# Bank for International Settlements chief sounds another warning on financial system

**Nick Beams**
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The Swiss-based Bank for International Settlements has again sounded the alarm bell on the dangers to the global financial system posed by the ultra-loose policies of the world's major central banks, which have boosted stock exchanges and other markets.

In an interview by Britain's *Telegraph*, published on July 13, BIS chief Jaime Caruana indicated that the financial system may be even more vulnerable to a crisis than it was in 2007, because debt in emerging markets has increased markedly since the collapse of the Lehman Brothers investment bank in September 2008.

Caruana said investors seemed to be ignoring the risk of tightening monetary policies in their voracious search for yield. "Markets seem to be considering only a very narrow spectrum of potential outcomes," he said. "They have become convinced that monetary conditions will remain easy for a very long time, and may be taking more assurance than central banks wish to give."

In its annual report issued at the end of last month the BIS, a consortium of the world's central banks, warned that the policies of "quantitative easing," carried out in various forms by the US Federal Reserve, the Bank of England, the Bank of Japan and to some extent by the European Central Bank (ECB), had led to "euphoric" conditions in equity markets.

Amid low growth rates in the advanced countries and outright recession in parts of Europe, the BIS pointed to a "puzzling disconnect" between "the markets' buoyancy and underlying developments globally."

This warning was rapidly dismissed by the central banks and a range of media pundits, including *New York Times* columnist Paul Krugman, who claimed the BIS report lacked any method and was an "attitude, looking for justification."

In response to the BIS report, US Fed chairwoman Janet Yellen made clear that the policy of ultra-easy money would continue, claiming that so-called macro-prudential regulation would deal with any risks in the system. Yellen insisted that a tightening of monetary policy would only create increased unemployment. When questioned, however, about how effective regulations were, given that financial markets have a record of getting around them, she replied that she did not have a "great answer" to that question.

Yellen's stance was backed by representatives of the Bank of England and ECB chief Mario Draghi. While not specifically naming his critics, Caruana's July 13 interview was a reply to the dismissal of the BIS warnings.

Caruana noted that the international financial system was in some ways more fragile than in pre-Lehman days because of the build-up of debt. Debt ratios in the advanced economies had risen by 20 percent to reach 275 percent of gross domestic product (GDP), and 40 percent of syndicated loans were to sub-investment grade borrowers, a higher ratio than in 2007.

Caruana pointed out that rising economic powers in Asia were no longer in a position to provide a buffer as they had in 2008 because they may have become a source of risk themselves. The debt ratios of China, Brazil, Turkey and other "emerging" markets had risen by 20 percent and were now 175 percent of GDP. Emerging markets had increased their foreign currency debt by $2 trillion since 2008.

The BIS annual report pointed out that any crisis in emerging markets would have a much more serious impact than the Asian financial crisis of 1997–98 because these markets were much larger now and far more integrated into the global financial system. The ramifications would be particularly serious "if China,

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home to an outsize financial boom, were to falter."

Caruana would not make a prediction as to when he thought the bubble might burst, but added: "As Keynes said, markets can stay irrational longer than you can stay solvent."

It seems that the irrationality is going to continue. On Monday, the International Monetary Fund (IMF) issued its annual report on the Eurozone. It said that while the region was "recovering," deep-seated problems remained. The recovery had turned out to be weaker than expected, output and investment were still well below pre-crisis levels and large debt burdens, higher real interest rates in stressed economies, as well as weak banks and contracting credit, posed obstacles to a resurgence of economic activity.

With inflation still well below the ECB's target range of 2 percent, the IMF said the central bank "may need to expand its balance sheet substantially as other central banks have done, to provide a strong signal that it will use every available tool to fulfil its price stability mandate."

Inflation in Europe had been too low for too long and a failure to meet the inflation target could undermine central bank credibility, the IMF report said. "A negative external should tip the economy into deflation."

While warnings of the BIS have been largely dismissed—just as similar warnings were ignored in the lead-up to the Lehman collapse—they received confirmation last week when supposedly minor problems at Portugal's Banco Espirito Santo sent a tremor through European and global markets.

In his interview Caruana was dismissive of the claims by the Fed and other central bank officials that macro-prudential regulations should be the first line of defence against financial turbulence. "On their own there is little evidence that they can constrain financial imbalances," he said.

A report that appeared in the *Financial Times* last month provides weight to this assessment. It said regulators around the world were "struggling to keep pace with the constantly evolving shadow banking sector" and while it was easy to sketch out the concept of shadow banking it was "proving far harder to write rules for the sector's menageries of entities."

The "shadow" banking system has evolved precisely in order to get around the regulations imposed by central banks and other financial authorities by means of "arbitrage"—taking advantage of very slight differences in two or more markets to gain a profit.

Former Bank of England deputy governor Paul Tucker told the *Financial Times*: "My issue is that it is not obvious that the current model of regulation we have around the world is equipped to keep up."

Any misplaced conceptions that, based on the experiences of 2008, global regulators now have the financial system under control, were dispelled by David Wright, secretary-general of Iosco, an umbrella regulatory group.

"It is extraordinary that here we are, nearly seven years in [from the financial crisis] and we still have an inadequate understanding of some of the key aspects of financial markets," he told the *Financial Times*. "How these markets interconnect with each other and the contagion channels is very difficult to calibrate."

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