Central banks facing pandexit challenges

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Ladies and gentlemen

Welcome to the presentation of our 91st BIS Annual Economic Report. I sincerely regret that for a second year in a row we have to do this in virtual format. On the other hand, positive developments in the fight against Covid-19 indicate that this will be the last time we need to proceed in this way.

The Covid-19 pandemic caused an unprecedented global downturn last year. Today, things look much better. New Covid-19 cases are declining and vaccination rates increasing. After forceful and wide-ranging policy support, economic conditions are much improved. In many countries, a remarkable recovery is under way. However, the pandemic is far from over, with emerging market economies (EMEs) still lagging behind advanced economies (AEs) in defeating the virus. The recovery is highly uneven and incomplete, and the global outlook is uncertain.

My remarks will highlight that policymakers still face daunting challenges as we exit the pandemic. Monetary policy will need to respond flexibly in the face of an uncertain near-term landscape. Public and private debt are very high, and the pandemic's adverse legacies are large. This means that finding a sustainable path for fiscal and monetary policies is the main longer-term challenge. The best way to meet this challenge and reduce tensions between the two policies is by raising sustainable growth. The quest for growth calls for forceful and continued structural reform policies supported by growth-friendly fiscal measures.

As disaster was averted, the recovery takes hold

As last year's Annual Economic Report stressed, 2020 would be a year for the history books. It surely turned out that way. But economic disaster was averted, and the global economy bounced back more quickly than expected.

Consumers and firms adapted surprisingly quickly to the restrictions. The rotation in demand from services to goods limited the drop in activity. And consumption rebounded strongly in the second half of last year as restrictions were lifted. International trade returned swiftly to pre-pandemic levels. The financial system proved robust. As the data improved, growth forecasts were progressively revised upwards.

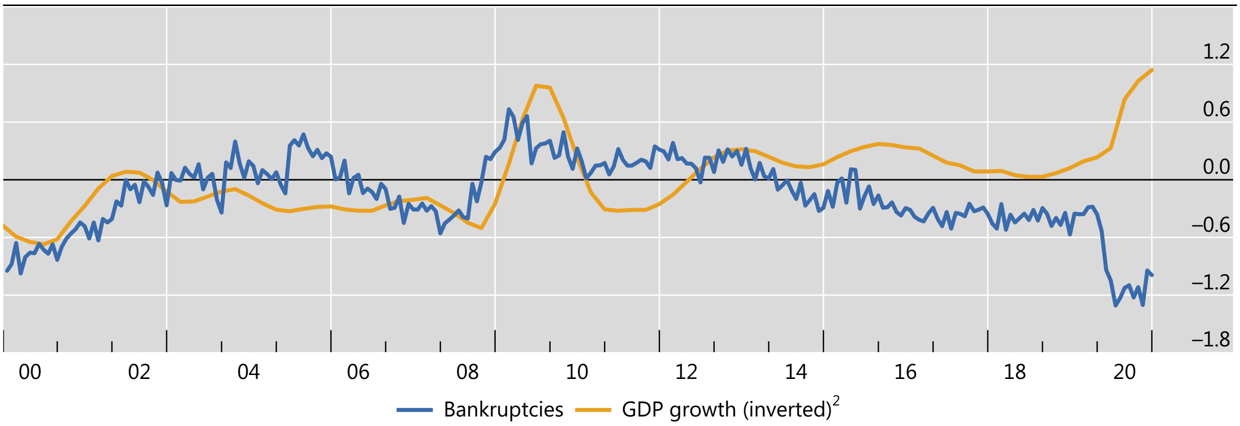
Much of this "better than expected" picture reflected unprecedented macroeconomic policy accommodation. Fiscal support remained ample. Central banks, working closely with fiscal authorities, maintained their asset purchase programmes and refinancing facilities for commercial banks and, in some cases, expanded them. These actions kept financial markets stable and funds flowing to the real sector. Furthermore, as supervisors, central banks provided the needed flexibility to financial institutions to maintain financing. Policymakers did all this even as, for many, available policy space appeared limited.

These actions helped households and firms. Widespread furlough schemes in many economies kept unemployment low and household income up, while bolstering firms' bottom lines. Loans and guarantees shielded firms. Transfers to households boosted personal disposable income, which in some cases actually grew strongly. Corporate bankruptcies did not spike as many had predicted. Scarring of households and firms was limited. The very strong monetary and fiscal policy support also contained the increase in income inequality that recessions typically exacerbate.

Bankruptcies decoupled from economic activity[1]

In standard deviations

Graph 1

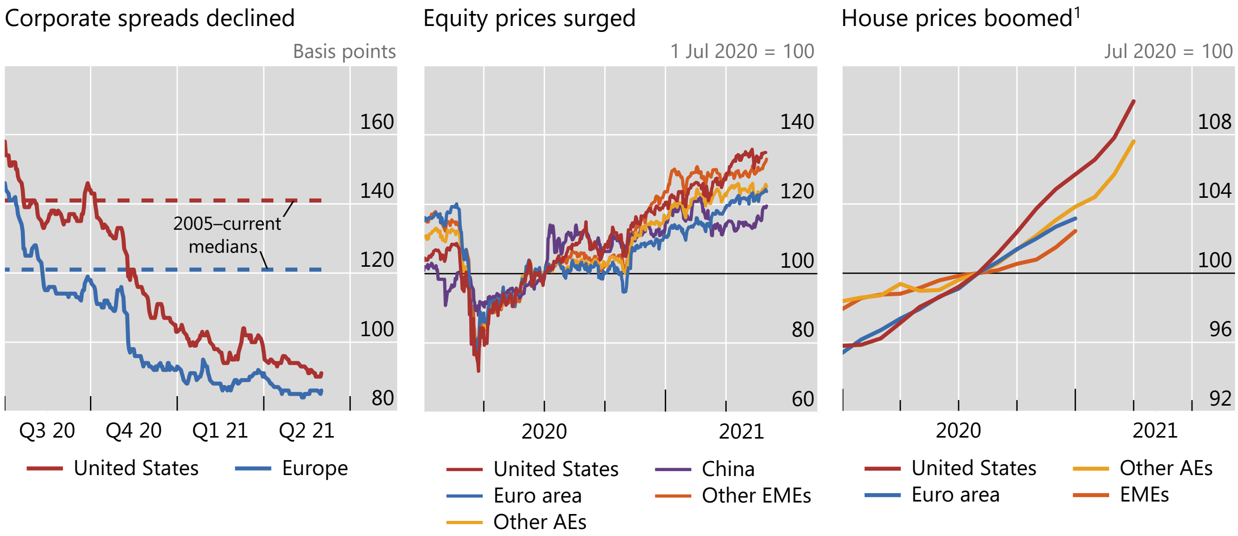


[1] The mean and standard deviations are calculated over the period 2000–19 on an individual country basis for 11 AEs and 12 EMEs. The graph shows the average of the standard deviations from the mean across countries, where data are available. [2] GDP growth line is inverted, ie values are multiplied by –1.

Sources: Datastream; national data; BIS calculations.

In the wake of all this, financial conditions remained extraordinarily easy. Credit spreads declined close to historical lows. Even as profits tanked, corporate funding flowed at record levels, much more so than during the Great Financial Crisis (GFC). There were signs of frothiness and aggressive risk-taking in financial markets, as equity prices surged and housing markets boomed in many economies. The large losses at several banks that had lent to Archegos put the spotlight on vulnerabilities in non-bank financial intermediation. This mainly reflected hidden leverage and liquidity mismatches.

Financial conditions remained exceptionally accommodative Graph 2



[1] GDP and PPP exchange rates weighted averages: euro area = DE, FI, FR, IE, NL and PT; other AEs = AU, CA, GB, IS and SE; EMEs = AE, BR, HK, IL, KR, MX and TH.

Sources: Bloomberg; BoAML ICE indices; Datastream; national data; BIS calculations.

A solid outlook, but not out of the woods

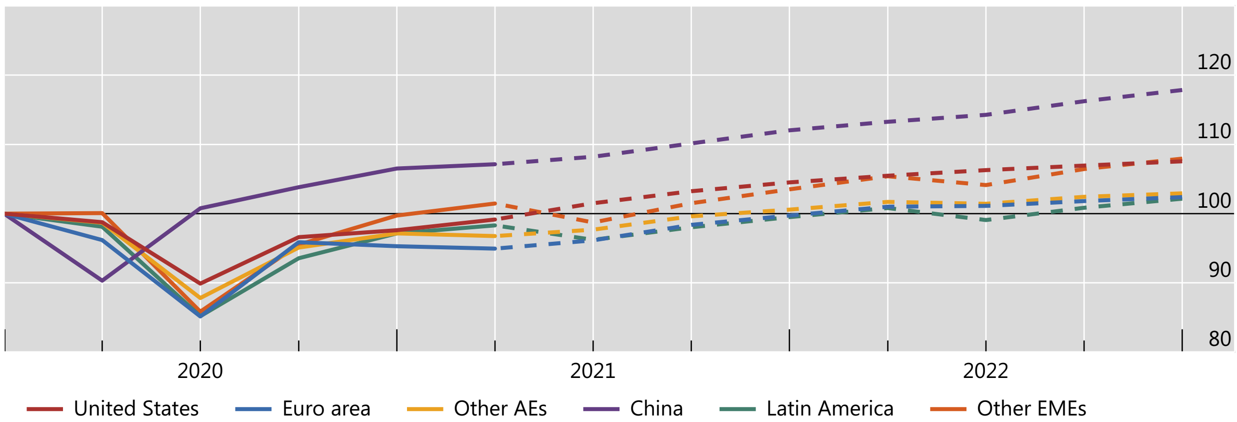
The consensus outlook is for further improvements, although at uneven speeds across countries and sectors.

The United States and China, with their solid expansions, are ahead of the pack. The euro area and many other AEs are catching up, some after double-dip recessions. China aside, many EMEs are lagging behind, due to renewed virus waves and lockdowns as well as more constrained policy support. Some sectors are booming. But many service industries are only now coming back. International tourism and travel are languishing.

While the recovery is under way and the central scenario is relatively benign, we are not out of the woods yet. Considerable uncertainty remains. Thus, the report presents two plausible and more challenging alternative scenarios. In one, inflation is higher than expected and global financial conditions substantially tighter. In the other, the recovery stalls as the pandemic takes a turn for the worse.

The recovery to strengthen in H2 2021[1]

Q4 2019 = 100 Graph 3



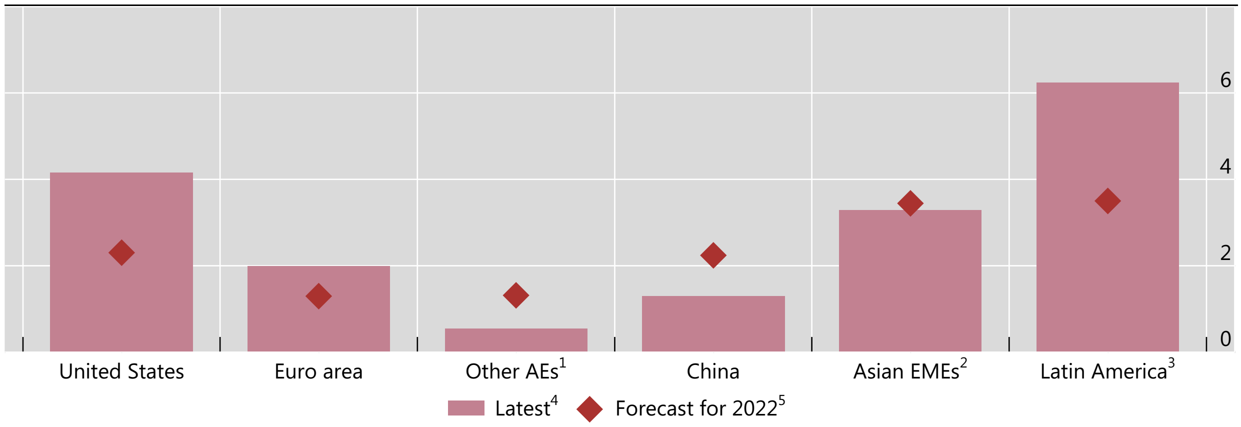
[1] Levels based on quarter-on-quarter percentage change. Dashed lines indicate forecasts.

Sources: Consensus Economics; JPMorgan Chase; BIS calculations.

A key question going forward is whether the recent strong increase in inflation will be temporary or more persistent. As of today, we at the BIS consider that it will most likely be temporary. There are many reasons for this. In addition to higher commodity and food prices, recent increases mainly reflect base effects, various short-run supply disruptions and bottlenecks. These should dissipate reasonably quickly. Globalisation and technological change should continue to keep price pressures in check.

Inflation converging closer to targets in 2022

In per cent Graph 4

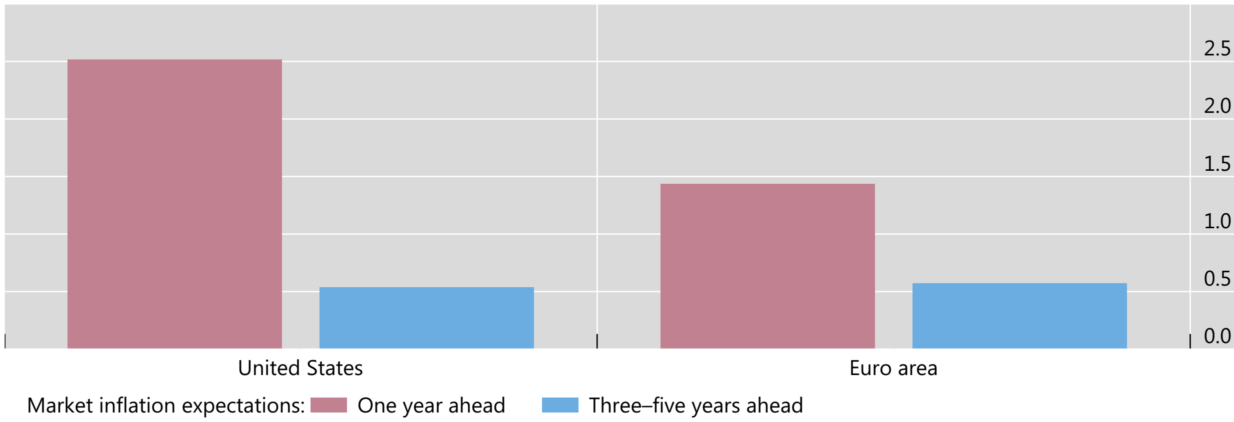


[1] AU, CA, CH, GB, JP, NX and SE; PPP-weighted average. [2] HK, ID, IN, KR, MY, SG and TH; PPP-weighted average. [3] BR, CO, CL, MX and PE; PPP-weighted average. [4] March 2021 for AU; April 2021 for CA, GB, IN, JP, PL and ZA; May 2021 for the rest. Year-on-year changes. [5] Average annual changes, year-end changes for Latin American countries.

Sources: Consensus Economics; national data; BIS calculations.

Change in inflation expectations, today compared with 2020

In per cent — Graph 5

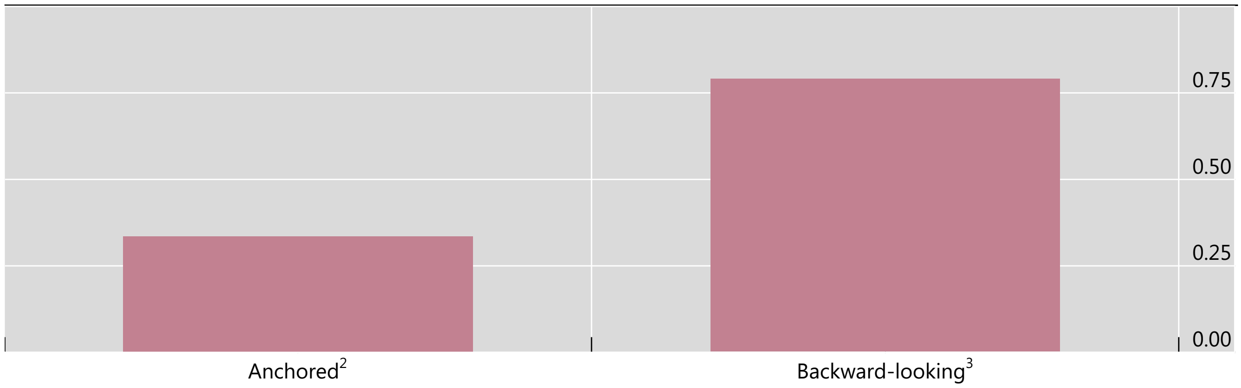


Sources: Bloomberg; BIS calculations.

Professional forecasters and investors have revised their inflation expectations upwards. But the increase has been much sharper in the near term than the medium term. As shown in Graph 5, inflation swaps imply that investors expect US inflation to rise markedly only over the next 12 months. The increase in expectations about inflation three to five years from now has been much more modest. There are similar, although less pronounced, patterns in the euro area, where medium-term expectations remain subdued. This anchoring is in part thanks to central banks' hard-earned anti-inflation credentials. Moreover, some of the increase in inflation is welcome in AEs where it has been stubbornly below target.

Long-run inflation response to a 1 percentage point output gap tightening[1]

In per cent — Graph 6



[1] Impulse response of inflation to a permanent 1 percentage point increase in the output gap. Estimates based on the model $\pi_{it} = \alpha_i + \beta_1 \pi^{ye}_{i,t-1} + \beta_2 gap_{i,t-1} + \varepsilon_{i,t}$, where $\pi_{i,t}$ is quarterly CPI inflation in country i in quarter t, $\pi^{ye}_{i,t}$ is year-on-year inflation and $gap_{i,t}$ is the output gap, measured using an HP filter with $\lambda = 1600$. The model is estimated on an unbalanced panel of 14 AEs over two samples: (i) Q1 1970–Q4 1989; and (ii) Q1 1990–Q4 2019. [2] Post-1990 relationship. [3] Pre-1990 expectations, post-1990 slope.

Sources: National data; BIS calculations

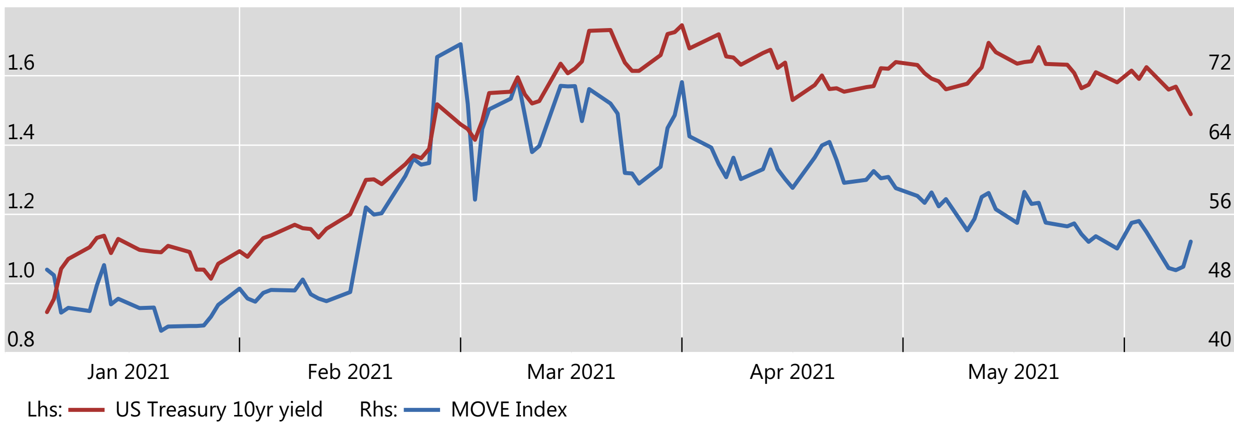
Nevertheless, there are risks. The first alternative scenario that we lay out notes that household savings built up in the pandemic could be drawn down faster than expected. Fiscal stimulus, particularly in the United States, could have a larger than expected impact on growth. The relationship between output and prices, the Phillips curve, could turn out to be steeper in some ranges.

As inflation rises, inflation expectations could become more "backward-looking", as was the case before 1990. This could also cause inflation to increase. If inflation were to become as backward-looking as it was in the 1970s and 1980s, a 1 percentage point tightening in the output gap would deliver twice as much inflation as more recent estimates imply.

Time will tell, but financial markets do not wait, as we observed earlier this year. As Graph 7 shows, on signs of higher inflation in the United States bond market volatility, as measured by the MOVE index, rose, and government bond yields crept up. Financial markets are more sanguine about inflation today, but risks remain. Markets could be caught wrong-footed, adjusting strongly if they anticipate a monetary policy tightening, even if inflation increases prove temporary in the end. A disorderly unwinding of leveraged positions could generate stress. The associated sharp tightening in financial conditions would have broader repercussions. EMEs would find themselves at the sharp end of such events.

Interest rates in the US increased alongside higher uncertainty

In per cent | Graph 7



Sources: Bloomberg; BIS calculations.

The second alternative scenario centres on the virus. The vaccination campaign could flag, better treatment could lag behind and new strains of the virus, resistant to vaccines, could emerge, leading to new lockdowns. Those countries with more limited policy headroom, notably many EMEs, would be the hardest hit. In this case, corporate sector losses would surge and some banking systems could face strains.

In the face of these uncertainties, macroeconomic policy faces many near-term challenges, differing by economy. Policies will need to provide support while remaining flexible and retaining policy headroom.

Fiscal support will need to become more targeted, as it has already started to do in several jurisdictions, while avoiding cliff effects and unnecessary corporate insolvencies. This will preserve policy space, although it is unlikely to be enough to restore fiscal buffers quickly. For EMEs, the key challenge is to make the best use of their limited fiscal space. The reallocation of resources needed to meet the changes in the composition of demand makes it urgent to facilitate debt workouts.

Monetary policy will have to be flexible and prudent. Last year's events called for boldness and decisiveness. Accommodative policies are still needed, although the recovery could be fast. Careful communication will be at a premium to smooth the ride.

If inflation surprised on the upside and financial conditions tightened, central banks would be severely tested. It would be hard to avoid bouts of high volatility and tension in markets. Staying ahead of the curve and signalling a path towards normalisation will be essential. This will help mitigate the build-up of vulnerabilities fuelled by easy financial conditions. This is the case not only in housing markets and the corporate sector, but also among non-bank financial intermediaries.

As policymakers try to cushion their economies, those in EMEs could face the headwinds of tightening global financial conditions. This would increase their domestic yields, as happened earlier this year to different degrees. This may become another tussle, and one that will stretch some EMEs' monetary policy. Last year, with inflation expectations anchored, and with global financial conditions easing, EME central banks could cut interest rates and use unconventional policies. Today, the policy trade-offs are starker.

In the face of rising inflation, some EMEs may well have no choice but to adjust their monetary policy stance. Not doing so risks capital outflows and currency depreciations, further stoking inflation. Should the US dollar also appreciate, the pressure on many would mount further. Sovereign debt downgrades might follow, possibly associated with a need for international support.

Longer-run, many challenges lie ahead

Policymakers face various long-run challenges. Many centre on the interactions between monetary and fiscal policies. In supporting the economy last year, both policies reinforced each other, consistent with their mandates. However, this has been just a temporary state of affairs, generated by extraordinary circumstances.

As conditions allow, in the years ahead countries will need to restore safety margins for both policies. This is a necessarily gradual and long process. Recessions will re-occur as part of the normal business cycle. As the past year has shown, buffers are needed for unexpected shocks.

But normalising policies over the longer term will not be easy. Public debt is at a post-World War II peak. Likewise, central bank balance sheets have only rarely reached similar heights, and then only during wars.

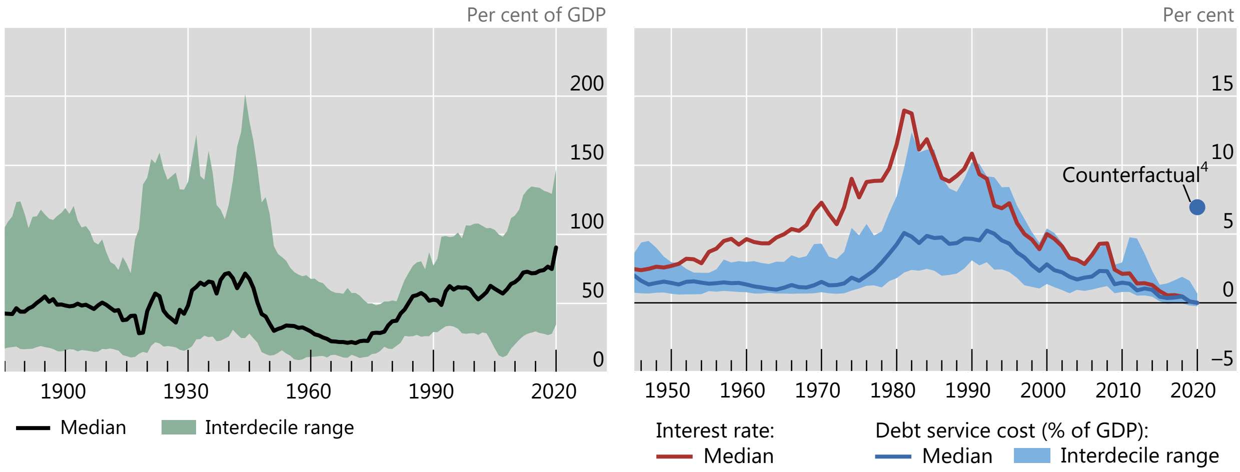
Monetary policy normalisation will have to be very gradual. The post-GFC experience has shown the difficulties when structural factors keep inflation low and act as headwinds, and there are sometimes tugs of war between financial markets and central banks.

Normalising fiscal policy will not be easy either. It is true that nominal interest rates have never been so low and real interest rates have not been negative for so long. This can make the task easier. However, it would be imprudent to count on this constellation. Concerns about debt sustainability have triggered interest rate rises, making for sovereign stresses and even worse outcomes.

The fact that normalising policy is a joint task further complicates matters. As interest rates increase, tensions could well arise. If interest rates return to the levels prevailing in the mid-1990s, when inflation had already been conquered, current debt levels would mean median government service costs would exceed the previous wartime peaks, as shown by the counterfactual in the right-hand panel of Graph 8.

Normalising monetary and fiscal policy will not be easy — Graph 8

Government debt[1, 2] — Debt service costs and interest rates[1, 3]



[1] Sample of 19 AEs and five EMEs. [2] General government debt at nominal value, latest available quarter for 2020. [3] Debt/GDP multiplied by the simple average of short- and long-term interest rates. [4] Median debt service if nominal interest rates had stayed at the 1995 level.

Sources: O Jordà, M Schularick and A Taylor, “Macrofinancial history and the new business cycle facts”, in M Eichenbaum and J Parker (eds), *NBER Macroeconomics Annual 2016*, vol 31, 2016; S M Abbas, N Belhocine, A El-Ganainy and M Horton, “A historical public debt database”, *IMF Working Papers*, no 10/245, 2010; European Commission, AMECO database; IMF, *World Economic Outlook*; OECD, *Economic Outlook*; Bloomberg; Datastream; Global Financial Data; Oxford Economics; BIS total credit statistics; BIS calculations.

An often-overlooked consideration here is that the large central bank holdings of government debt, funded through bank reserves, have made the consolidated public sector balance sheet more sensitive to changes in short-term interest rates. At some point, this could start to endanger price and financial stability, and eventually could threaten central bank credibility. Increases in fiscal deficits have in the past gone hand in hand with a greater risk of higher inflation outcomes. This is more so in EMEs than in AEs. Transparency and other safeguards need to be in place, and assuring central bank independence will be critical.

Thus, the task further out, including for regaining monetary policy space, is assuring the general sustainability of public debt. Successfully reducing government debt-to-GDP ratios has typically required a combination of running fiscal primary surpluses and favourable interest rate-economic growth differentials. These conditions have now prevailed for some time. This suggests that the window of opportunity should not be missed.

Higher sustainable growth would facilitate the policy normalisation process immensely. Higher growth increases tax revenue and lowers the cost of income support measures. It also means that the stock of existing debt gets smaller relative to the size of the economy. As an added bonus, faster growth will allow for a quicker return to positive real interest rates. In the end, a well functioning economy should operate with positive real interest rates to help ensure capital is allocated efficiently.

Achieving higher growth calls for structural reforms, supported by growth-friendly fiscal policies. Evidence shows that the degree and speed of entry of new firms depends on the degree to which unprofitable firms are wound down or restructured. A greater number of new firms, in turn, spurs growth in employment and overall number of firms. With private fixed investment in the years leading up to the pandemic lagging, restoring productivity will require extra effort. Investment in education will be key, as well as in healthcare.

Facilitating the adoption and better use of technology for societies as a whole can further boost growth over the longer term. Addressing climate change could also unleash growth opportunities.

Let me conclude. Central banks, after all their heavy lifting last year, face many uncertainties and challenging tasks ahead. In the near term, they need to address the risk that the recovery stalls and financial vulnerabilities build up, while assuring price stability. These tasks involve difficult policy trade-offs and raise delicate communication challenges. Tasks for the longer term centre on rebuilding safety margins and the interactions between monetary and fiscal policy. In this context, it is essential to put public finances on a sustainable path and preserve central bank independence.

These challenges all call for durable higher economic growth. But central banks alone cannot generate this. Structural reforms, which have been flagging for some years, are now needed to deliver a vibrant, flexible and competitive economy. Growth-friendly fiscal policies could also play a useful role. Global cooperation is of the essence: today, for an equitable distribution of vaccines across countries. And tomorrow, for better treatment, and for those other common public goods underlying a sustainable recovery. Together we can make this happen.