The world is defenceless against the next financial crisis, warns BIS

Peter Spence

The world will be unable to fight the next global financial crash as central banks have used up their ammunition trying to tackle the last crises, the Bank for International Settlements has warned.

The so-called central bank of central banks launched a scatching critique of global monetary policy in its annual report. The BIS claimed that central banks have backed themselves into a corner after repeatedly cutting interest rates to shore up their economies.

These low interest rates have in turn fuelled economic booms, encouraging excessive risk taking. Booms have then turned to busts, which policymakers have responded to with even lower rates.

Claudio Borio, head of the organisation's monetary and economic department, said: "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."

G3 real interest rates have never been so low for so long

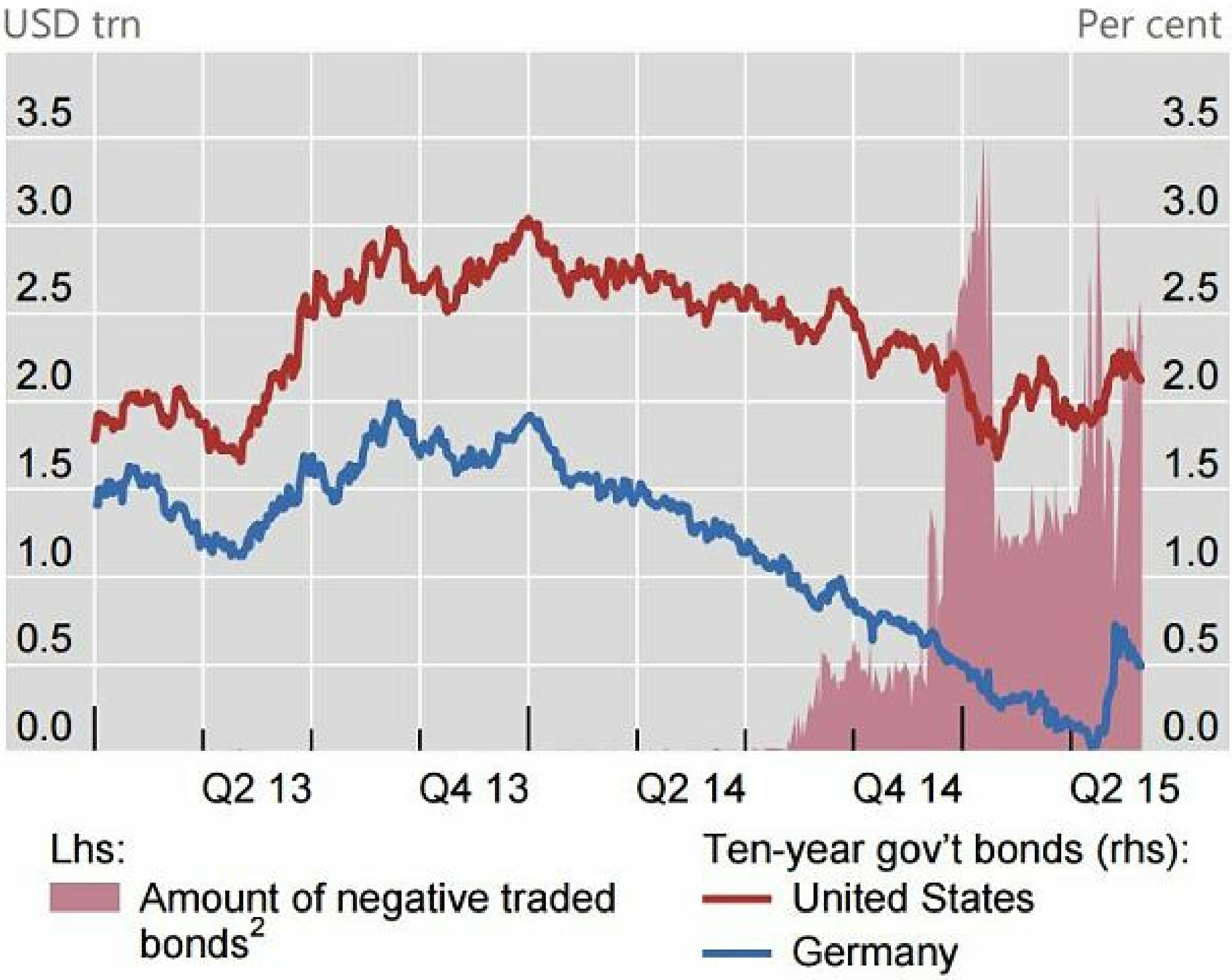
"Rather than just reflecting the current weakness, they may in part have contributed to it by fuelling costly financial booms and busts and delaying adjustment. The result is too much debt, too little growth and too low interest rates.

"In short, low rates beget lower rates."

The BIS warned that interest rates have now been so low for so long that central banks are unequipped to fight the next crises.

"In some jurisdictions, monetary policy is already testing its outer limits, to the point of stretching the boundaries of the unthinkable," the BIS said.

Policymakers in the eurozone, Denmark, Sweden and Switzerland have taken their interest rates below zero in an attempt to support their economies, contributing to a decline in bond yields.



The decline of bond yields into negative territory is the "most unusual development" of the last year

Extraordinarily low interest rates are not a "new equilibrium" said Jaime Caruana, general manager of the BIS, rejecting the theory of so-called "secular stagnation" which some economists blame for the continued decline in global lending rates.

"True, there may be secular forces that put downward pressure on equilibrium interest rates … [but] we argue that the current configuration of very low rates is neither inevitable, nor does it represent a new equilibrium," he said.

Mr Caruana said that interest rate hikes "should be welcomed", as global economies have started to grow at close to their historical averages, and a slump in oil prices has provided the global economy with a boost.

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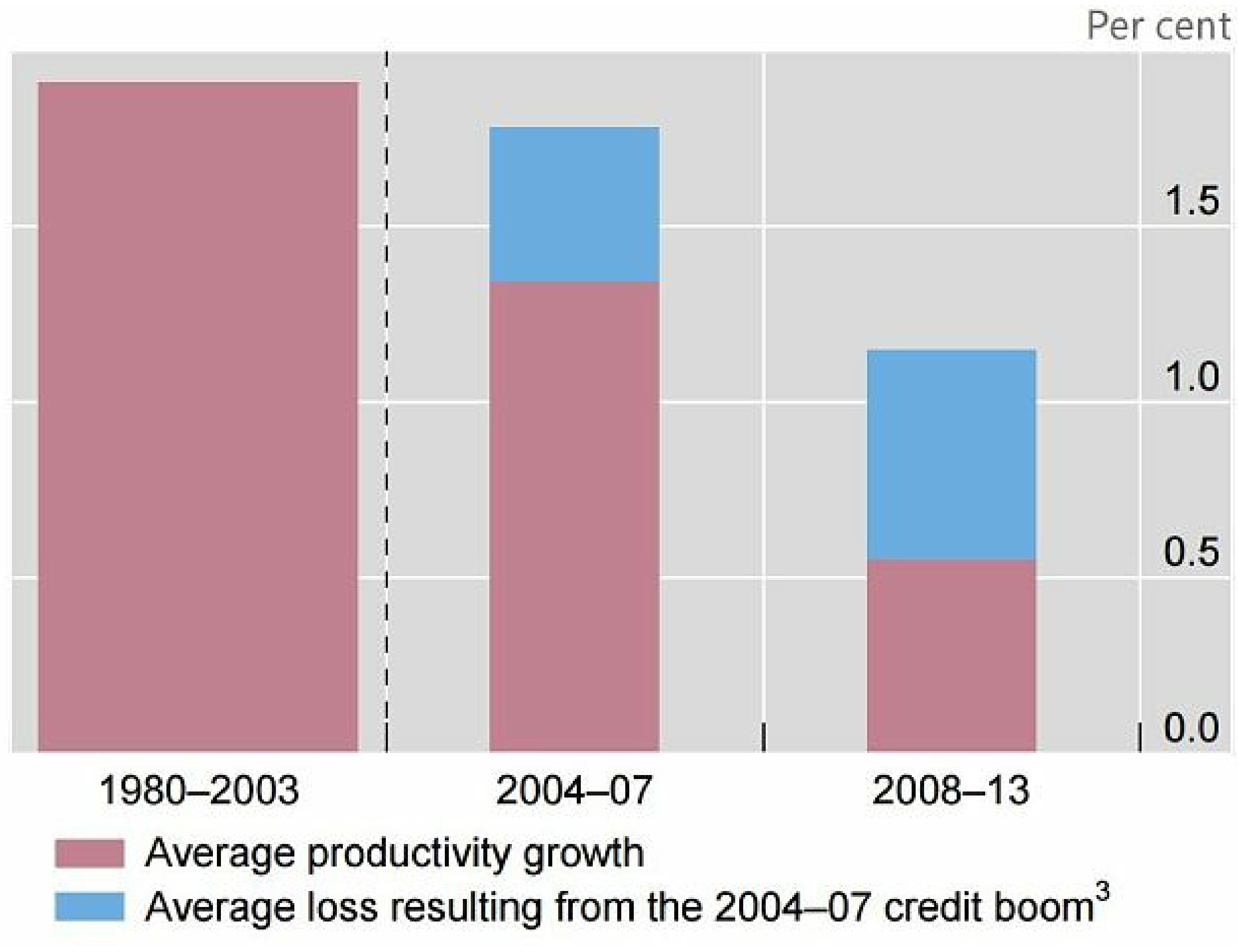
The BIS report described the threat of a new bust in advanced economies as a "main risk", with many reaching the top of the economic cycle.

The economies worst hit by the last crisis are now suffering the costs of persistent ultra-low rates, the organisation said, which could "inflict serious damage on the financial system", sapping banks and weakening their balance sheets and their ability to lend.

And the continued misallocation of resources during busts prompted by central banks's rock-bottom interest rates has also hammered productivity growth, the BIS said, as a prolonged reliance on debt had been used in its place.



Economic mismanagement has hampered productivity growth

This problem is compounded as the world's populations continue to age, the organisation warned, making debt burdens harder to bear. Yet politicians have relied too much on temporary growth boosts by using debt, rather than making painful choices, said the BIS.

Mr Caruana said that during booms, workers and capital are shifted to slow-growing sectors, with a "long-lasting negative" impact on productivity growth. "Misallocated labour needs to move from these sectors to other parts of the economy," he said.

The BIS said that the current turmoil in Greece typified the kind of "toxic mix" of private and public debt being used as a solution to economic problems, rather than making the proper commitment "to badly needed" structural reforms.

Mr Caruana said that policymakers must now focus on the supply side of the economy, introducing the right reforms, rather than continue to lean on debt which will inevitably undermine growth.

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