BANK FOR INTERNATIONAL SETTLEMENTS

The financial cycle, the debt trap and secular stagnation

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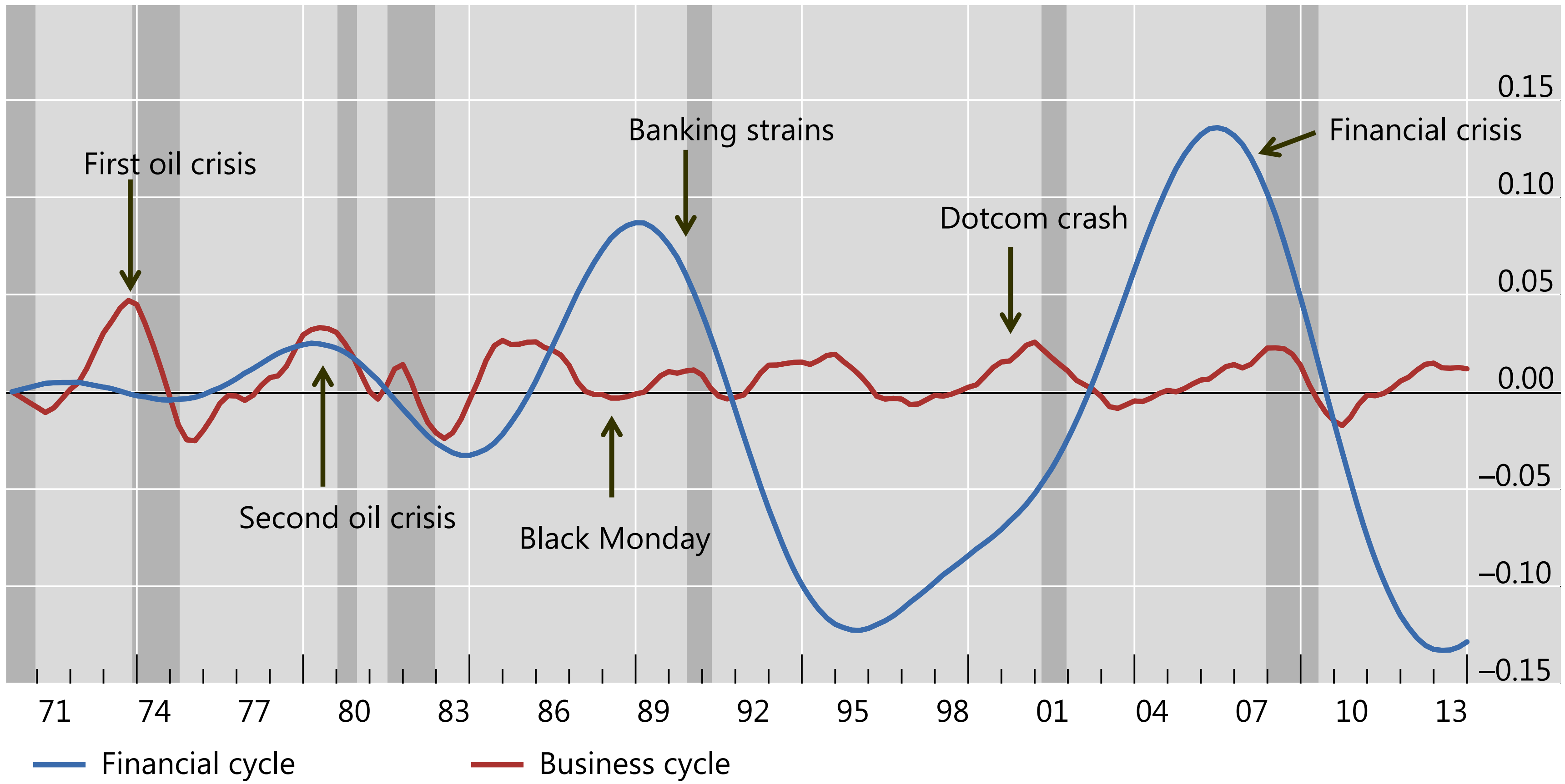
Themes and takeaways

- Two Annual Report themes
  - The financial cycle
  - Debt trap
    - Link to decline in interest rates and "secular stagnation"
- Takeaways
  - The financial cycle is necessary to understand global economic challenges
  - Coming to grips with the financial cycle calls for more symmetric policies across boom and bust phases
  - Failing to tame the financial cycle raises material risks

The financial cycle, the crisis and the recession

- Financial cycle = self-reinforcing interaction between risk perceptions/attitudes and financing constraints
  - Can lead to financial crises and huge macroeconomic costs
- Credit and property prices are key
- Financial cycles are much longer than business cycles
- An outsize financial cycle caused the financial crisis
- Financial cycles have become bigger since the early 1980s
  - Size and length depend crucially on policy
- Financial cycle busts coincide with balance sheet recessions
  - Permanent output losses
  - Less policy room for manoeuvre
  - Less responsive to aggregate demand policies

The financial and business cycles in the United States



The financial cycle as measured by frequency-based (bandpass) filters capturing medium-term cycles in real credit, the credit-to-GDP ratio and real house prices. The business cycle as measured by a frequency-based (bandpass) filter capturing fluctuations in real GDP over a period from one to eight years.

Source: M Drehmann, C Borio and K Tsatsaronis, "Characterising the financial cycle: don't lose sight of the medium term!", *BIS Working Papers*, no 380, June 2012. See 84th Annual Report, Chapter IV.

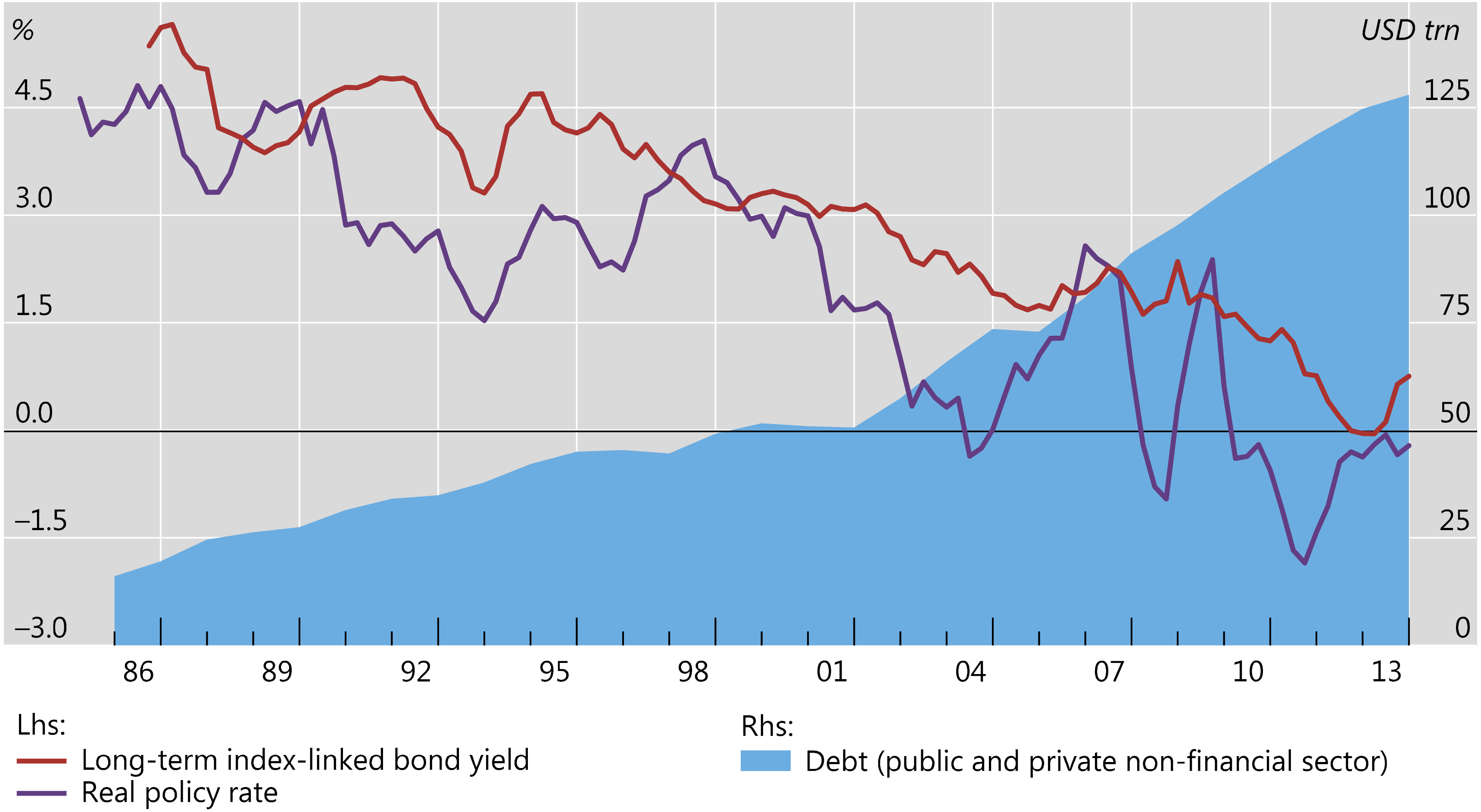
Adjusting policy frameworks

- Dealing with the financial cycle requires policies to tame it, ie that
  - Fully recognise its existence: put it on the radar screen!
  - Have a medium-term focus
  - Are more symmetric across boom and bust phases than current ones
  - Are holistic
- Key elements of the frameworks
  - Macroprudential frameworks
  - Monetary policy that leans against financial booms
  - Extra-prudent fiscal policies

Three risks

- Conjunctural: episodes of financial distress in next few years?
  - Annual Report identifies a number of unsustainable financial booms
- Structural: entrenching instability in the system?
  - Asymmetric policies, sequence of financial crises and loss of policy ammunition
    - Downward bias in interest rates and upward bias in debt
    - Debt trap (form of “time inconsistency”)
    - Low interest rates become self-validating
- Institutional: rupture in the open global economic order?
  - Temptation for nation states to withdraw
  - Temptation to inflate debts away

Global debt and interest rates



[1] From 1998; simple average of Australia, France, the United Kingdom and the United States; otherwise only Australia and the United Kingdom. [2] Weighted averages based on 2005 GDP and PPP exchange rates. [3] Because of limited data availability, it includes debt from the following countries: Australia, Canada, China, Germany, Spain, France, Greece, Ireland, Italy, Japan, Portugal, United Kingdom, United States.

Sources: IMF; national data; BIS estimates.

Bottom line

- Taming the financial cycle is important: the stakes are high
- Progress has been made, but more needs to be done
- The road ahead may be a long one
  - Reason to start the journey sooner rather than later