helped sustain the momentum in recent months, as they have been adapting their policy stances as new information has come in. Inflation has remained very subdued despite many economies operating close to, or above, standard estimates of potential output and record low unemployment.

Still, there are some factors weighing on growth. If anything, the slowdown appears to be worsening and spreading since the Report went to press. There are signs of weaker consumption and investment. And significant near-term risks exist. Notably, the trade tensions that contributed to the slowdown could flare up again. Other threats include political economy risks in some countries. China's deleveraging is not complete. And if past experience is anything to go by, the contraction phase of the financial cycles under way in many countries is likely to act as a headwind for global growth.

Importantly, after the prolonged period of easy financial conditions, many vulnerabilities have built up and could throw the global economy off course.

One such vulnerability is high household debt in many advanced economies, especially those not directly affected by the Great Financial Crisis. These historically high debt levels limit the scope for households to drive economic activity.

Another vulnerability is clear signs of overheating in the corporate sector in a number of advanced countries. Following high growth, the leveraged loan market is now some USD 3 trillion in size, comparable to the collateralised debt obligations that amplified the subprime crisis. Structured products such as collateralised loan obligations (CLOs) have surged. Credit standards have been declining as investors have searched for yield. Should the leveraged loans sector deteriorate, the economic impact could be amplified through the banking system and other parts of the financial system that hold leveraged loans and CLOs. There could be sharp price adjustments and funding tensions. These risks should be seen in the broader context of the longer-term deterioration in credit quality and the generally high corporate leverage in many advanced economies.

High levels of debt also point to vulnerabilities in a number of emerging market economies (EMEs). In some cases, these are in the household sector. Most often, they are in the corporate sector, not least as foreign currency debt has expanded strongly since the crisis. The current vulnerabilities reflect in part spillovers from prolonged accommodative monetary policies in advanced economies, as EMEs are especially vulnerable to capital flow reversals and exchange rate fluctuations. In Chapter II of the Report we discuss how EMEs have sought to address this higher sensitivity by adopting monetary policy practices that have, in some respects, moved ahead of received theory. Rather than strictly sticking to inflation targeting with free-floating exchange rates, they have combined it to varying degrees with foreign exchange intervention and the active use of macroprudential measures. This mix has provided some hard-won degrees of freedom to better secure price, macroeconomic and financial stability. Still, the challenges ahead should not be underestimated.

Country differences aside, despite having more capital than pre-crisis, banks in a number of jurisdictions face profitability challenges. Profits are the first line of defence against losses, by far the primary source of capital, and the foundation for banks' ability to lend and support the economy. Low prospective profitability is reflected in very low bank valuations. Many banks have not yet managed to fully repair their balance sheets and adjust their business models. The emergence of big tech as a competitor, analysed in Chapter III of the Report, further adds to banks' challenges.

While not obvious risks to global financial stability as yet, these vulnerabilities can pose threats to the sustainability of the economic expansion, the more so as overall debt – private and public – is very high by historical standards and has risen during the last years. So the path for the global economy is likely to remain bumpy. It makes sense to keep safety belts on, but it is not enough. To make steady progress towards clear economic skies, we need to maintain a proper long-run vision and act accordingly.

Setting a course for clear skies

Last year, the major central banks set a course towards normalisation, with a very gradual and anticipated tightening given that global growth was robust. But as world trade weakened and financial markets dived, the normalisation was put in a holding pattern. Financial markets quickly rebounded. More shocks occurred, and policy adjustments were again made. These events showed how hard it is to proceed along the normalisation course, with markets so sensitive to signs of policy tightening. But the decisions in the last few months have also showed that central banks can be nimble and respond quickly to unfolding events in pursuit of their mandates.

How should monetary policy respond in the event of a sharper than expected weakening of economic activity? While most economies still have adequate monetary policy space, in adjusting policy central banks need to think of the vulnerabilities that their immediate actions might create. How much to adjust in the short term depends on how one views the possibility of some delicate intertemporal balancing acts.

These potential balancing acts arise in those situations where policy actions have clear welcome effects in the short run but at the same time might increase the risk of unwelcome ones in the longer run. For monetary policy, these potential trade-offs become more apparent when there is a need to regain room for policy manoeuvre; inflation remains stubbornly below target even as economies operate in the region of full capacity; growth shows signs of weakening; and, financial vulnerabilities have built up. Central banks are fully aware of the need to find a balance. Inevitably, a good degree of judgment is called for. That is why decisions may differ across countries and circumstances. Let me elaborate on the terms of these potential trade-offs.

The arguments for a more gradual approach are clear. Price stability – central banks' key mandate – naturally reinforces the case for maintaining policy accommodation, or easing further, as inflation is below target. Closely related is the need to bring inflation expectations back towards target. This approach is even more compelling if financial markets look fragile, as they appeared late last year, and could impact the economy adversely. The greater the uncertainty about conditions in the financial system and the macro economy, the stronger the case for a more gradual strategy.

At the same time, the gains from such a strategy could be associated with costs and less room for policy manoeuvre in the future.

The possible costs arise mainly through financial channels. The historically low-for-long interest rates tend to compress banks' margins, lower profits and hence reduce banks' ability to build up capital, essential for a productive economy. Very easy financial conditions may boost growth in the near term but may further build up vulnerabilities. And persistently low rates may undermine efficient resource allocation and productivity.

Under such circumstances, the future room for policy manoeuvre could shrink for two reasons. To the extent that normalisation does not end up weakening economic activity, a more gradual approach would reduce policy space directly. More subtly, the side effects of very accommodative policies might themselves sap the economy's ability to withstand higher rates, making any normalisation harder.

These considerations underline how difficult a balancing act central banks face. The risk of slowing to stall speed needs to be balanced against the risk of burning fuel too fast. More broadly, these considerations highlight the fact that monetary policy cannot be the engine of higher sustainable economic growth. More realistically, it is better regarded as a backstop.

To see past the clouds to blue sky, a more balanced policy mix is badly needed. The plane cannot fly on one engine only; it has to ignite all four. Economic performance continues to rely on extraordinary support from central banks, even with global growth that is still sound. Thus we need a better balance between monetary policy, fiscal policy, macroprudential policies, and structural reforms.

Fiscal authorities can help where space is available. Factors such as the levels of public and private debt will influence whether and when to use fiscal policy, as well as the appropriate balance with monetary policy. When the scenario presents itself, fiscal policy should be used judiciously to boost sustainable growth, supporting aggregate demand with targeted and temporary expansions. In the process, it is important to avoid the trap of carrying out procyclical policies. And often it is best to undertake structural fiscal reforms, like reducing the bias of tax systems in favour of debt or strengthening automatic stabilisers.

Macroprudential measures can help too. They can provide degrees of freedom to better reconcile price, macroeconomic and financial stability over the medium term, as reviewed in Chapter II in the case of EMEs.

Structural reforms are vital. Hard as it is politically, it is essential to revive the flagging efforts to implement structural policies designed to boost growth. These days, policies to adapt economies to rapid technological and other structural changes are especially important. The regulatory response to big techs' inroads in finance, analysed in Chapter III of the Report, is one such example.

Clear skies may be over the horizon, but we have yet to cross it. Many risks and vulnerabilities exist, and political uncertainty is high. The course towards normalisation has called for some deviations. A sustainable flight path requires the long-overdue full engagement of all four policy engines, rather than short-term turbo charges. By taking a longer view, one can better balance the needs of today with the needs of tomorrow.

Let me now hand over to Claudio Borio, Head of the Monetary and Economic Department, and Hyun Song Shin, Economic Adviser and Head of Research, who will elaborate on the special chapters.