Global realignment and policy rebalancing

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Good morning, ladies and gentlemen.

A warm welcome to the presentation of this year's BIS Annual Report. With this Report, we contribute to the ongoing debate among policymakers, the private sector and academics on the global economy. We bring to this debate a medium-term perspective that puts the focus on the underlying trends that drive the global economy.

Before turning to the presentation, I would like to say a few words on the EU referendum in the United Kingdom, the outcome of which has resulted in high volatility in financial markets.

Extensive contingency plans by the private sector and central banks have been put in place to limit disturbances in financial markets. Stronger capital and liquidity buffers in the private sector have also made financial systems more resilient to such market disturbances. Central banks have already communicated that they are closely monitoring the situation and stand ready to take the necessary actions to ensure orderly market functioning. Central banks have acted swiftly in the past, they stand ready to act again, and they have the tools.

There is likely to be a period of uncertainty and adjustment. The United Kingdom is closely integrated in the global economy, and it hosts one of the world's most important financial centres. With good cooperation at the global level, I am confident that uncertainty can be contained and that adjustments will proceed as smoothly as possible.

Let me now come back to the Annual Report and its medium-term perspective. One of the main topics of this year's Report is the realignment that has been taking place in the global economy – a process that now faces the additional adjustment I just mentioned. I will talk about the risks that have built up over time; and some priorities in light of the "rebalancing" of policies that we are recommending. The main point is that, more than ever, monetary policy will have to be supported by prudential, fiscal and structural reform policies.

After my presentation, Claudio Borio, Head of the Monetary and Economic Department, and Hyun Song Shin, Economic Adviser and Head of Research, will each elaborate on some of these points.

A global realignment

Since the time of our previous Annual General Meeting, the world economy has kept growing – and, in fact, it has done better than some perceptions or rhetoric suggest. It is true that global growth remains uneven and below pre-crisis benchmarks. However, when adjusted for demographic trends, it is slightly above the long-term average. Job creation has also been fairly strong, and a number of large economies are actually growing above potential.

At the same time, the world economy conveys a sense of unfinished adjustment and fragile confidence. Interest rates have fallen even further. The share of outstanding bonds trading at negative yields reached new peaks. Even before the market disturbances of the past few days, there had already been a period of large exchange rate and commodity price movements.

These developments can be seen as part of an ongoing realignment in the global economy that became more evident last year. In the Annual Report, we argue that this realignment reflects the interaction of several long-term underlying forces.

Let me elaborate. Since the global financial crisis, we have seen a rotation of financial booms and busts. In the advanced economies at the heart of the crisis, the private sector slowly started to deleverage. At the same time, leverage picked up elsewhere. Signs of unsustainable financial booms began to appear especially in emerging market economies. The pattern was similar to that of previous boom episodes: credit and property prices increased strongly, supported by foreign currency borrowing.

Exchange rate movements and commodity prices helped drive this trend. The dynamics are well known: strong economic growth in more energy-intensive emerging economies pushed commodity prices higher. Higher commodity prices, in turn, reinforced financial booms. Stronger currencies made the corporate balance sheets in emerging economies look stronger and reduced credit risk premia. In an environment of ample global liquidity, borrowing in foreign currencies, in particular US dollars, became very easy and cheap. We analyse this so-called "risk-taking channel of exchange rates" in some detail in the Annual Report. Hyun Shin will also talk more about it in his presentation.

Over the past year, these various elements have begun to reverse. Domestic financial cycles have been maturing in a number of emerging economies. Growth has slowed. Commodity prices have fallen. And US dollar appreciation, supported by actual and expected US monetary policy, has tightened financing conditions, particularly for those who had borrowed heavily in dollars. These shifts in market conditions have interacted with the vulnerabilities that have accumulated over time.

Coping with the "risky trinity"

This year's Annual Report analyses three underlying sources of risk for the global economy. Financial cycles have been a common driver of this "risky trinity":

- The first is rising debt levels. This is both private debt, mainly in emerging market economies, and public debt in advanced economies, as governments tried to cushion the economic fallout of the bust.
- The second source of risk is lower productivity growth. The slowdown in productivity growth is a complex process with many factors at play. Financial cycles are one driver. They lure too many resources into expanding but low-productivity-growth sectors like construction. Once the bust occurs, it takes time for these misallocated resources to shift back to more productive uses. Our analysis indicates that these effects can be significant and persistent.
- The third risk factor is diminishing room for policy manoeuvre. This results from asymmetric and unbalanced policy responses. Policy has not leaned against credit booms, or has not leaned enough – but it has eased persistently during the busts.

This risky trinity has, in turn, given rise to three main threats. One is economic instability because of maturing financial cycles and tighter global liquidity. We saw episodes of this in the second half of 2015 and early 2016, when foreign currency borrowing by emerging economies peaked and credit conditions tightened. These episodes of stress and market volatility show that underlying vulnerabilities persist.

To be sure, emerging market economies today are more resilient to external developments. They have stronger macroeconomic frameworks, better financial infrastructures and regulatory arrangements, and flexible exchange rates coupled with large foreign exchange reserves. But in some of these economies, debt has increased much more than in the past. Emerging economies now have a greater weight in the global economy than before and are more tightly integrated in it through trade and financial linkages. This means that any strains in emerging economies will have a bigger global impact than in the past.

The second threat concerns the persistence of exceptionally low interest rates. Such rates tend to depress risk premia and stretch asset valuations. By implication, prices become more vulnerable to a snapback. Persistently low, or even negative, rates erode banks' lending margins, create more return mismatches for insurance companies, and boost the value of pension fund liabilities. Over time, all this can have a debilitating impact on the real economy. On top of that, negative rates can shake household confidence and affect saving and investment behaviours in ways that are hard to predict.

As the room for manoeuvre narrows, the third threat is a loss of confidence in policymaking. Unrealistic expectations about growth and the ability of present policies to lift global growth can create disappointment and weaken confidence.

What to do now?

There is a need to rebalance policies in order to shift to more robust and sustainable growth and address accumulated vulnerabilities. Rebalancing requires that prudential, fiscal and structural policies take a more prominent role. New shocks hitting the economy or the financial system do not fundamentally change the need for this rebalancing. They may make the task more complex, but also more necessary.

From a medium- and long-term perspective, rebalancing requires a coherent macro-financial policy framework that systematically incorporates financial stability considerations into analysis and policymaking. Developing such a framework is obviously a difficult task.

This year's Annual Report contributes a few new analytical elements in this regard and discusses priorities for current policies. In my remarks, I will focus on prudential, fiscal and monetary policies. This is not to say that the importance of structural reforms has diminished. On the contrary, these country-specific measures improve productivity and add flexibility to the reallocation of resources – an essential contribution to achieving robust and sustainable growth.

For prudential policy, a lot has already been done. I would highlight, as one main priority, finalising the Basel III framework and devoting more resources to consistent implementation, proactive supervision and careful monitoring of the consequences. Minimum capital requirements have been raised significantly to reasonable levels.[1] The critical point is to conclude the work, ensuring that capital reflects underlying risks. Public debates often underestimate how much regulatory changes can support the economy. A strong capital position goes hand in hand with more credit and robust liquidity. Hyun Shin will talk about this in a minute.

There is a second priority, consistent with the first. In countries that were hit by the financial crisis, this calls for completing bank balance sheet repair and restoring the basis for sustained bank profitability.

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In those countries where financial booms are more advanced, taking early action is essential to strengthen defences.

For monetary policy, the persistence of exceptional accommodation continues to raise important issues. A particularly difficult factor is stubbornly low inflation despite unprecedented central bank actions. In the Annual Report, we argue that, in addition to low oil prices and cyclical factors, low inflation partly reflects positive secular supply side developments that have weakened the link between inflation and domestic slack. The spreading of global value chains is one example. A product such as a smartphone may contain parts sourced from many countries and indeed may have been partly assembled in different locations. This implies that cost-cutting innovation at the global level is transmitted more quickly to domestic prices. While this is positive for consumers, it may contribute to inflation that remains below central banks' numerical targets.

This year, we also contribute to the policy debate on how to think about leaning against the wind and equilibrium interest rates. This work suggests that there are significant gains from adopting a policy framework that takes financial stability systematically into account. The emphasis is on "systematically" – meaning in both booms and busts, and not just occasionally when signs of unsustainable financial booms become evident. Claudio Borio will elaborate on some of these issues in his presentation.

For fiscal policy, strengthening the foundations for sustainable growth requires taking targeted action while avoiding destabilising debt dynamics. Questions about the remaining room for manoeuvre are therefore particularly important for fiscal policy. In emerging economies, fiscal positions have weakened substantially, especially for commodity exporters. In advanced economies, current interest rates provide relief to budgets, but uncertainty about fiscal space looms large. In the Annual Report, we illustrate how much the estimates of fiscal space diverge. The uncertainty surrounding estimates calls for a prudent interpretation of fiscal space. Getting close to the limits may trigger a loss of market confidence that may be hard to reverse.

There are a number of positive steps fiscal policy could take. One is improvements in the quality of public spending, by shifting the balance from current transfers to physical and human capital investment. Another is to carry out needed infrastructure investments, where proper governance is in place. Yet another crucial step would be to support balance sheet repair and complement structural reforms.

Beyond these considerations, it is important to think of fiscal policy also as part of a macro-financial stability framework. We dedicate a chapter in the Annual Report to this topic. The link between fiscal policy and financial stability goes in both directions.

On the one hand, protecting the sovereign from financial cycles requires incorporating the effects of financial booms into fiscal positions. For example, rising tax revenues during a housing market boom should not be interpreted as a permanent improvement in fiscal positions.

On the other hand, weak public finances can have a substantial impact on financial stability. The sovereign exposures of banks are often large. The result may be an adverse feedback loop between the sovereign and banks in times of stress. A more balanced prudential approach, recognising the risky nature of public debt, would mitigate this feedback loop and provide a signal that no asset should be considered truly default-free.

In defence of central banking

Let me conclude with a few remarks in defence of central banking.

The rebalancing of policies and improvements to frameworks carry high stakes for central banks. The past few years have confirmed how indispensable the institution has become. Independence, within their mandates, allowed central banks to act with determination to cope with the financial crisis. This determination was critical at the time for putting the global economy on the path to recovery.

But the extraordinary burden placed on the institution since the crisis is generating growing strains. Markets and the public at large have increased their dependence on and expectations about what central banks can do. The wish list has become quite long: restore full employment; ensure sustained growth; preserve price stability; and deliver a foolproof financial system. This is a tall order, and central banks alone cannot deliver on it.

Indeed, the extraordinary measures taken to stimulate the global economy have sometimes tested the boundaries of the institution. The line between monetary and fiscal measures has become increasingly blurred.

Central banks function best if they focus on their area of competence and excellence: achieving monetary and financial stability. More realism and clarity about what central banks can and cannot achieve would help them focus on these areas. An institutional framework that clearly delineates their responsibilities from those of other policymakers is key. Monetary policy needs to work alongside prudential, fiscal and structural policies as part of the rebalancing we are calling for today. Central bank independence, backed by transparency and accountability, remains as crucial as ever.

Thank you very much.