BIS report points to mounting economic and financial instability

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1 July 2024

The annual report of the Bank for International Settlements (BIS), the umbrella organisation of the world's central banks, issued on Sunday, has presented a relatively upbeat assessment of the state of the world economy and financial system, at least on the surface.

It said the world economy appeared to be finally leaving behind the legacy of the pandemic and the price shock of the war in Ukraine, noting that the "worst fears did not materialise" and a "smooth landing" appeared to be ahead," which was a "great outcome."

But the body of the report was replete with warnings of risks both on the economic and financial front.

Under conditions where central banks, including the US Federal Reserve, are contemplating interest rate cuts or have already made them, the BIS said policymakers should set a "high bar" for easing, warning of a surge in inflation in the services sector and an increase in wages.

"A premature easing could reignite inflationary pressures and force costly policy reversal—all the more costly because credibility would be undermined."

It said central banks had to be alert to the risk of further significant price rises and not hesitate to "tighten again if inflation proves to be more stubborn and unresponsive than anticipated."

In conditions where high interest rates are hitting the living standards of the working class as well as threatening to set off recessionary trends and unemployment, the BIS emphasised that the dictatorship of central banks over the economy must be maintained and even strengthened.

In the guarded language, which is always used when bankers raise the issue of opposition to their policies from the mass of the population, it said there was a "need to shield the central bank from political economy pressures."

"Safeguards for central bank independence," that is the ability to operate ruthlessly in the interests of finance capital whatever the social consequences, were "essential" and "may become even more important in the years ahead."

While the assessment of the immediate situation was upbeat, the longer-term outlook was not.

"Financial vulnerabilities have not gone away. Fiscal positions [that is the growth of budget deficits and debt] cast a shadow as far as the eye can see. Subdued productivity growth clouds economic prospects. Beyond the near term, laying a more solid foundation for the future is as difficult as ever," the review said.

The BIS breathed a sigh of relief over the impact of higher interest rates on the financial system, at least so far, saying the outcome had been surprisingly benign but warned that "tougher tests" may be ahead.

It said the significant strains in March 2023, when three large American banks collapsed, stemmed mainly from interest rate risk alone and did not lead to defaults. But what it called the "materialisation of credit risks" was still to come, the only question being when and how intense it would be.

It warned there were indications that financial cycles had started to turn, savings buffers were dwindling and "debts will have to be refinanced."

One of the main areas of concern is commercial real estate. While this market is smaller than residential real estate it represents "a greater risk to financial stability." It noted that the pandemic had created a "structural shift" in this area, due to the falling demand for office space which had been compounded by higher interest rates.

This had put downward pressure on prices, reduced valuations and created losses for lenders which had started to generate stress at some banks and other financial intermediaries.

It said there were latent losses in the commercial real estate sector because of the "extend and pretend" policy of banks as they continue to supply credit "in the hope of a reprieve from lower interest rates in the future."

But this only increased the risk of a "disorderly adjustment" in the future when losses and revaluations, in some cases upwards of 40 percent, had to be recognised.

As with other major financial institutions, including the International Monetary Fund, the BIS review pointed to the dangers of the growth of government debt, in the US and more broadly.

In his remarks on the review, BIS general manager Agustin Carstens said "fiscal outlooks" were even more concerning than financial problems created in areas such as commercial real estate.

"In the near and medium term, they pose the biggest threat to macroeconomic and financial stability.… Without consolidation, public debt ratios are set to climb, even if interest rates remain below economic growth rates. With mounting spending needs, markets could at some point question fiscal sustainability. High public debt issuance could raise the risk of bond market dysfunction, threatening financial stability."

As with other reports on the financial system, the BIS review directed attention to the growth of private credit funds in the workings of the financial system noting that their assets under management had tripled in the past decade, rising by 50 percent in what it called the "post-pandemic period" to an estimated $2.1 trillion. It noted that due to the "opaqueness of the sector" it was difficult to assess the risks involved.

In its policy prescriptions, the BIS identified two targets—the wages of the working class and government spending.

The review acknowledged that "as inflation surged, real wages plummeted across most jurisdictions, and have yet to recover despite robust labour markets" and this may lead to "persistent wage demands."

That is, the cut to workers wages resulting from the surge of inflation, which began in 2022 and has continued, must be maintained through the continuation of high interest rates and that if there was a significant wages push central banks may even have to raise them again.

In his remarks on the review, Carstens emphasised that "fiscal policy must consolidate." Under conditions where military spending is expanding, this means major cuts in social spending on health, education and other services.

They will go across the board. As Carstens put it: "From the perspective of longer-term fiscal sustainability, the need to consolidate has never been greater. The end of low-for-long interest rate intensifies the need to put the fiscal house in order, and multi-pronged consolidation strategies should be considered."