BANK FOR INTERNATIONAL SETTLEMENTS

Dealing with a balance-sheet recession

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Introduction

- Objective:
  - Explore link between private debt, public debt and financial instability in the aftermath of a financial boom gone wrong
- Question
  - How should policy respond to a balance-sheet recession?
- 3 takeaways
  - Balance-sheet recessions are very different from normal recessions
  - Key policy challenge: address head-on debt and capital stock overhangs through balance sheet repair
  - Traditional rules of thumb for prudential, fiscal and monetary policies need reconsideration
- Roadmap
  - Background: what is a balance-sheet recession?
  - Policy response: prudential, fiscal and monetary (PP, FP, MP)
  - Global considerations in context of asynchronous financial cycles

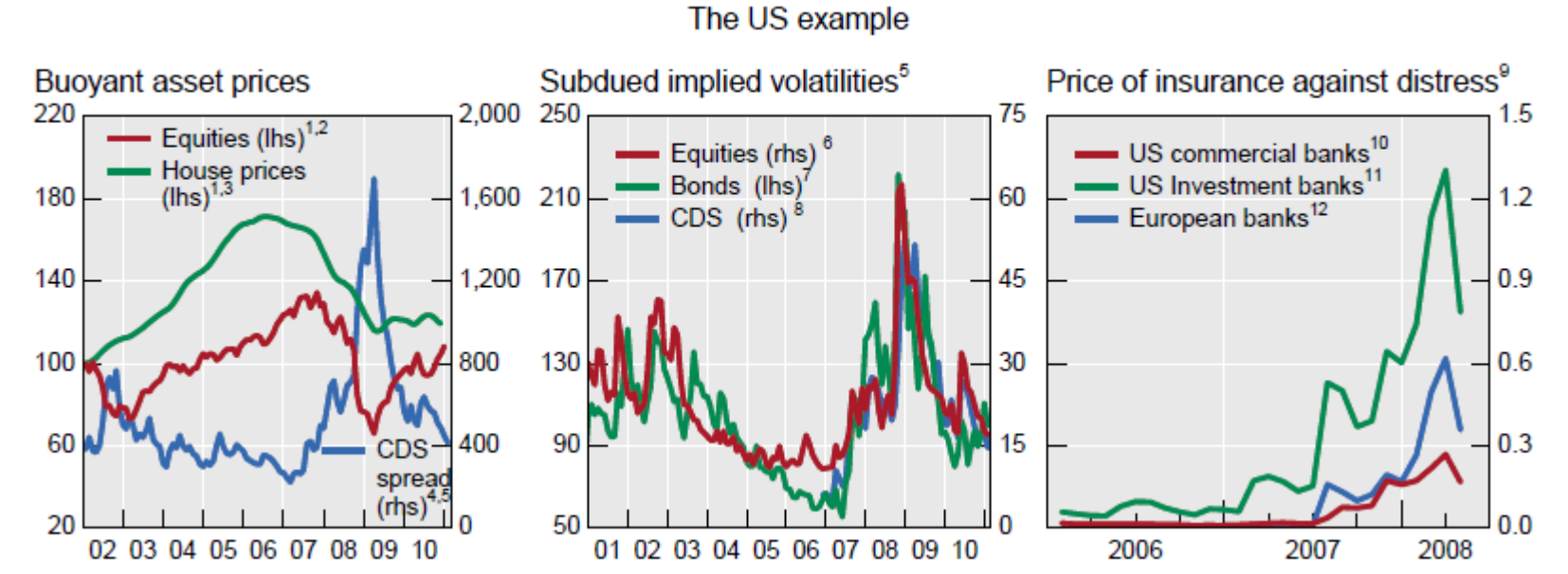
I – Background: financial boom and bust

- Recent recession: major financial cycle bust against backdrop of low inflation
- Very different from typical post-war recession triggered by a MP tightening to constrain rising inflation:
  - Preceding expansion/boom much longer
  - Following debt, asset price and capital stock overhangs much larger
  - Financial sector much more impaired
    - Japan in the early 1990s is closest equivalent
- Historical evidence indicates that these busts
  - Coexist with permanent output losses
  - Are followed by weak recoveries
- Why? Most likely this reflects a mixture of
  - Overestimation of potential output and growth during the boom
  - Misallocation of resources, notably of capital, during that phase
  - Oppressive effect of the subsequent debt and capital stock overhangs
  - Disruptions to financial intermediation

I – Background: limited room for manoeuvre

- Policy room for manoeuvre is greatly constrained
  - PP: no capital and liquidity buffers to draw down
  - FP: deficits typically balloon
    - possibly even threatening a sovereign crisis
  - MP: interest rates start from relatively low levels
- This is no coincidence: systematic result of response to financial boom
  - PP: financial boom flatters the financial institutions' accounts
    - "Paradox of financial instability":
      - Market and accounting indicators of risk look stronger…
      - …as the unsustainable financial boom proceeds
    - Act as contemporaneous, not leading indicators of financial distress
  - FP: financial boom flatters the fiscal accounts (one-off unsustainable revenues)
    - Overestimation of potential output and growth
    - Structure of revenues
    - Unrecognised build-up of contingent liabilities
  - MP: fails to respond to the build-up of financial imbalances

Footprints of the paradox of financial instability



[1] End-2001 = 100. [2] S&P 500. [3] S&P Case Shiller index, 20 cities. [4] Five-year on-the-run CDX.NA.HY 100 spread. [5] In basis points. [6] VIX index (implied volatility on S&P 500). [7] MOVE index (implied volatility on treasury options). [8] Implied volatility on the 5-year-on-the-run CDX.NA.HY 100 spread. [9] In per cent, based on CDS spreads. Risk-neutral expectation of credit losses that equal or exceed 15% of the corresponding segments' combined liabilities in 2006 (per unit of exposure to these liabilities); risk-neutral expectations comprise expectations of actual losses and attitudes towards risk. Taken from Tarashev and Zhu (2008). [10] Ten banks headquartered in the United States. [11] Eight banks headquartered in the United States. [12] Sixteen universal banks headquartered in Europe.

Source: Borio (2011), based on Bankscope; Bloomberg; Datastream; JPMorgan, Markit; Tarashev and Zhu (2008); author's calculations.

II – Addressing the bust: two phases

- Distinguish two phases
  - Crisis management (CM) and crisis resolution (CR)
- Priorities
  - CM: prevent the implosion of the financial system and economy
    - Use room for manoeuvre for aggressive responses
  - CR: balance-sheet repair to lay basis for a self-sustained recovery
    - Adjust policies accordingly
- Good example: Nordic countries
  - Despite limited room for expansionary MP and FP (external crisis)
  - Promoted quick and self-sustained recovery after recession
- Bad example: Japan
  - Had much more room to expand but experienced lost decade
  - Postponed balance-sheet repair

II – What did the Nordics do?

- CM phase: prompt and short
  - Stabilised financial system (liquidity support; guarantees)
- CR phase: addressed balance-sheet problems head on
  - Enforced comprehensive loss recognition (write-downs)
  - Recapitalised institutions (subject to tough tests)
  - Sorted institutions based on viability
  - Dealt with bad assets (including disposal)
  - Reduced excess capacity in the financial system
  - Promoted operational efficiencies
- Implications
  - Need for public money
  - Need for forceful approach (address conflicts of interest)
    - Degree of public control is inevitable

II – Pitfalls of prudential policy

- Pitfall: focus exclusively on recapitalising banks with private sector money without enforcing full loss recognition
  - To prevent a credit crunch/deleveraging
- Why?
  - Fails to reduce cost of equity (and funding more generally)
  - Can generate wrong incentives
    - To avoid recognition of losses
    - To misallocate credit
      - Keep afloat bad borrowers (ever-greening)
      - Charge higher rates to healthy borrowers
      - Bet for resurrection
- In CR phase, when reduction in overall debt and asset prices is inevitable
  - Issue is not so much overall amount of credit…
  - …but its quality (allocation)
    - Form of "hysterisis"

II – Pitfalls of fiscal policy

- Pitfall: risk of weakening further fiscal positions
  - Not using available (scarce) ammunition efficiently

- Better to use available fiscal capacity to address balance sheets head-on…
  - To absorb losses/inject strength in private sector balance sheets
  - Calls for substitution of public for private sector debt (eg, debt relief)
    - Buck for buck much better use of public money
    - eg, (purely illustrative) 20% GDP debt overhang = .5-1% deficit max (2.5-5% interest rate)
- …than pump-priming: one-off effect without doing much for balance sheets
  - Fails to unblock private demand

- Broad-ranging policy action needed
  - eg, to address household debt overhang

II – Pitfalls of monetary policy

- Pitfall: aggressive and protracted easing – interest rate and balance-sheet policy (large-scale asset purchases, liquidity support) – buys time but can delay adjustment
- Mechanisms: it can…
  - Mask underling balance-sheet weaknesses
    - Delay recognition of losses/repayment of debt (if no refinancing option)
  - Numb incentives to reduce excess supply in financial sector and encourage betting behaviour
    - Encourage risk-taking in trading/specific sectors (eg, commodities? currencies?)
  - Undermine earnings capacity of financial sector
    - Compress interest margins (low short-term rates, flat yield curve)
    - Create strains in insurance/pension fund sectors (low long-term rates)
  - Atrophy financial markets as central bank takes over intermediation
    - eg, masking/delaying market signals
- … while having limited traction on output
  - No wish to borrow

II – Basic logic and some preliminary evidence

- Basic reason for limitations
  - MP typically operates by encouraging borrowing, boosting asset prices and risk-taking
  - But initial conditions already include too much debt, too high asset prices (property) and too much risk taking
    - Inevitable tension: how policy works and direction economy needs to go
- Recent preliminary empirical evidence
  - Balance-sheet recessions are indeed different
- Approach
  - 24 countries since mid-1960s; 65 recessions; 28 financial crises
  - Distinguish recessions (downturns) without and with financial crises
  - Control for various factors (severity downturn, etc)
- Findings: traditional macroeconomic policies are less effective
  - In normal recessions, the more accommodative MP in the downturn, the stronger the subsequent recovery
    - but this relationship is no longer apparent if a financial crisis occurs
  - Similar result for fiscal policy
  - The faster the deleveraging in the downturn with a financial crisis, the stronger the subsequent recovery

III – The exchange rate and global dimension

- MP: any induced exchange rate depreciation can be quite effective
  - Boosts income and output
  - Helps repair balance sheets
- Export-driven credit-less recoveries: typical way out of financial crises
- But
  - Option is less effective for large, more closed economies
  - Can be seen as having a beggar-thy-neighbour character
  - May result in unwelcome capital flows and exchange rate pressures
    - If economic and financial cycles are not synchronised
- Are we seeing this again globally?
  - Several EMEs are seeing serious symptoms of build-up of financial imbalances
    - Real interest rates unusually low globally

Conclusion

- Balance-sheet recessions are different
  - Need to deal with debt and capital stock overhangs directly (balance-sheet repair)
- Traditional rules of thumb for policy are less effective
  - May be adequate for CM but less well suited for CR
  - Buy time but can make it easier to waste it
    - Can delay the necessary balance-sheet adjustment
    - Can make eventual exit harder
    - Can promote imbalances elsewhere in the global economy
- New form of time inconsistency?
  - Responses that seem compelling in the short-run generate costs that build over time
  - Short horizons are key:
    - Risk of making similar mistakes to those that contributed to the crisis in the first place?

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