



BANK FOR INTERNATIONAL SETTLEMENTS

Has the search for efficiency made the financial world less safe?

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* Views expressed are those of the author and not necessarily the views of the BIS



Overview

- The search for efficiency
- So far so good
- Financial headwinds
- Possible effects of tighter monetary policy



The search for efficiency

- In the real economy
- In financial markets
- In the conduct of monetary policy



Efficiency in the real economy

- Deregulation in industrial economies
- Productivity and IT
- Transition economies and globalisation
- A disinflationary bias?



Efficiency in financial markets

- Deregulation and technology
- Risk decomposition and risk management
- New products and new players
- Cheaper and better services



Efficiency in the conduct of monetary policy

- More focus on near-term price stability
- More reliance on market processes
- More attention to communication



So far so good

- Lower and less volatile inflation
- Higher and less volatile growth
- More resilience to shocks



But could financial “headwinds” be a problem?

- Evidence from the past
- Evidence from the present
- Speculation about the future



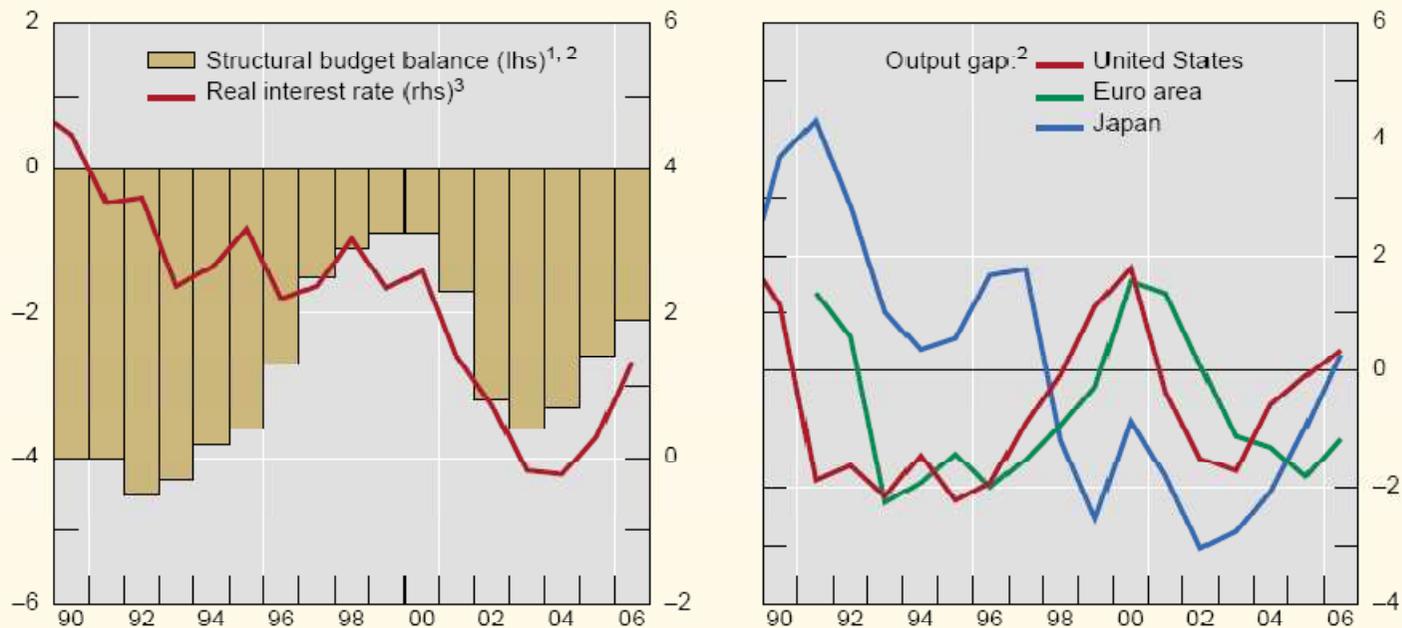
Financial headwinds: evidence from the past

- Low real interest rates and the Wicksellian natural rate
- Rapid credit growth
- Diverge between stock prices and underlying profits



Real interest rates, structural budget balance and output gaps

In per cent



¹ General government in the OECD countries. ² As a percentage of potential GDP. ³ Weighted average, based on 2000 GDP and PPP exchange rates, of OECD countries' short-term interest rates deflated by annual consumer price inflation. Sources: OECD; national data.



Aggregated private credit growth in major industrial countries and global foreign exchange reserves

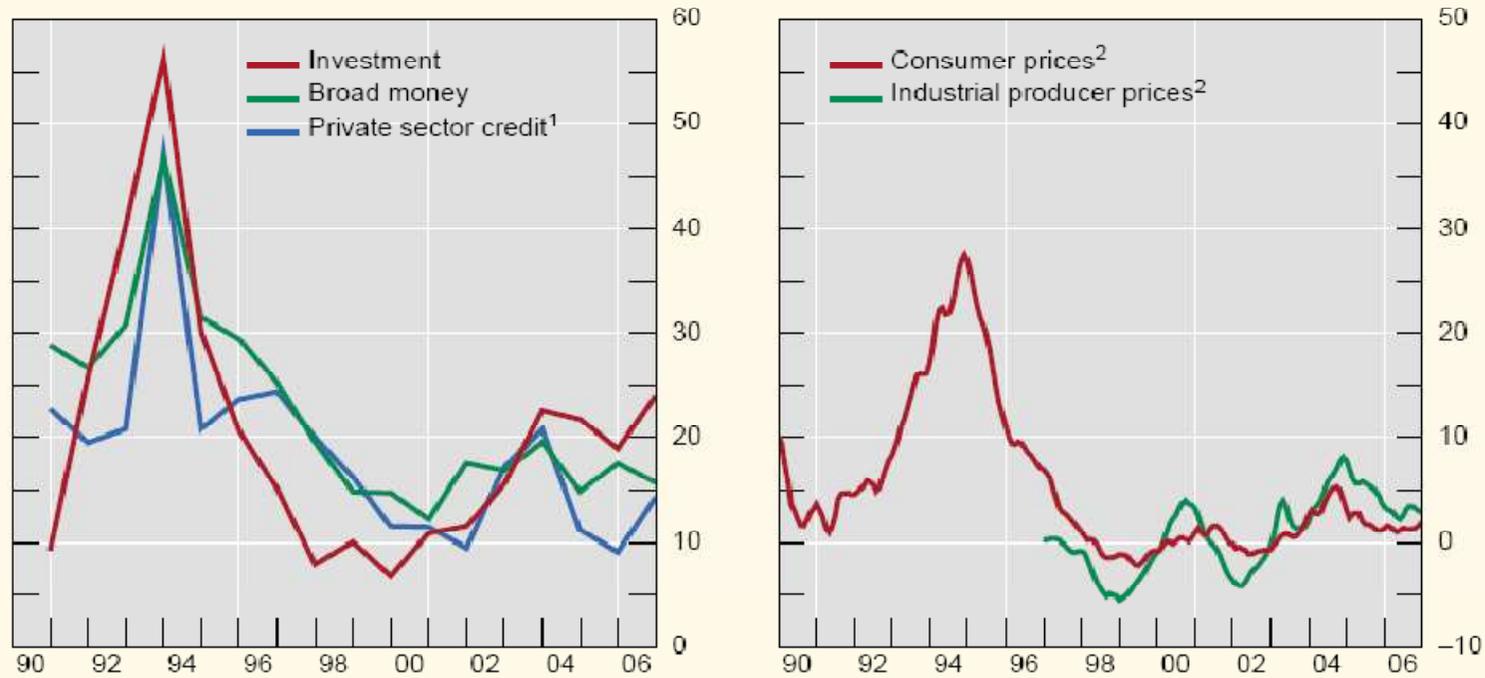


Sources: IMF; national data.



Investment, money, credit and prices in China

Annual changes, in per cent

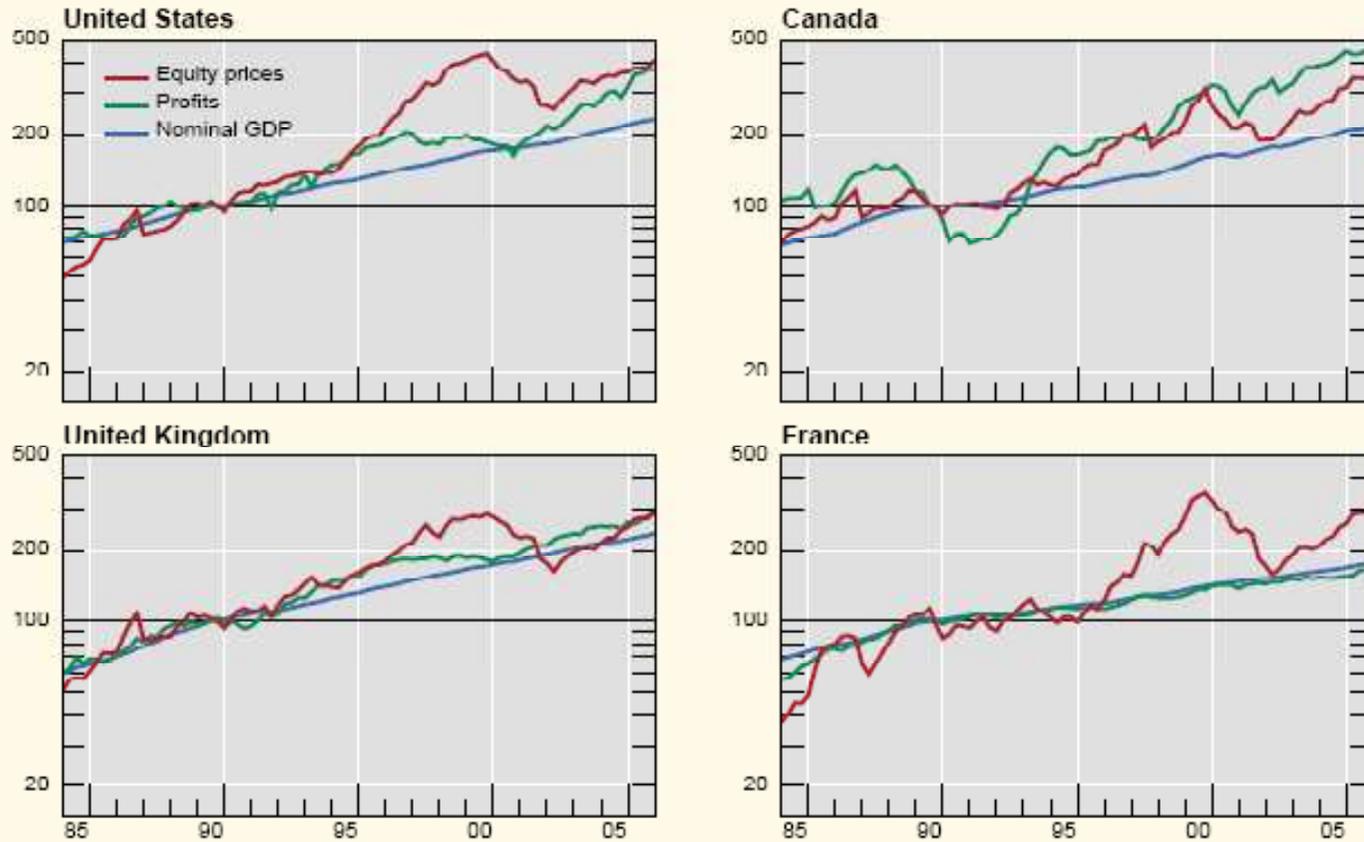


¹ Domestic credit to the private sector. ² Three-month moving average.
Sources: IMF; CEIC; national data.



Equity prices, profits and nominal GDP

Quarterly data; 1990 = 100 (semi-logarithmic scale)



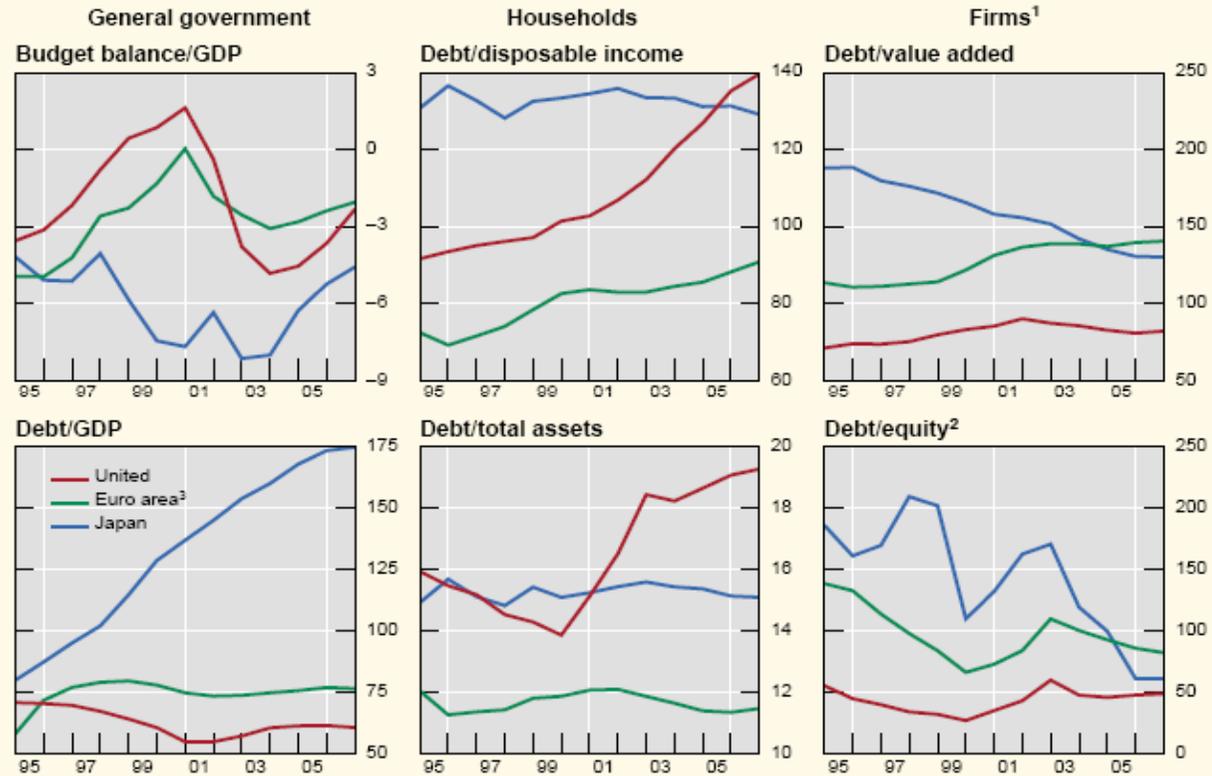


Financial headwinds: evidence from the present

- Over extended consumer and household balance sheets
- Large external imbalances
- Lessons from Japan



Sectoral indebtedness In per cent



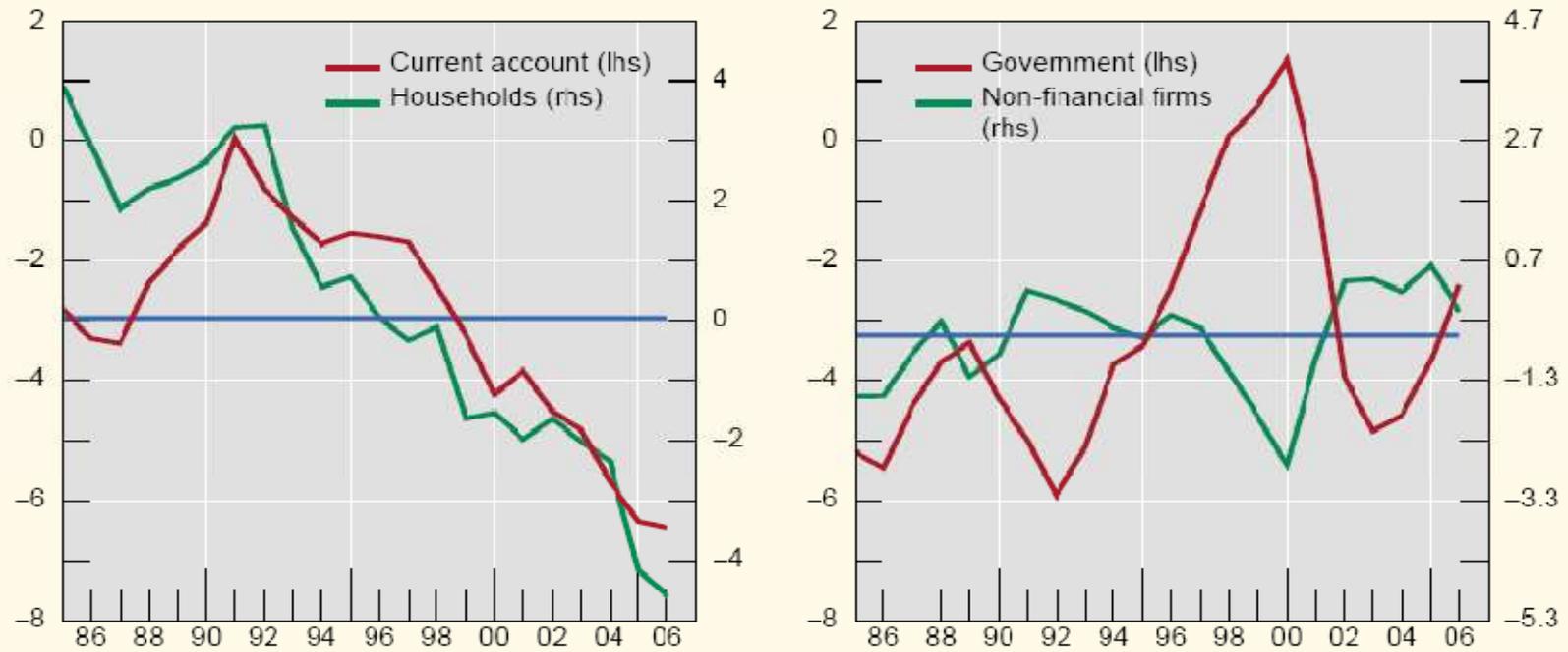
¹ Non-financial corporations. ² Equity defined as the market value of outstanding equities. ³ For households and firms, weighted average of France, Germany and Italy, based on 2000 GDP and PPP exchange rates.

Sources: OECD; national data; BIS calculations



US sectoral financial balances

As a percentage of GDP



Note: The blue lines represent the 1985–2006 means of the respective financial balances.
Source: National data.

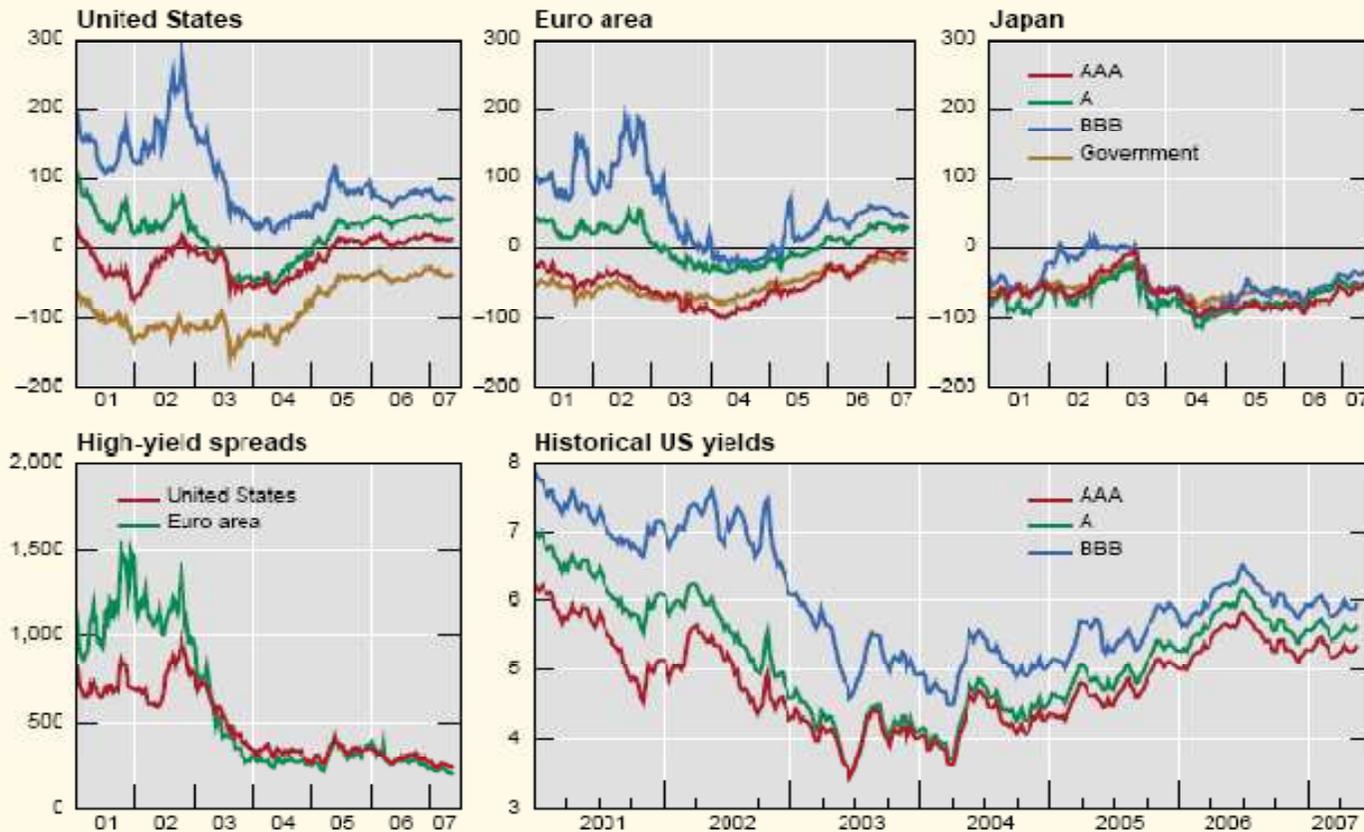


Financial headwinds: more evidence from the present?

- Low long rates
- Low corporate spreads
- Low sovereign spreads
- Low volatility
- High real estate prices



Corporate and government bond spreads¹

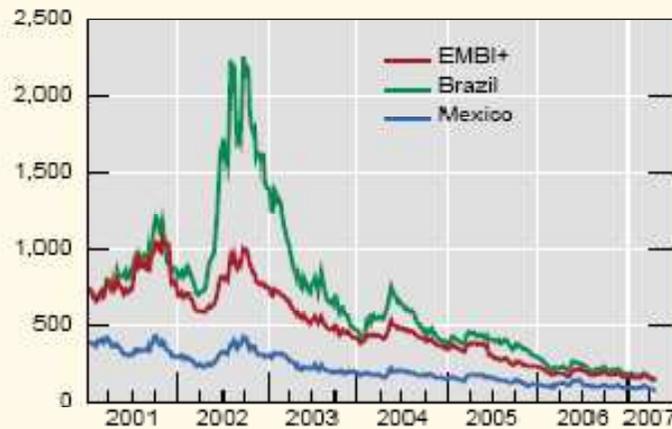
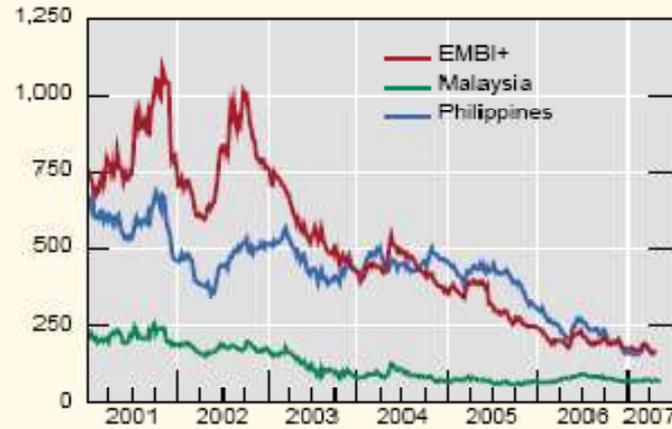


¹ Bond index yields against 10-year swap rates, in basis points, except for historical US yields (in %).

Sources: Bloomberg; Merrill Lynch; national data.

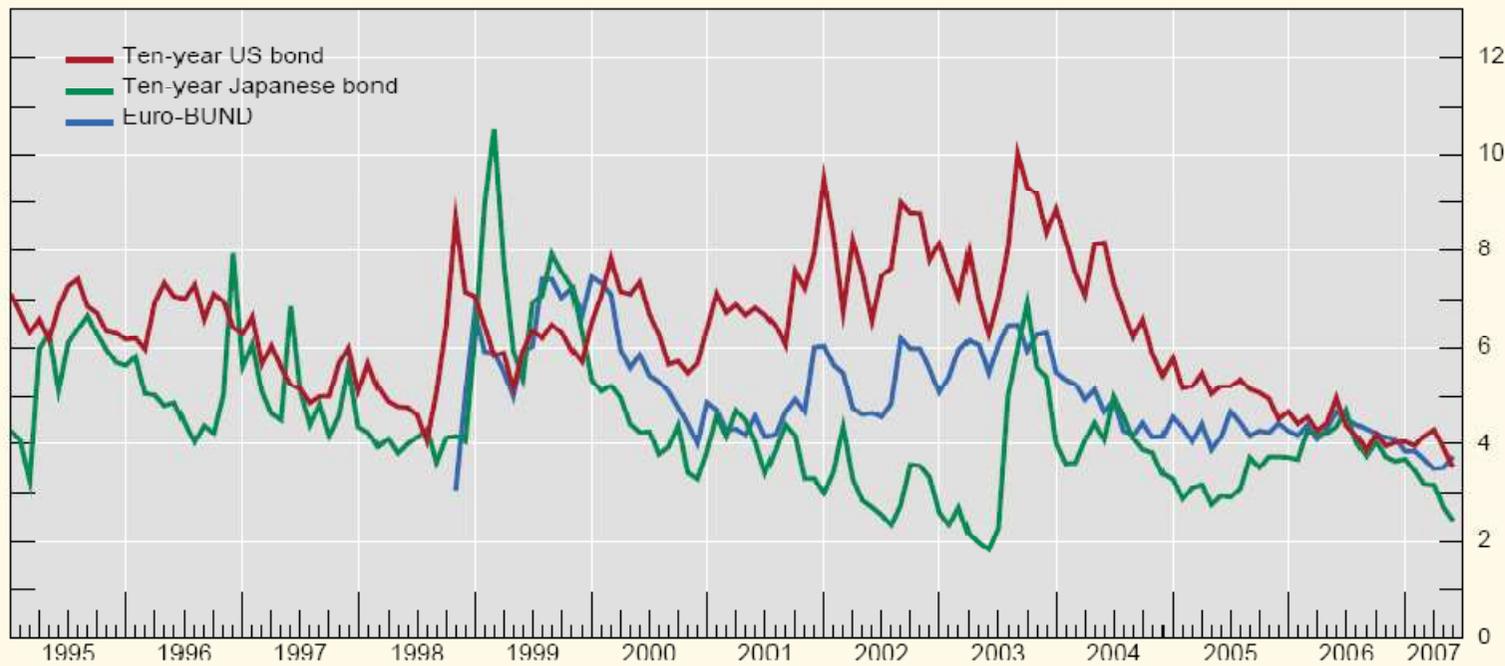


Spreads of US dollar sovereign bonds





Implied volatilities of bonds¹



¹ At-the-money call implied volatility; monthly averages.

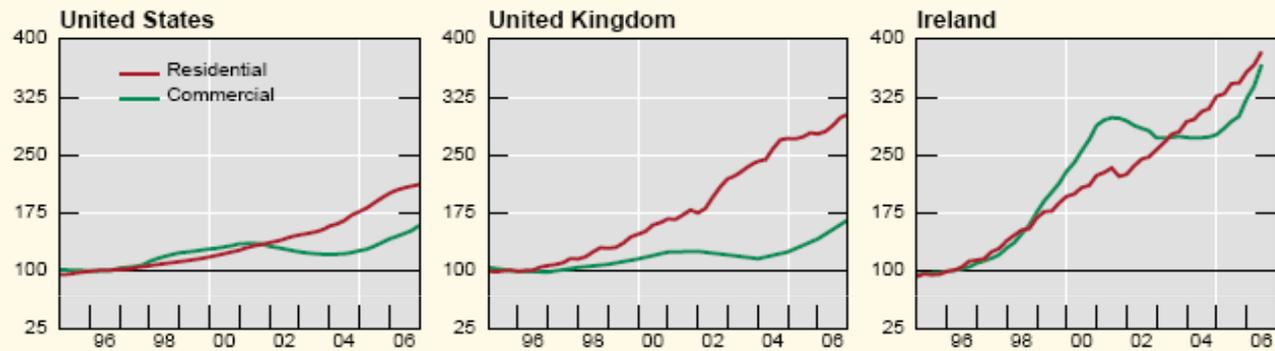
Source: Bloomberg.



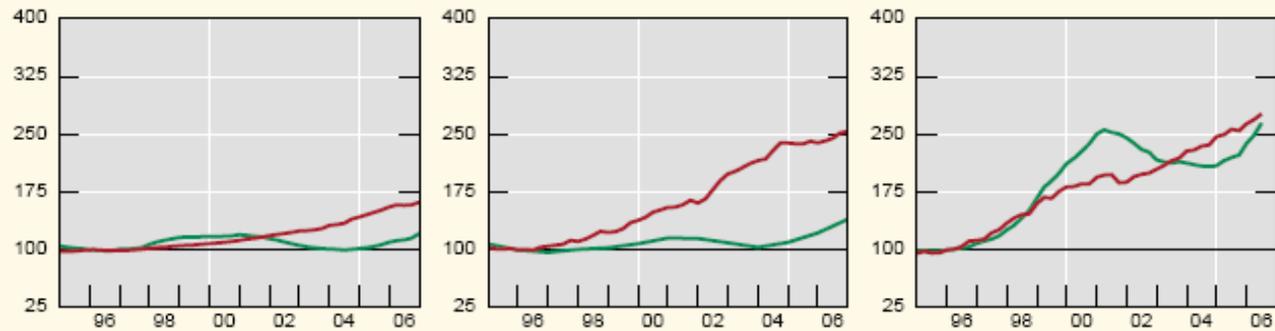
Real estate prices¹

Fourth quarter 1995 = 100; quarterly averages

In nominal terms



Inflation-adjusted



¹ Representative nationwide indices.

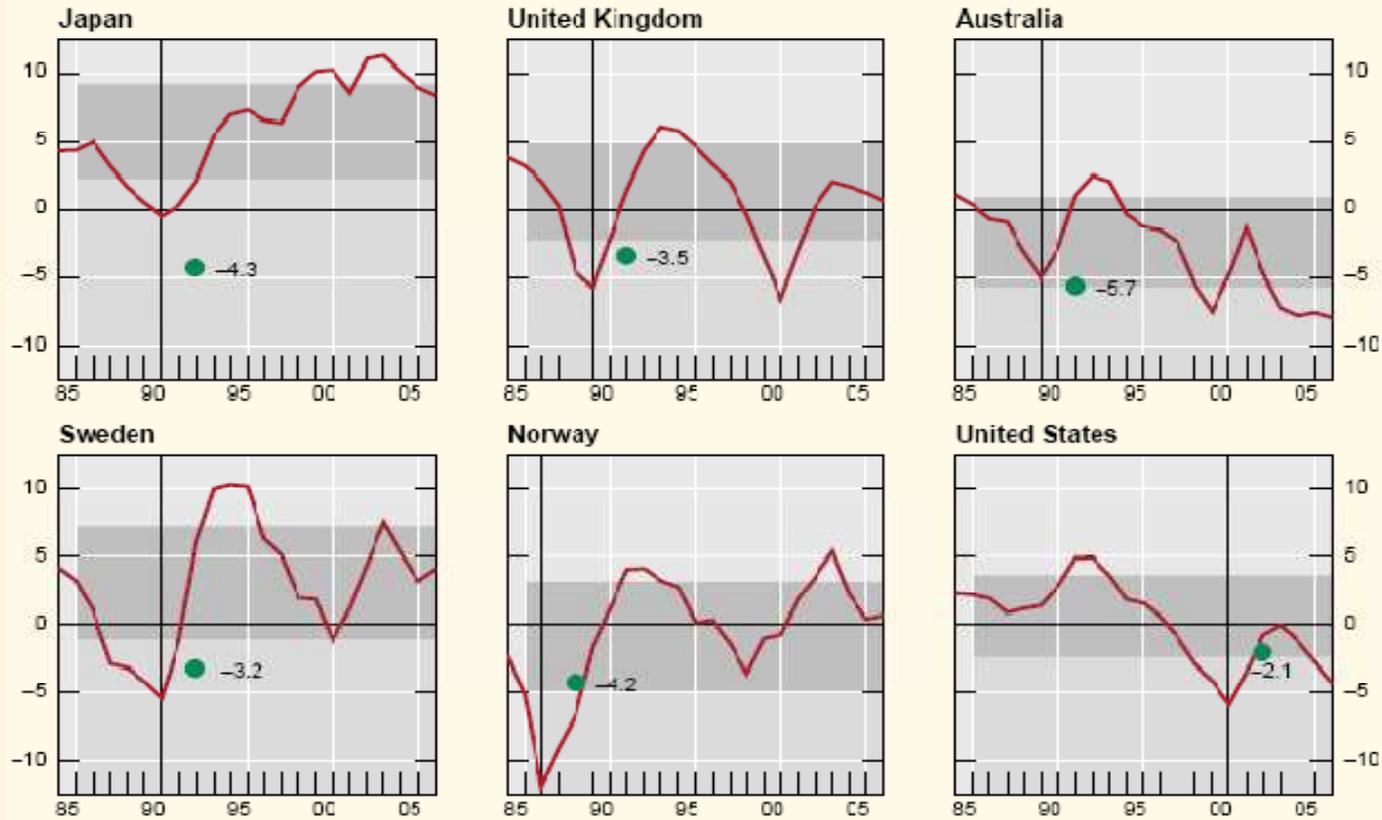


Financial headwinds: speculation about the future?

- Net private savings
- Credit cycles and financial stress
- Possible effects of higher policy rates



Net private saving¹

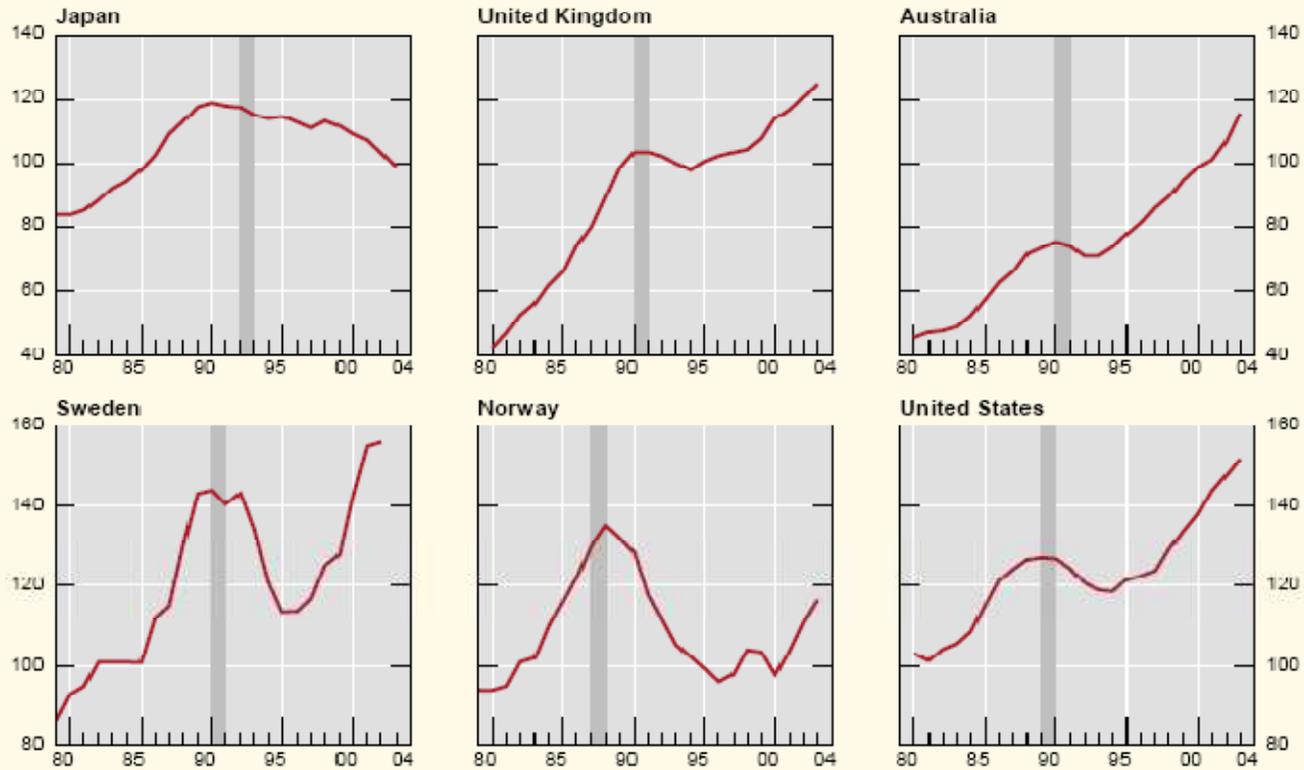


Note: The shading represents ± 1 standard deviation around the mean of the observation period, and the dots the change in GDP growth two years after the indicated trough. ¹As a percentage of GDP.

Sources: OECD; national data.



Credit cycles and financial stress¹



¹ Private credit as a percentage of GDP; comparability across countries is restricted by differences in the definition of private credit. The shaded areas mark the onset of stress in the financial system.

Sources: G Kaminsky and C Reinhart, "The twin crises: The causes of banking and balance-of-payments problems", American Economic Review, June 1000; national data; BIS estimates.



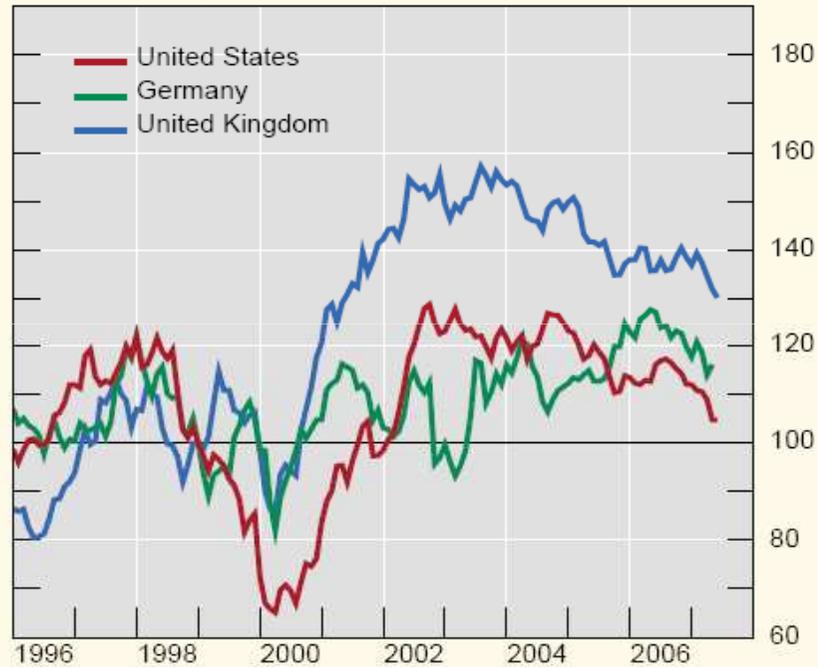
Possible effects of higher policy rates

- On financial institutions
- On financial markets
- On rates of foreign exchange



The banking system remains resilient

Bank share prices¹



Expected default probability²

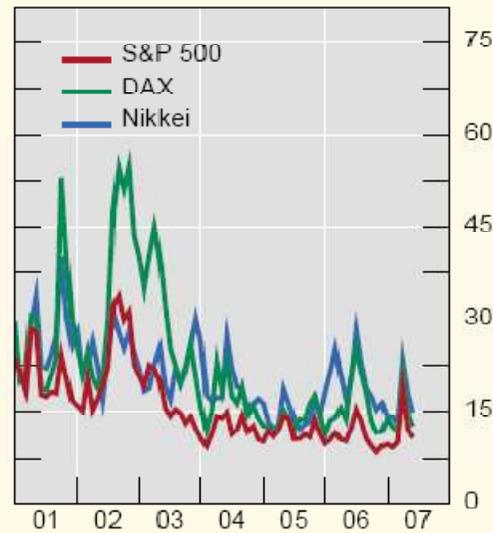


¹ Ratio to broad share price index, end-1998 = 100. ² The expected probability, in percentages, that a company will default within one year. Sources: Datastream; KMV; national data.

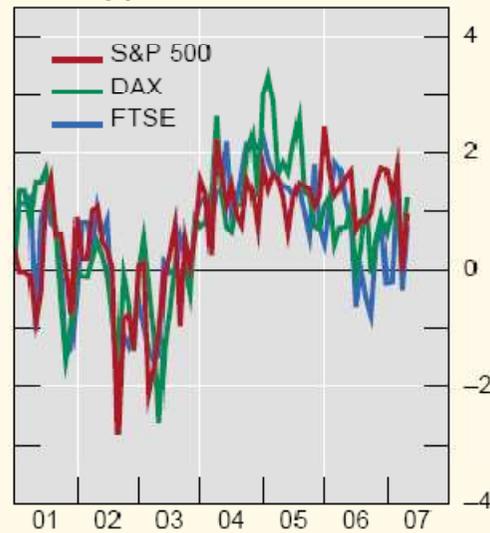


But greater appetite for market risk ...

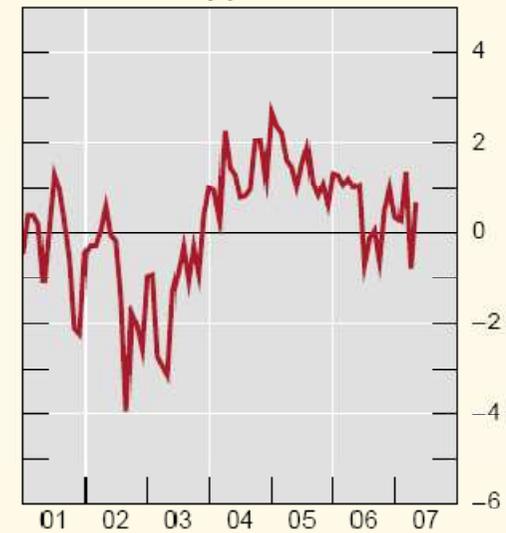
Volatilities¹



Risk appetite indicators²



Global risk appetite³

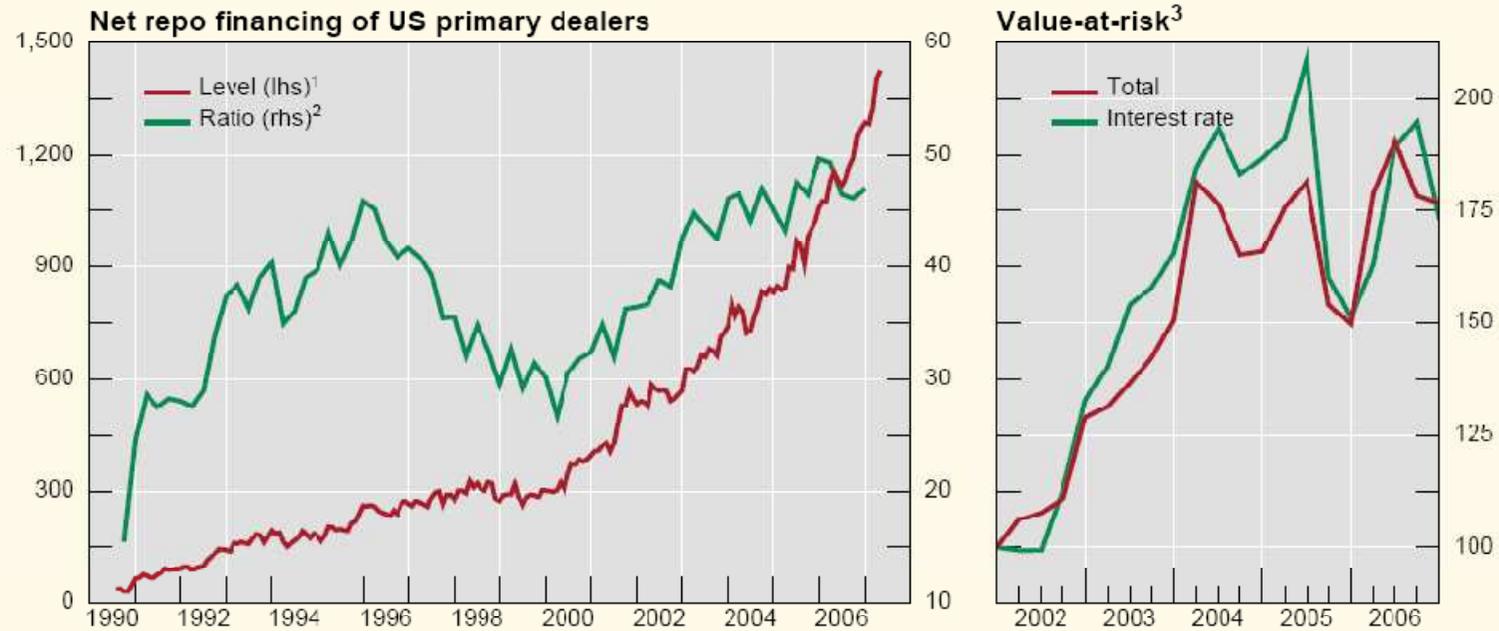


¹ Conditional volatilities of daily returns from an asymmetric GARCH(1,1) model; estimated over the period Jan 1990-Nov 2004. ² Derived from the differences between two distributions of returns, one implied by option prices with varying strike prices and one based on actual returns estimated from historical data. ³ Derived from principle components analysis of the three risk appetite indicators; estimated over the period Dec 1995-Nov 2004; first component plotted.

Sources: Bloomberg; Chicago Mercantile Exchange; Eurcx; LIFFE; BIS calculations.



... and greater market exposure



¹ In billions of US dollars. ² As a percentage of total assets of securities dealers. ³ Market capitalisation-weighted averages of eight large institutions' total and interest rate VaR; 2001 Q4 = 100; quarterly data, in per cent.

Sources: Company reports; national data.



With the US dollar of particular concern?

- Growing international indebtedness
- No signs of a current account turnaround
- Challenge to shift from non-tradeables to tradeables
- And "patience" is running out



Conclusion

- Resilience to date
- Many signs of “imbalances”
- But the future need not resemble the past