Banker's speech points to global problems

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A speech last month by Malcolm Knight, general manager of the Bank for International Settlements (BIS), has pointed to some potential problems for the world economy arising from the growth of government debt and the present low interest rate regime.

Addressing the annual congress of the Swiss Society for Economics and Statistics in Basel, Knight began by pointing to the generally brighter economic picture of the past six months. A global recovery was underway, China had become a second engine of economic growth alongside the United States, there was evidence of buoyancy in Asia and, while consumer spending still lagged in Europe, there were signs that confidence had strengthened. Moreover, the international system had recovered from a series of shocks, including the financial crisis in Argentina, the collapse of the IT bubble and the demise of corporations such as Enron and Parmalat.

But Knight then turned his attention to certain concerns within this "apparently benign environment". He began by pointing out that global economic growth is being driven by three powerful forces: very expansionary fiscal policies in some countries, accommodative monetary policies almost around the world and an investment boom in China that is "literally without precedent".

In Knight's view, the problem facing the world economy is that none of these drivers of growth can continue to operate indefinitely. Fiscal policies in several countries had provided a "massive stimulus" to aggregate demand during the recent years of weak economic growth. In the US, the fiscal balance has moved from a surplus of 1 percent of gross domestic product (GDP) in 2000 to a deficit of 5 percent of GDP this year, fiscal deficits in Europe have also widened, while the deficit in Japan has been running at over 5 percent of GDP since 1998.

Interest rates set by the major central banks are also at historically low levels, with a "particularly dramatic" fall in the US from 6.5 percent at the end of 2000 to only 1 percent at present.

While the investment boom in China was "one manifestation of what is little short of a new industrial revolution" with "millions of new workers being brought into the international economy", there were signs of "overheating" in the Chinese economy and risks of overinvestment in some areas. "The production capacities built up in some sectors may never be profitable, and an overhang of capacity could blight investment prospects in the future."

Knight warned that "abrupt revisions" of expectations by investors could translate into "gyrations in financial markets." At some point interest rates would have to return to more "normal" levels and, with inflation in the US around 2 percent, a neutral rate is considered to be around 5 percent. The challenge was how to shift the current accommodative monetary policy without creating excessive volatility in the bond market.

But interest rates could not be kept at very low levels indefinitely, because such a policy creates its own problems. There was evidence of high leverage as money market operators took on longer-term risk, financed by very low interest rate short-term liabilities. "And with long-term interest rates on risk-free government bonds so low, many investors, whether leveraged or not, have been increasingly tempted to 'search for yield'. This has resulted in a large net flow of funds into risky credits."

While it appears that key international financial institutions are well placed to cope with higher interest rates and the financial system has shown a greater capacity to absorb shocks than in the past, this "reassuring picture" does not mean that the present situation is without risks, Knight warned.

"It is not difficult to paint a much less encouraging

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scenario. For instance, any sudden unwinding of positions by leveraged investors would itself accentuate volatility, and perhaps trigger further adjustments by the wider investor community. Higher interest rates would well undermine present asset valuations. Debt service burdens of households and corporations could rise and lead to a deterioration in loan quality across the financial system."

Concerns about the risks associated with the US Federal Reserve Board's continued low-interest rate regime have been voiced in other quarters as well.

In a recent editorial, the *Economist* magazine commented that a rise in rates "could help to avoid another dangerous bubble by warning investors and homebuyers that asset prices cannot rise for ever." The *New York Times* has also called for the Fed to "get started" in a shift to higher interest rates.

In February, *Newsweek* magazine published an "open letter" from Morgan Stanley chief economist Stephen Roach to Fed chairman Alan Greenspan, calling on him to lift the Fed's base rate from 1 to 3 percent and "restore some semblance of normalcy to financial markets." Only four years after the bursting of the first bubble, Roach wrote, "the risks of new bubbles abound."

In a comment published on March 5, Roach voiced his fear that "America's post-bubble recovery is in serious danger of spawning a new round of asset bubbles that could well pose the most deflationary risks of all" with the risk intensifying as "the Fed clings to its stance of extraordinary accommodation".

Roach's concern is that unless the Fed lifts rates some time soon it will have no room to manoeuvre in the event of a financial crisis, unlike the situation four years ago when the Fed rate was 6.5 percent and successive interest rate cuts helped soothe financial markets.

The January minutes of the Federal Open Market Committee (FOMC), the body that decides on interest rates, indicate that Fed governors share some of these concerns as well.

The minutes noted that while members acknowledged "there were risks in maintaining what might eventually prove to be an overly accommodative policy stance" they judged that "for now" it was "desirable to take risks on the side of assuring the rapid elimination of economic slack." But the minutes also disclosed that "a number of members" had commented that continued commitment to low interest rates "appeared to have contributed to valuations in financial markets that left little room for downside risks."

The argument of Roach and others is that the Fed should revert to more "normal" policies or run the risk of creating greater problems in the future. But, as calculations by Morgan Stanley show, these are far from normal times. As Roach noted in a comment published on March 8, with the US now 27 months into a so-called recovery, "private nonfarm payrolls are running about 8.2 million workers below the path that would have occurred in a more normal upturn." This means that the income of wage and salary earners is $400 billion below where it should be. This has led to a situation where increased consumption spending is not being financed from additional income but by tax cuts and the cash made available through rising house valuations.

Under these conditions an interest rate rise, even to the level of 3 percent proposed by Roach, let alone the 5 percent level considered normal by the BIS, would push the US economy, and ultimately the rest of the world, into recession. As these considerations make clear, the dilemmas confronting policy makers flow from the fact that far from operating "normally," the world economy is afflicted by deep-seated problems.

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