Media briefing on the BIS Annual Report 2015

Claudio Borio*, 24 June 2015

You'd hardly know it from financial markets' constant frenzy and the round-the-clock media razzmatazz that eggs them on. But economic time moves slowly, much more slowly. The developments that really matter and shape our lives take a long time to unfold. Economic time should be measured in years or decades, not in minutes or microseconds.

One year has gone by and the global economy is not that far away from where we left it last June. True, the sharp appreciation of the dollar, mainly driven by actual and prospective divergences in monetary policy stances, has generally benefited weaker economies at the expense of stronger ones. And the even sharper oil price drop has, on balance, boosted global growth and added temporarily to disinflationary pressures - a welcome windfall. As a result, growth has picked up somewhat and has been proceeding at close to historical rates. But the expansion is still unbalanced. Debt burdens and financial risks are still too high, productivity growth too low and room for manoeuvre in macroeconomic policy too limited. Despite the progress made, the global economy is still struggling to shake off completely the post-crisis malaise.

The most visible symptom of this predicament is the persistence of ultra-low interest rates. Interest rates have been exceptionally low for an extraordinarily long time, against any benchmark. Moreover, the negative bond yields that have prevailed in some sovereign bond markets are simply unprecedented and have stretched the boundaries of the unthinkable. The recent market gyrations have not fundamentally altered the picture.

Persistent exceptionally low rates reflect the central banks' and market participants' response to the unusually weak post-crisis recovery as they fumble in the dark in search of new certainties. The rates are a vivid reminder of the extent to which monetary policy has been overburdened in an attempt to reinvigorate growth. They have underpinned the contrast between high risk-taking in financial markets, where it can be harmful, and subdued risk-taking in the real economy, where additional investment is badly needed. And in the longer term, they risk weakening the financial sector and economic activity, by hindering rational investment decisions and entrenching debt dependence.

This Annual Report builds on last year's, elaborating on an analytical lens that may help us understand why all this is happening and what the consequences might be. That lens focuses on financial, medium-term and global factors, whereas the prevailing perspective focuses more on real, short-term and domestic factors. We argue that the current malaise may to a considerable extent reflect a failure to come to grips with how financial developments interact with output and inflation in a globalised economy. For some time now, policies have proved ineffective in preventing the build-up and collapse of hugely damaging financial imbalances, whether in advanced or in emerging market economies (EMEs). These have left long-lasting scars in the economic tissue and have complicated global rebalancing.

Seen from this angle, the very low interest rates that have prevailed for so long may not be "equilibrium" ones, conducive to sustainable and balanced global expansion. Rather than just reflecting the current weakness, they may in part have contributed to it by fuelling costly financial booms and busts and delaying adjustment. The result is too much debt, too little growth and too low interest rates. In short, low rates beget lower rates.

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This Report, besides updating developments, takes last year's narrative further in four respects:

First, it looks more closely at the relationship between financial booms and busts and productivity. It finds evidence that, by misallocating resources, financial booms can sap productivity both as booms unfold and following the crisis they leave in their wake. This is yet another, hitherto underappreciated, channel through which what is financial becomes real.

Second, the Report examines vulnerabilities in EMEs more closely. There is no doubt that, in several respects, these economies are in better shape than in the 1980s and 1990s, when they faced crises triggered by a reversal in accommodating global financial conditions. Even so, caution is called for, given the signs of the build-up of financial imbalances in recent years. And were strains to materialise, their impact on the rest of the world would be considerably larger than in the past, as EMEs' heft has grown substantially since then.

Third, the Report devotes a whole chapter to the weaknesses of the international monetary and financial system. Rather than promoting sustainable and balanced global growth, the system risks undermining it. It has spread exceptionally easy monetary and financial conditions to countries that did not need them, exacerbating vulnerabilities there. Paradoxically, an easing bias in the short term may end up being contractionary longer-term, as financial imbalances unwind.

Finally, the Report explores developments in the non-bank sector more closely. As banks have retrenched post-crisis, risks have been migrating to other parts of the financial system. Persistent exceptionally low interest rates have exacerbated this, by weakening the financial strength of insurance companies and pension funds and by encouraging an aggressive search for yield, partly channelled through a burgeoning asset management industry. These risks should be monitored and managed closely.

If the diagnosis is correct, promoting robust and sustainable global growth would require a triple rebalancing of policy: away from illusory short-term macroeconomic fine-tuning towards medium-term strategies; away from overwhelming attention to near-term output and inflation towards a more systematic response to slower-moving financial cycles; and away from a narrow own-house-in-order doctrine to one that recognises the costly interplay of domestic-focused policies. Lasting global monetary and financial stability are two sides of the same coin.

In this rebalancing, one essential element will be to rely less on demand management policies and more on structural ones. The aim would be to replace the debt-fuelled growth model that has acted as a political and social substitute for productivity-enhancing reforms. The oil price dividend provides an opportunity that should not be missed. Monetary policy has been overburdened for far too long. It must be part of the answer but it cannot be the whole answer.

Shifting the focus from the short to the longer term is more important than ever. Financial markets have compressed reaction times and policymakers have chased financial markets more and more closely in what has become an ever tighter, self-referential relationship. This has been happening precisely as the emergence of slow-moving financial booms and busts has stretched the time over which the economic developments that really matter unfold. Ultimately, it is this combination of slowing economic time and shorter horizons that helps explain where we are - and how, before we know it, the unthinkable can become routine. It should not be allowed to.