

Markets too dependent on central banks, BIS warns

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Two crucial meetings of central bank governing authorities take place on Wednesday, both of which could have major consequences for the international financial system, in the short and longer term.

The US Federal Reserve will decide on its interest rate policy, while the Bank of Japan will discuss a review of its quantitative easing program, under which it annually buys 80 trillion yen (\$US785 billion) worth of bonds and other financial assets.

The US Fed is generally expected to again keep its base interest rate on hold, after increasing it by 0.25 percentage points last December. The main focus will be on the statement of its open market committee and remarks by chairwoman Janet Yellen as to the future direction of policy.

Financial markets are less sure about what may emerge from the meeting of the Bank of Japan (BoJ) policy board. It will consider a comprehensive review of its monetary policy in the face of its evident failure to meet its stated objective of lifting inflation toward 2 percent. According to data from financial markets, inflation is expected to remain close to zero for the indefinite future.

BoJ governor Haruhiko Kuroda has insisted that his policies will lift Japanese inflation toward 2 percent on a sustainable basis by the end of his term in 2018. He will push to maintain the ultra-easy monetary policy, and will likely attribute its failure to uncontrollable external factors, such as the fall in oil prices and slowing Chinese growth. But the policy board is divided on the issue, and any sign of tightening could have an impact on international bond and other financial markets.

If markets believe that monetary policy could be tightened, even if only slightly, this could send bond yields rising and bond prices falling (the two move in

opposite directions), leading to losses for speculators who have banked on the continuation of ever-cheaper money. In the past week or so, bond yields have started to rise on the basis that the policies of the major central banks are running out of steam.

The two meetings are being held in the wake of the quarterly review issued by the Bank for International Settlements (BIS) in Basle, sometimes referred to as the central bankers' bank. It repeated earlier warnings that markets are too dependent on the actions of the major central banks.

The BIS said central banks had "reasserted their sway over financial markets in recent months, after two quarters punctuated by bouts of sharp volatility." While markets had proven "resilient" to a number of political developments, in particular the Brexit vote, "questions lingered as to whether the configuration of asset prices accurately reflected the underlying risks."

In other words, the rise in both equity and bond markets could be creating the risk of the sharp downturn and market turbulence.

In presenting the review, Claudio Borio, the head of the BIS monetary and economic department, said it was "becoming increasingly evident that central banks have been overburdened for far too long."

"A more balanced policy mix is essential to bring the global economy into a more robust, balanced and sustainable expansion," Borio said. The BIS, one of the few financial institutions to warn of the build-up of risks before the 2008 crisis, has long expressed the view that excessive dependence on monetary policy has only boosted financial asset prices, while doing little or nothing to increase activity in the real economy.

Borio said the continuing decline of bond yields and the flattening of the yield curve, as longer-term bond yields move toward those at the shorter end, was a "tell-

tale sign of low growth.”

“Adding to the sense of gloom,” the BIS official continued, “was talk of the prospect that the global economy would be stuck in low gear into the distant future. And similarly discouraging were discussions of the need for permanently lower interest rates to counter secular weakness.”

Borio said there had been a “distinctly mixed feel” to the recent rise of share markets, with “more push than pull, more frustration than joy. This explains the nagging question of whether market prices fully reflect the risks ahead. Doubts about valuations seem to have taken hold in recent days. Only time will tell.”

In its review, the BIS pointed to the apparent “dissonance” between record low bond yields and sharply higher stock prices with subdued volatility, which “cast a pall over such valuations.” Before the financial crisis, low bond yields pointed to lower growth or a recession, while high stock prices pointed to economic expansion.

“Banks’ depressed equity prices and budding signs of tension in banking funding markets added another sobering note,” the BIS review stated.

The BIS also pointed to rising concerns over the stability of the Chinese financial system. It said that the “credit to GDP gap” in China had reached 30.1, the highest level to date. This is well above levels reached before the Asian financial crisis that broke in 1997, and above levels reached in the US before the sub-prime mortgage bubble led to the collapse of Lehman Brothers in September 2008.

Commenting on the growth of Chinese debt, Ambrose Evans-Pritchard, the international business editor of the UK-based *Daily Telegraph*, noted: “Outstanding loans have reached \$28 trillion, as much as the commercial systems of the US and Japan combined. The scale is enough to threaten a worldwide shock if China ever loses control.”

The problems facing Chinese authorities are being compounded by low global growth and the apparent slowing of the US economy.

The *Financial Times* reported yesterday that US imports from China dropped “sharply” in July, “in the latest sign that that the engine of growth for the world’s developing economies is sputtering.”

According to figures from the US Federal Reserve, US merchandise imports from China have been

contracting in value terms since March and in volume terms since April.

Elissa Braunstein, an economist at the UN Conference on Trade and Development, described the result as “extraordinary,” given that reports of US growth and a higher dollar should boost the American demand for imports.

“It is going to be much harder in future [for emerging market exporters]. If exports are going to deliver the growth they promised, you really need external demand,” she said.



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