Bank for International Settlements warns on low interest rate regime

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The main thing to be said about the annual report of the Bank for International Settlements (BIS) which was issued on Sunday is that it reflects the uncertainty of policymakers about the future direction of the world economy and whether previous prescriptions are applicable in the post global financial crisis world.

On the key question of monetary policy, the BIS, sometimes referred to as the central bankers' bank, called into question whether, given low inflation, sticking to inflation rate targeting as the guide for setting interest rates was creating the conditions for more financial problems.

Central banks around the world have kept interest rates at historically low levels in the years since the crisis of 2008 and are looking to return to a more "normal" regime. But inflation and, most significantly wages growth, remain at historic lows and consequently monetary policy has remained loose. However, this may cause problems, according to the BIS.

"Keeping interest rates too low for long could raise financial stability and macroeconomic risks further down the road, as debt continues to pile up and risk-taking in financial markets gathers steam," the report said.

It noted that raising rates too quickly could cause financial market turbulence, as in the so-called "taper tantrum" of 2013, when the US Federal Reserve indicated it was going to pull back on its quantitative easing program. On the other hand, if rate rises were delayed this would mean that rates would have to rise faster and further in the future.

"Central banks may have to tolerate longer periods where inflation is below target, and tighten monetary policy if demand is strong—even if inflation is weak—so as not to fall behind the curve with respect to the financial cycle," Claudio Borio, the head of the BIS monetary and economics department said.

The world's major central banks have inflation targets of around 2 percent but prices remain below that level despite official figures which claim unemployment is falling. According to the previous "models" with which policymakers have worked, prices and wages should now be rising. But this is not taking place.

The report pointed to some of the reasons, noting that global labour markets had seen "profound changes over the past decades with significant implications for wage and price formation. As labour market slack diminishes, wage growth is expected to rise. But wage demands have lagged more than in the past. Rather than a purely cyclical phenomenon, this wage behaviour appears to reflect long-term forces that are reshaping the global economy."

The main change, though this was not alluded to in the report, is that so-called full-employment is now largely a misnomer because a growing proportion of "new" jobs are not full-time but part-time or casual. In the US, for example, some 94 percent of the 10 million jobs created under the Obama administration took this form.

One expression of this process is the long-term decline of the labour share of national income, some details of which were provided in the report. In the 1970s, for example, the share of wages in manufacturing in G7 economies was well over 60 percent. In the years 2010 to 2016 it had fallen to around 53 percent.

Productivity figures for manufacturing industry showed the same tendency. While productivity increased to 300 from a base of 100 in 1980, real compensation for hours worked lagged by at least 50 points over the same period.

These figures show the impact of the growth of financial parasitism in the major economies over this period in which profits have been accumulated through relentless cost cutting, dictated by financial markets, and the accumulation of profit not through the expansion of productive investment but increasingly via financial operations. This tendency has accelerated in the wake of the financial crisis and the provision of trillions of dollars of ultra-cheap money by the world's major central banks.

In its overall review of the global economy, the BIS pointed to the change in facts and above all sentiment in the past year with clear signs that growth had gathered momentum. But, it continued, "sentiment has swung even more than facts" and "despite the best near-term prospects for a long time, paradoxes and tensions abound."

Elaborating on whether sentiment had swung too far, Borio said "doubts about the future derive from tensions that will have to be resolved at some point and from long-term developments that may eventually threaten growth."

Among those tensions was the contrast between financial market volatility, which has plummeted, and increased political uncertainty and that between soaring stock markets and long-term bond yields which "have not risen as much as economic prospects have brightened."

The report identified four major risks to the sustainability of the present apparent upswing. A significant rise in inflation could choke the expansion by forcing central banks to tighten policy more than expected. Serious financial stress could materialise if financial cycles mature and their contraction phase turns into a "a more serious bust." Even without financial stress "consumption might weaken under the weight of debt," and investment might fail to take over as the main growth engine. "Finally, a rise in protectionism could challenge the open global economic order."

It said what it called the "risk trinity" remained in place: unusually low productivity growth, unusually high debt and unusually narrow room for policy manoeuvre.

Warning of the growth of a housing property bubble in some countries, the BIS said that "leading indicators of financial stress signal risks from high private debt and house prices in economies that were not at the epicentre" of the global financial crisis.

It noted that Australia, Canada, Sweden and Switzerland had experienced a 2-3 percent growth rate in household debt in 2016 with most of the money used to purchase houses. Over the past four years the Australian household debt has climbed almost 15 percentage points.

Taken together with slowing wages—in Australia for example wage growth is at its lowest rate in the post-war period—the rise in debt could spark a crisis.

"Household debt—or debt more generally—outpacing GDP growth over prolonged periods is a robust early warning indictor of financial stress," the report said.

In the face of what it termed "paradoxes" and "tensions" the BIS concluded that at the global level a "multilateral approach to policy" had to be reinforced as the only way of "addressing the common problems the world is facing."

But here events are moving in the other direction. Protectionism, as the report acknowledged, is on the rise and the "America First" agenda of the Trump administration is increasing trade and economic tensions between the major powers.