

### Unwinding the leverage-led growth model

The leverage-led growth model—a combination of excessive leverage in the financial system, overindebtedness of households, low interest rates, and global imbalances—was at the heart of the crisis.

But the paradox is that the policies that have been adopted to remedy the crisis consist, all in all, of even more of the same: borrowing, debt, leverage.

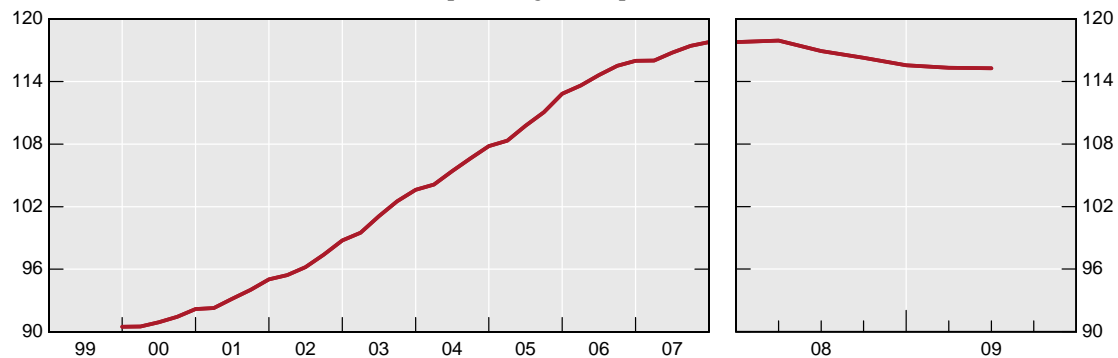
Let me illustrate this with a few facts regarding the main balance sheet adjustments under way:

- There has been some reduction of household debt but it still remains at a very high level (Figure 1).

Figure 1

#### Household debt, major advanced economies<sup>1</sup>

As a percentage of disposable income



<sup>1</sup> The United States, the euro area, Japan, and the United Kingdom; weighted average using 2005 GDP and PPP weights.

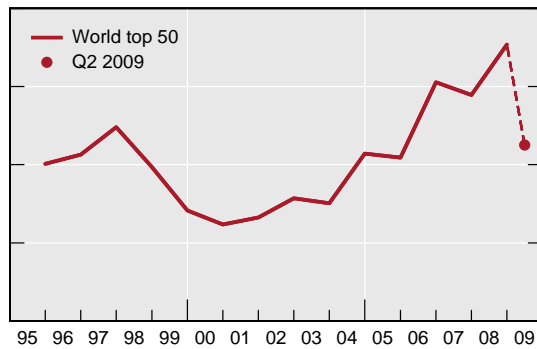
Source: National data.

Figure 2

### Bank leverage ratio, assets, and equity

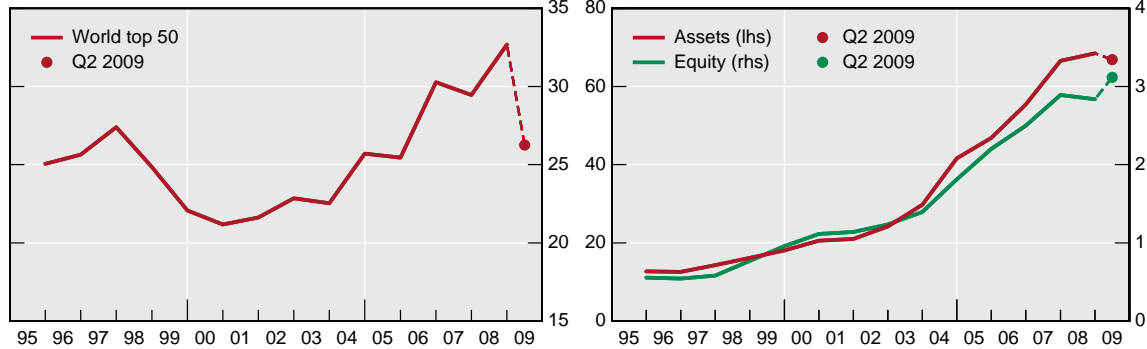
#### Bank leverage ratio

Total assets / total equity, weighted by asset size



#### Assets and equity

World top 50 banks, in trillions of U.S. dollars

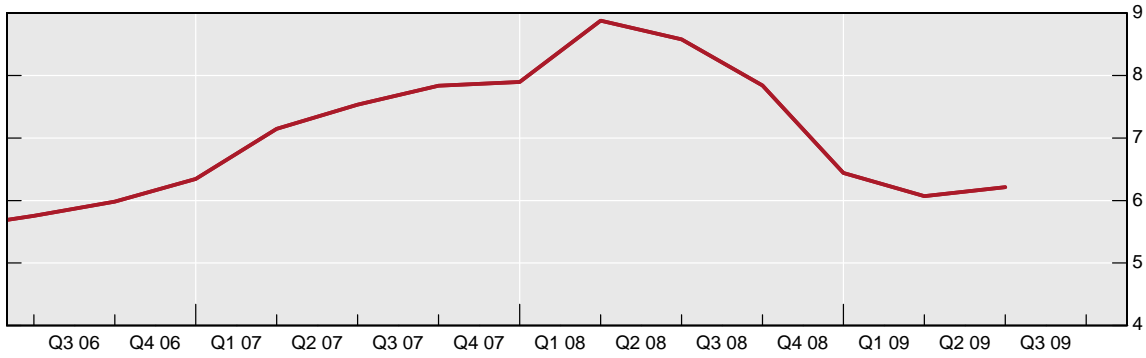


Source: BankScope.

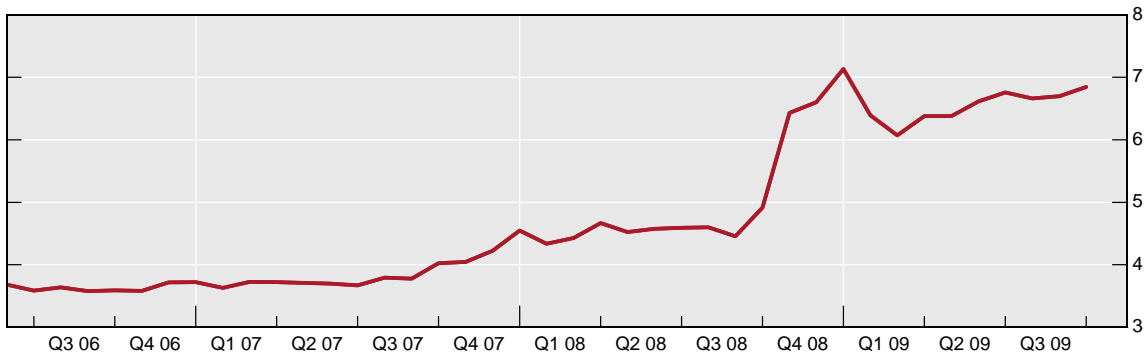
- Leverage of banks also remains high by historical standards despite a reduction in the first half of 2009 (Figure 2).
- The decline in commercial bank intermediation has been more than offset by the sharp rise in central bank balance sheets (Figure 3). While interbank claims of BIS reporting banks have shrunk by \$3 trillion since early 2008, central bank balance sheets have surged from \$3.5 trillion to around \$7 trillion. This has cushioned the decline in the growth of private bank credit, which turned negative in the last quarter. The near-zero interest rate policy conducted by G-10 central banks has also supported the maintenance of private debt but poses the risk of spurring risk-taking.
- And last but not least, there has been a colossal surge in public debt in advanced economies, by 20 percentage points of GDP in two years, to almost 100 percent of GDP in 2009.
- Overall, taking decelerating private debt and accelerating public debt together, major economies are still leveraging up (Figure 4). Private debt seems to be still rising in relation to GDP well after government interventions. The ongoing surge in public debt in relation to GDP leaves aggregate leverage (total debt) on a rising trend in many advanced countries.

Figure 3

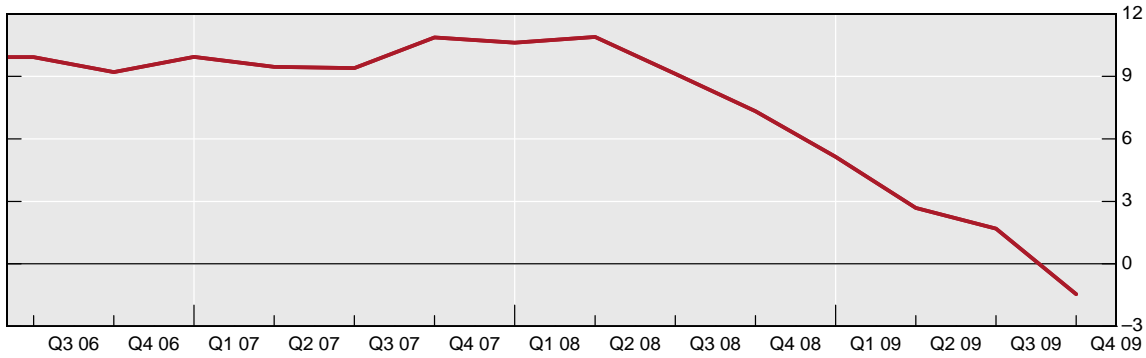
**Global interbank claims<sup>1</sup>**



**Central bank assets<sup>1,2</sup>**



**Bank credit to the private sector<sup>2,3</sup>**



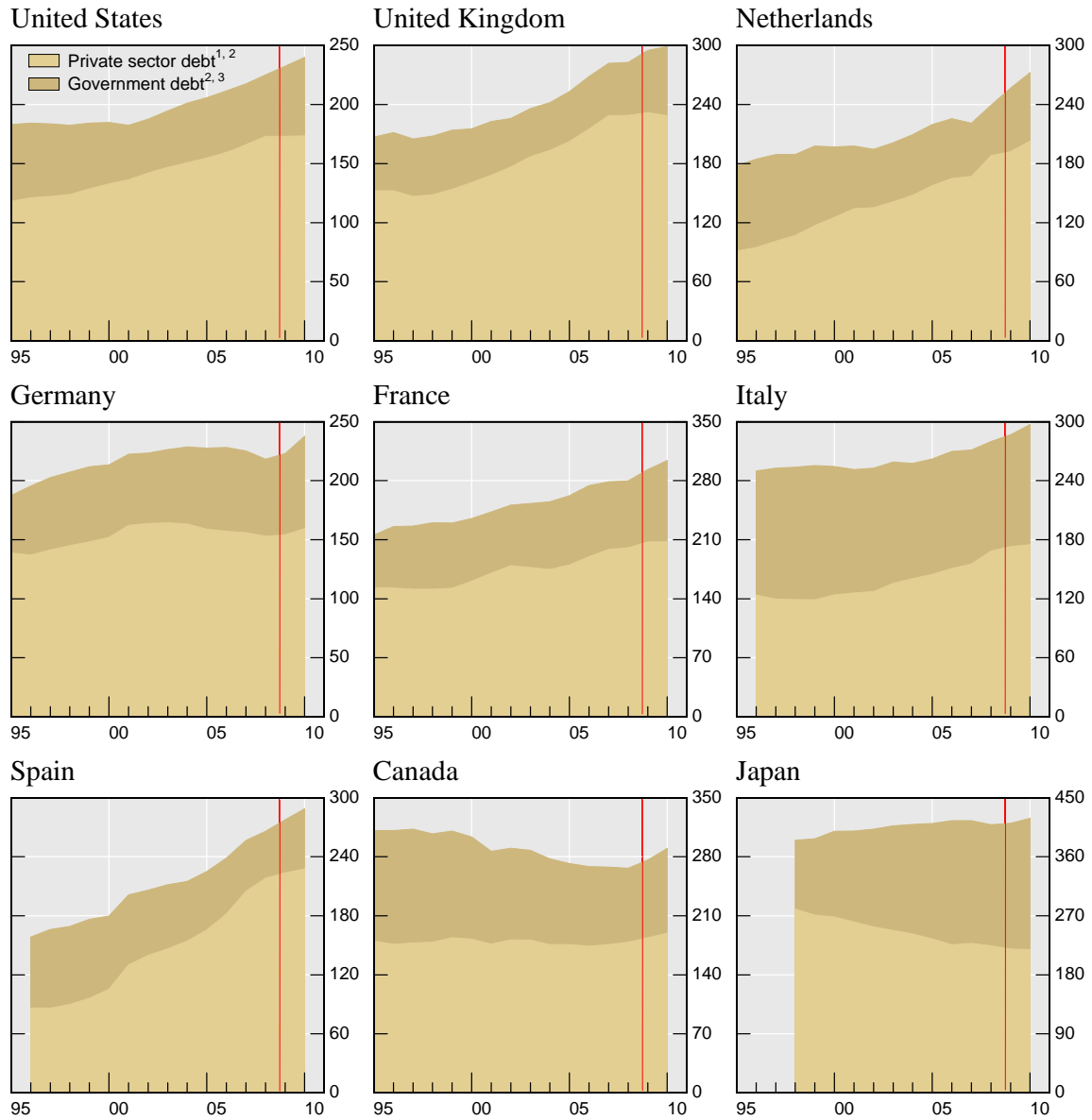
<sup>1</sup> In trillions of current U.S. dollars; BIS reporting banks. <sup>2</sup> Total for the United States, the euro area, Japan, Canada, Sweden, Switzerland, and the United Kingdom. <sup>3</sup> Annual percentage change in bank credit to the private sector; weighted average of growth rates using 2005 GDP and PPP weights.

Sources: Datastream; national data; BIS.

Figure 4

**Private and public debt**

As a percentage of GDP



The red vertical line marks September 15, 2008, the date of the Lehman Brothers bankruptcy.

<sup>1</sup> Total debt excluding equity issued by nonfinancial businesses, households and nonprofit organizations; definitions may differ across countries; for the Netherlands, bank credit to the private sector. <sup>2</sup> Data for 2009 are based on latest quarterly information available; for France and Germany, bank credit used to update private sector debt. <sup>3</sup> General government total debt; for the Netherlands, data for 2009 are OECD projections.

Sources: IMF; OECD; national data.

In a nutshell, we are implementing the leverage-led growth model while promising to break with this model in the future by designing sound medium-term frameworks for fiscal consolidation and bank capital regulation. Promising to “be virtuous, but not now” is a perilous balancing act for policymakers.

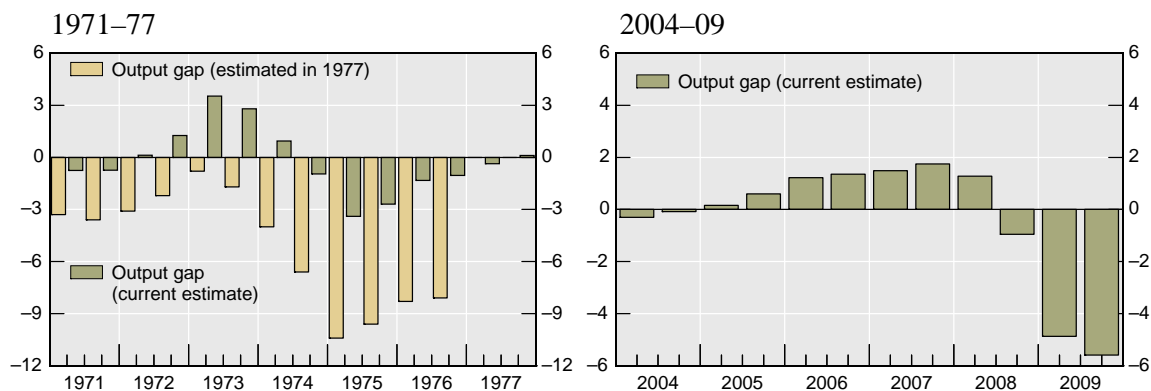
## Timing and speed of unwinding

The current debate on “exiting too soon” versus “exiting too late” echoes the debate a year ago on the calibration of the stimulus deemed necessary to counter the recession (the risk of “not doing enough” versus the risk of “doing too much” and of overcalibrated stimulus). The difficulty at this point is that, while the recession is abating and the recovery is gaining pace, there is a question mark over the exact measurement of the large-scale stimulus that is in the pipeline and therefore a question mark over the calibration of the stimulus. It may well be that the combination of central banks’ balance sheet expansion and government debt issuance will more than compensate for private credit retrenchment (Figure 4), resulting in overcalibrated stimulus. Another key uncertainty for policymakers arises from the well-known fragility of the measurement of output gaps. As was the case in the 1970s, we may be seriously overestimating economic slack. Mismeasurement of output gaps and growth potential by a wide margin may lead to an understatement of the underlying deterioration in fiscal positions (Figure 5).

Figure 5

### Output gap in major advanced countries<sup>1</sup>

In percent



<sup>1</sup> Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States; weighted averages using 2000 and 2005 GDP and PPP weights.

Source: OECD, *Economic Outlook* (various issues).

The dominant view is that “it is too soon to be implementing the exit strategy but not too soon to be planning for it” or, to be more specific, that “it is too soon to implement any fiscal, prudential, or monetary tightening.” I think that our views should be less categorical.

#### *On fiscal policy*

The dominant view (“it is too soon to tighten”) is highly questionable. Postponing the fiscal adjustment to a time when the recovery has consolidated may not be possible.

Inaction and postponement could prove to be a risky policy. Simply communicating on the design of future medium-term frameworks for consolidation may calm the rating agencies for a while, but it does not address the mounting concerns in the bond markets about fiscal solvency in the medium to long term.

### *On interest rate policy*

The dominant view (“it is too soon to tighten”) may be right. But central banks need to keep open the option of starting to reverse the near-zero interest rate policy at any point in time so as to avoid any perception of unconditional commitment to keeping interest rates very low indefinitely. Otherwise market participants will take the current easy financial conditions for granted and start speculating again. Central banks therefore need to make clear that they are adding weight to the “risk-taking channel” of monetary policy and that they will not accept a return to financial excesses.

### *On central banks’ unconventional balance sheet policies*

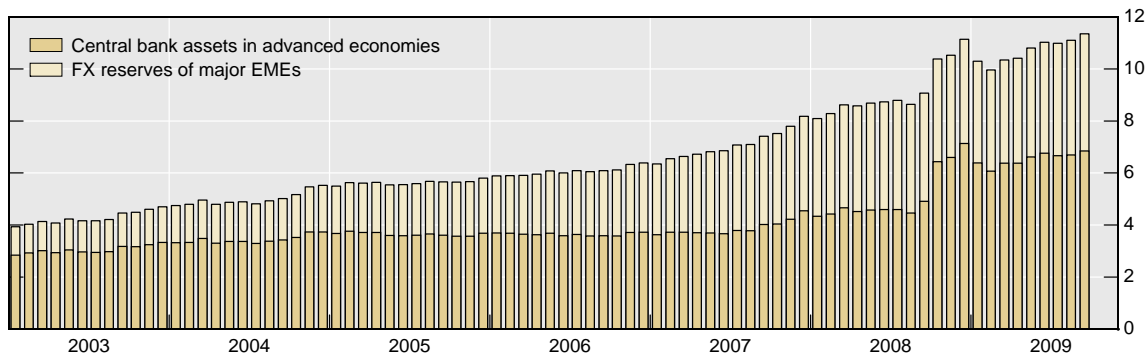
The dominant view emphasizes the risks associated with the premature withdrawal of unconventional balance sheet policies. Here we need to distinguish between central banks’ short-term liquidity-providing measures and their large-scale outright purchases of long-term securities.

The short-term liquidity-providing facilities can be self-unwinding (a number of them having a fixed expiration date in 2010) and do not pose major exit problems. The pace of that unwinding should be linked to confirmation of the normalization of the LIBOR-OIS spread and a smooth return to private credit intermediation.

Figure 6

### **Global liquidity: central bank assets<sup>1</sup> and foreign reserves<sup>2</sup>**

In trillions of current U.S. dollars



<sup>1</sup> Total of Canada, the euro area, Japan, Sweden, Switzerland, the United Kingdom, and the United States. <sup>2</sup> Total of major emerging market economies (Brazil, China, Hong Kong SAR, India, Korea, Malaysia, Mexico, Russia, Singapore, Taiwan Province of China, Thailand, and Turkey).

Source: National data.

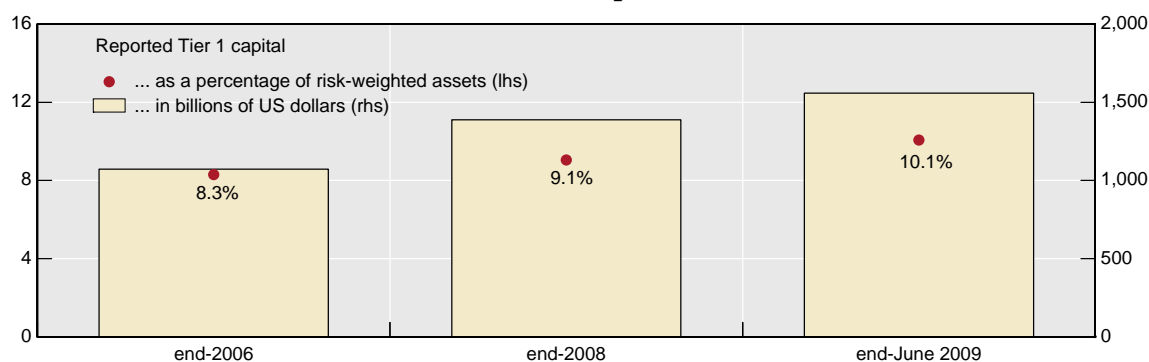
Exiting from the outright asset purchases will be more challenging. Given the potential impact on asset prices, central banks may be tempted to adopt a “buy and hold” stance. However, the key issue here relates to the potential role of central banks in directly influencing long-term bond yields and credit spreads: market participants should be under no illusion that we are entering into a new permanent accommodative monetary policy regime in which central banks would be able and willing to control the entire length of yield curves as well as credit spreads and mortgage rates. The unconventional measures should not be seen as an additional set of tools that central banks would use in their normal day-to-day conduct of policy.

In normal times, central banks will need to go back to their usual approach of controlling only the short end of the yield curve and of refraining from interventions with potentially distorting effects on relative asset prices. Exiting from unconventional monetary policy is necessary to make clear that the unconventional will not become the new normal. The sooner the exit, the better.

### *On prudential policy*

On prudential policy, the consensus view again is that “it is too soon to tighten capital requirements”: stronger capital requirements for banks are to be phased in as financial conditions improve and the economic recovery is assured, with the aim of implementation by end-2012. This medium-term phasing-in adopted by the Basel Committee and the G-20 addresses the concern over whether banks would be able to continue their financial intermediation function of providing stable flows of lending. In the meantime, there has been a market-driven increase in banks’ Tier 1 capital ratios of around 2 percentage points between end-2006 and end-June 2009 (Figure 7). But we should not draw too much comfort from this improvement since we know that credit losses in banking lag the business cycle.

Figure 7  
Tier 1 capital<sup>1</sup>

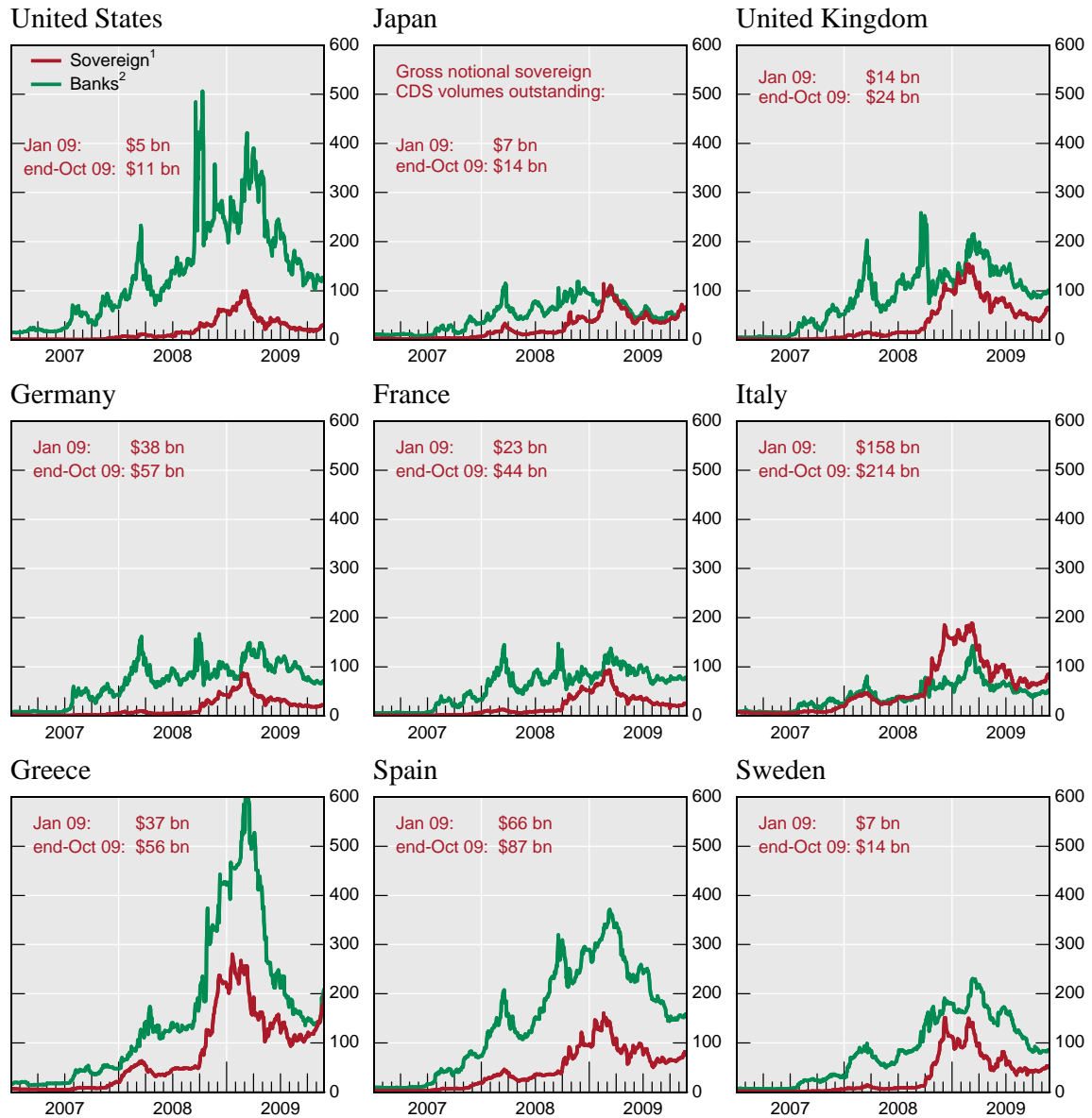


<sup>1</sup> For the following 21 large banks: Bank of America, Citigroup, HSBC, JPMorgan Chase, Mitsubishi, Industrial & Commercial Bank of China, Royal Bank of Scotland, Crédit Agricole, Banco Santander, BNP Paribas, Barclays, HBOS, Mizuho, UniCredit, ING Bank, UBS, Sumitomo Mitsui, ABN Amro, Deutsche Bank, Société Générale, and Credit Suisse.

There is at least one area where the postponement of a tightening of capital requirements is simply not defensible: the trading book. The additional capital charge there needs to be implemented by the end of 2010 given the extremely low current level of capital requirements on the trading book, even relative to banks’ economic capital estimates.

Figure 8

**Credit default swap premiums**



<sup>1</sup> Five-year on-the-run CDS spreads. <sup>2</sup> Simple average over sample of major banks.

Sources: Datastream; Depository Trust & Clearing Corporation; Markit; BIS calculations.

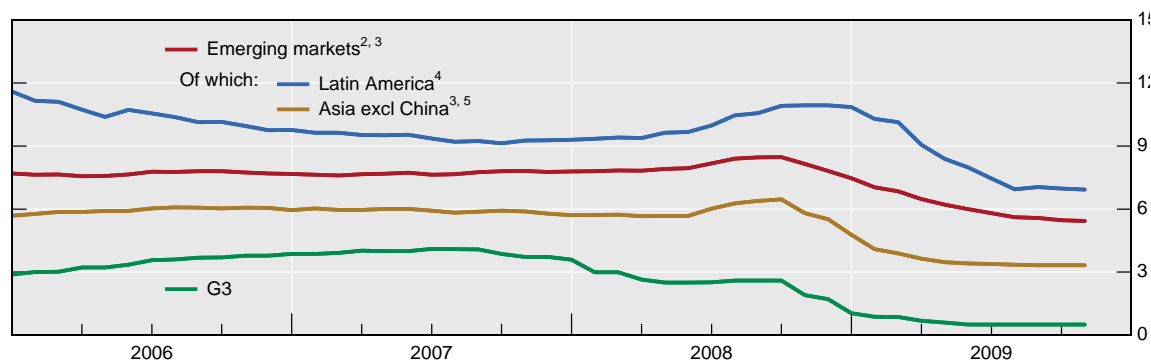


To conclude on the timing and speed of unwinding: as a minimum, we should recognize that a premature exit and a late exit can be equally damaging.<sup>1</sup>

Beyond that, experience suggests that the biggest risk is exiting too late and too slowly or, in the case of fiscal policy, not exiting at all. The political economy pressures are overwhelmingly in that direction. There are three serious risks associated with the policy of “doing nothing now”:

- On the fiscal side, the “do nothing” stance could fuel the concern over fiscal solvency, with the potential to trigger bond market disruption. In some G7 countries, sovereign CDS spreads are as high as bank CDS spreads (Figure 8). It would be more prudent to start the fiscal consolidation effort in 2010 already.
- On the interest rate policy side, in addition to the medium-term inflation risks posed by excessive stimulus, the biggest risk in the short term is related to asset price misalignments. The combination of near zero policy rates in G10 countries and excessive risk-taking could create a series of asset price bubbles. Indeed, many observers are concerned by the ongoing resumption of carry trades on currency markets induced by the large interest rate differentials between advanced and emerging market economies (Figure 9). This calls for monetary policy to take better account of asset prices and credit booms, as the BIS has long been advocating.<sup>2</sup>

Figure 9  
Policy rates<sup>1</sup>



<sup>1</sup> In percent; aggregates are weighted averages based on 2005 GDP and PPP exchange rates. <sup>2</sup> Argentina, Brazil, Chile, China, Colombia, the Czech Republic, Hong Kong SAR, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, the Philippines, Poland, Russia, Singapore, South Africa, Taiwan Province of China, Thailand, and Turkey; for China, one-year lending rate. <sup>3</sup> For Hong Kong SAR, Singapore, and Taiwan Province of China, money market rates. <sup>4</sup> Argentina, Brazil, Chile, Colombia, Mexico, and Peru. <sup>5</sup> Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore (three-month market rate), Taiwan Province of China, and Thailand.

Sources: IMF; Bloomberg; JPMorgan Chase.

<sup>1</sup> Lorenzo Bini Smaghi, “Monetary Policy in Challenging Times,” speech, London, November 19, 2009.

<sup>2</sup> William White, “Is Price Stability Enough?” *BIS Working Papers*, No. 205, 2006.

- On the prudential policy side, the biggest risk to long-term financial stability and sustainable economic growth would arise if the regulatory reform of banks' capital and leverage were sidetracked.

Some representatives of the banking industry have raised objections to the planned strengthening of capital requirements and the introduction of a leverage ratio as a supplement to the risk-based capital requirement framework to contain the build-up of leverage in the system.

I know that the regulatory authorities will remain firm on these two fronts. Some banks don't seem to "get it," and are still promising returns on equity of 20 percent or above to their shareholders. Excessive leverage and risk-taking can no longer be the way to deliver on such promises. They must be grounded in sound, sustainable business models that are robust over a full cycle.

To summarize, we need to embed exit strategies in an overall financial stability framework ensuring consistency across all the elements: unwinding of exceptional fiscal and monetary policies and strengthening of macro- and microprudential approaches to financial supervision.

### **International coordination of unwinding**

Let me finally move to the discussion of the elements of unwinding in which international coordination is essential.

The exit from monetary and fiscal stimulus will have to take into account domestic economic conditions and will therefore be essentially a national decision. That said, G-20 governments have been signaling coordinated fiscal stimulus for the past 18 months. This suggests that coordinated signals should symmetrically be expected in the direction of fiscal consolidation. On the monetary policy side, where decisions are also national, the interest rate cuts announced jointly by central banks on October 8, 2008 were an unprecedented collective action with a powerful signaling effect.

The intensity of the cooperation among central banks was also reflected in the reciprocal bilateral swap lines established to address cross-border foreign currency liquidity shortages. These arrangements will expire early next year, and a smooth coordinated unwinding can be expected.

More generally, the central banking community will continue to make use of existing cooperation forums—especially the committees hosted by the BIS (e.g., the Committee for the Global Financial System and the Markets Committee)—to share information and perspectives on the unwinding of unconventional interventions.

Regarding exit from government financial sector support, international coordination is crucial because of the global nature of large and complex financial institutions and the knock-on effects on other countries.

This is particularly the case for deposit insurance. Disengaging from extraordinary depositor protection measures requires strong international coordination, a good example of which is the initiative taken jointly by Hong Kong SAR, Malaysia, and Singapore to coordinate the exit from the full deposit guarantee.

Another area requiring strong international coordination is the removal of guarantees on wholesale bank liabilities, which may not be a smooth and easy process. The introduction of

these measures in the urgency of the crisis was poorly coordinated internationally as regards the fee structure, pricing, and subsidy element of the guarantees.

Among financial institutions, there are differing degrees of dependence on public support. Weaker banks continue to rely on government facilities, while stronger institutions are again able to fund themselves in the senior unsecured bond market. Although it is justifiable for markets to discriminate among financial institutions and to rank (tier) financial institutions according to their dependence on public support, those processes carry a risk: they might in turn lead to pressures toward a new wave of consolidation and even more concentration in the financial sector, thus aggravating the “too big to fail” problem. This means that prudential supervisors have to do everything they can to deal with weak institutions by continuing the process of disposing of bad assets, raising capital, and downsizing where necessary.

In addition, international coordination among market regulators could be useful in directing special attention in this period to the integrity of the information related to financial institutions, ensuring that the tiering assessments floated in the markets are based on solid facts and disclosures and not on rumors or stigma. International coordination in the domain of market integrity and fair competition within the financial sector is also essential to counter any temptation toward “financial protectionism” or promotion of national champions. Finally, internationally agreed prudential standards and their coordinated implementation are essential to ensuring a level playing field, as is the role of the Financial Stability Board in promoting coordination among the standard-setting bodies involved in global regulatory reform.