A SYMPOSIUM OF VIEWS

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E.
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Washington, D.C. 20002
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Yellen *vs.* the BIS: Whose Thesis Makes Better Sense?

For the first time since the monetarist *vs*. Keynesian debate of the 1970s, the economic policy world is in stark intellectual disagreement. At issue is the role of monetary policy and financial bubbles. The most recent annual report of the Bank for International Settlements highlights the limitations of monetary stimulus by the world's major central banks and the dangers ahead from financial bubbles. States the BIS report: "[L]ow interest rates can also have the perverse effect of incentivising borrowers to take on even more debt, making an eventual rise in rates even more costly if debt continues to grow. … [L]ow interest rates do not solve the problem of high debt." Federal Reserve Chair Janet Yellen has been quick to counterattack, arguing that the extraordinary monetary measures taken by the major central banks since the 2008 financial crisis reflect the prudent policy choice. States Yellen: "[W]hether it's because of slower productivity growth or headwinds from the financial crisis or demographic trends … so-called equilibrium real interest rates may be at a lower level than we've seen historically." Former Treasury Secretary Larry Summers adds his thesis that the economy's foundational underpinnings are so weak, financial bubbles may be perpetually necessary for the world to achieve sustainable growth.

Which side offers the more credible policy guide in coming years for the industrialized world economies? The BIS or the Yellen thesis?

More than twenty noted observers weigh in.

The central banks' obsession with short-run stability is misplaced.

HANS-WERNER SINN
President, Ifo Institute for Economic Research, and Professor of Economics and Public Finance, University of Munich

Our banks are no longer what they were a hundred years ago, when they needed a third of their assets as equity capital to convince creditors to lend them money. Under the increasing protection of informal bail-out guarantees by governments and formal deposit insurance schemes, they have become highly leveraged gambling machines with typically only 2 percent to 5 percent equity on their balance sheets, investing in overly risky and correlated assets, distributing the profits to shareholders when they come, and relying on bail-outs when systemic risks materialize. Given that policymakers do not dare risk the collapse of the economy in such cases, they see no alternative to opening taxpayers' wallets.

In the current financial crisis, even central banks helped avoid the losses by providing ample liquidity and taking fiscal risk-absorbing measures. The Fed tripled its balance sheet by printing money to buy huge volumes of assets from private portfolios to sustain their market values and protect the banks and other financial institutions from equity losses ("quantitative easing"). And the ECB allowed the central banks of Europe's six crisis countries (Greece, Ireland, Portugal, Spain, Italy, and Cyprus), which represent 30 percent of the eurozone's GDP, to print three-quarters of its entire money stock, lending it to local commercial banks at below-market interest rates against bad collateral, often even no-investment grade. These policies allowed the banks to gain fat and rescued many zombie banks. However, while aiming at short-run stability, both the ECB and the Fed became part of the commercial banks' long-run gambling strategy. They turned into powerful bail-out institutions, more powerful than all the direct fiscal bail-out and rescue funds taken together. The central bank bail-outs rescued the banks, but encouraged them to again invest the funds savers entrusted to them in dubious uses that otherwise would not be profitable.

Some say this is no problem, as central banks can absorb risks without burdening taxpayers. But this is not true, as taxpayers will either have to compensate for the missing profit distributions of the central banks to the respective governments or will have to bear the cost of outright fiscal transfers to borrowers (such as some local governments in Europe) to prevent the losses from materializing on the central banks' balance sheets. Seen this way, the central banks' free-of-charge lender-of-last-resort insurance is a hidden subsidy for risky and unprofitable investments with taxpayer money, which results in the usual welfare and growth losses for the economy.

There clearly is a trade-off in central bank policies between short-run stability and long-run efficiency of the capital market in terms of allocating savings efficiently to rival uses, and it is hard to judge whether central banks have found the right balance between alternative goals. My impression is that they have been leaning too much towards the short-run stability goal, because their mind-sets were captured by the interests of the financial industry, and because reckless public borrowers were often over-represented in their decision-making bodies. This bias has minimized the probability of a short-term financial crash, but it will also lead to long-run stagnation of the Japanese type, impose substantial risk on public budgets, undermine the stability of society, and reduce the Western world's dynamism. A policy of harder budget constraints placing more weight on long-run incentives might serve society better.

Forget the BIS advice. Yellen makes more sense.

SEBASTIAN DULLIEN
Professor for International Economics, HTW Berlin-University of Applied Sciences, and Senior Policy Fellow, European Council on Foreign Relations

At the moment, central banks should continue to run a very lax monetary policy until the major developed economies have reached a self-sustained point in the economic recovery. The notion that central banks should keep their interest rates at an elevated level because excess liquidity could cause new speculative bubbles and endanger financial stability is misguided on at least three counts.

First, empirically, the link between low interest rates and financial market bubbles is highly shaky. If we look at the large bubbles of the twentieth century, at least two major ones cannot be associated with particularly low interest rates. The stock market bubble in the late 1920s developed at a time of moderate real interest rates. While the Fed lowered its discount rate to 3.5 percent for a while in 1927, this was not very low in real terms as prices were actually falling. Moreover, the Fed reversed course pretty quickly at that time, so interest rates did not remain that low for long. Also, the stock market bubble of the 1980s developed against the background of rather high interest rates—the federal funds target rate was between 6 percent and 8 percent when stock market prices took off in the second half of the 1980s. There is no convincing evidence that low interest rates in an environment of sluggish growth actually produce bubbles.

Second, there is no real alternative to low interest rates now. No matter whether we have moved towards a fundamentally lower equilibrium interest rate or whether we are in a prolonged cyclical weakness, low interest rates are warranted. If we are faced with lower equilibrium interest rates, then keeping central bank rates excessively high will ultimately push the economy into deflation. If equilibrium interest rates have not changed, but we are only in an extended cyclical trough, then keeping interest rates high would prevent a swift recovery.

Third, what really endangers debt sustainability and financial stability is deflation, not low interest rates. If the opponents of lax monetary policy fear that low interest rates lead to higher debt levels, they should remember that debt sustainability is about the relationship between nominal debt and nominal income. Deflation is a process which most certainly brings up the debt-to-income ratio as debts are fixed in nominal terms while nominal incomes contract in a deflation. If one compares the United States and the euro area in the years just after the global economic and financial crisis after 2008, one can see that the U.S. economy deleveraged much more quickly than the euro area because the U.S. Federal Reserve was running a more expansionary monetary policy than the European Central Bank.

Thus, acting on Yellen's hypothesis clearly makes more sense than following the BIS advice.

Policymakers should avoid the trap of a "monetary illusion."

JACQUES ATTALI

President, PlaNet Finance, and former President, European Bank for Reconstruction and Development

In 2001, in the aftermath of the dot-com bubble bursting, the U.S. Federal Reserve decided to lower its rates in order to spur economic activity and employment. Global growth then resumed, fueled by the rising indebtedness of all actors. On the U.S. real estate market, a housing bubble and a credit bubble built up.

In 2008, the bursting of these bubbles triggered a new global crisis. To address its consequences, the central banks of advanced economies have resorted to a set of conventional and unconventional monetary decisions which have brought their policy rates close to the zero bound, and their balance sheets to an aggregate $10 trillion.

Today, all of them are, to some extent, facing the same conundrum: engaging in policy normalization too early might stifle a fragile recovery, while maintaining an accommodative stance for too long may favor the build-up of financial imbalances in the long run, which "has happened often enough in the past," according to the BIS.

Hence the debates on the necessity and desirable pace of interest rate increases, which in turn raise the question of rates' equilibrium level and of the "right" policy rules and inflation targets.

While these issues need to be addressed, the importance that they are taking in the public debate and the high expectations which are placed upon central banks' decisions should not lead citizens and policymakers to overlook one key observation: recovery is not here yet, and monetary policy cannot bring it alone.

First, monetary policy transmission mechanisms are broken, especially in the euro area: low interest rates fail to entice banks to lend to the private sector and firms to invest. Diverted from its objectives, further easing may therefore end up reinforcing dangerous resource misallocations.

Second, monetary policy cannot suffice to address core economic imbalances. Advanced economies' debt burdens remain stubbornly high: the debt of their non-financial sector has been standing at about 275 percent of GDP since 2009. General government gross debt still accounts for 106 percent of GDP in the United States, and 96 percent in the euro area. Structural reforms to restore fiscal sustainability are therefore urgent, and the favorable financing conditions that sovereigns currently enjoy should not be seen as an opportunity to elude them.

Last but not least, the key to recovery is to kick-start investments. In particular, European infrastructure projects—in energy, telecommunications, transportation, and other areas—are sorely needed, but they will not materialize without strong political will.

Policymakers should therefore be careful not to fall into the trap of a new "monetary illusion": if such reforms and investments are not undertaken with courage and persistence, especially within the framework of a united euro area, no other actor will be able to lay the foundations for solid and sustainable growth.

I share the BIS's concerns.

JÖRG ASMUSSEN

Deputy Minister of Labor, Germany, and former Member of the Executive Board, European Central Bank

The question of which institution—the Fed or the Bank for International Settlements—is pursuing the right strategy on monetary policy is of increasing importance for Europe since the European Central Bank appears to be following in the Fed's footsteps, at least in terms of using the prime rate.

Among the factors that might explain why these strategies differ are the respective mandates assigned to the central banks. While the ECB has a primary mandate, which is price stability, the Fed has a dual mandate that includes employment as well as price stability. As the central bank of central banks, the BIS itself is not active in the operational sphere and therefore has no operational mandate to fulfill. However, in recent years the BIS has focused its work on financial stability. Part of the dispute may thus be explained by the possible conflict of objectives: price stability versus financial market stability. For the ECB, there is a clear hierarchy of objectives and, where necessary, price stability takes priority over financial market stability. But this is not so obvious with other central banks. The fact that the conflict of objectives can be real is shown by the most recent interest policy decisions taken by the central bank of Sweden.

A second factor for understanding why the respective policy strategies differ—and in my opinion a key factor—is differing time perspectives in conjunction with different explanations for the causes of the sluggish growth. In my view, the Fed tends more to argue within a short-term framework, with little attention to the danger of possible spill-over effects on the rest of the world, while the BIS takes more of a long-term perspective and keeps the global monetary system in mind. The basic argument of the Fed is that a major output gap exists and that it must be remedied through an expansive monetary (and fiscal) policy. The Fed negates the question of whether the financial crisis has resulted in a structurally lower growth path that cannot be increased through expansionary policies. If such an output gap existed, lower interest rates would be the correct policy to choose for the present moment. But we have here a trade-off with financial market stability. The longer interest rates remain at very low levels, the greater the risk of faulty incentives for borrowers and investors—in short, for financial market stability.

Complicating the matter are the somewhat different positions taken by Europe and the United States on public and private debt and on the demographic trend. Viewed in overall terms, the United States is younger than Europe and the debt issue is more nuanced: The level of public debt in the United States is higher than in the eurozone, but the range within the eurozone is broad; the level of private debt varies among households, corporations, and the financial sector. An older population tends to lower the equilibrium interest rate; higher indebtedness makes economies vulnerable. One approach to solving the problem could be to extend the range of instruments to include measures beyond interest-rate policy. Efforts against bubble formation and savings misallocation can also be undertaken—and possibly in a more targeted manner—through financial market regulation, macro-prudential instruments (such as loan-to-value ratios), and better bank supervision.

In consideration of all the arguments, differing mandates, and varying starting positions, my choice is to support the viewpoint of the BIS. There are good reasons why central banks are not subject to the electoral cycles of the political world. That allows—and requires—them to attune their action to the longer term and to call attention to the long-term risks of policy strategies. What is correct in the short term can create long-term risks. At some point, the side effects of a correct therapy can become counterproductive. It is, and will remain, the art of monetary policy to find the right point in time for changing gears and sharing this knowledge with the markets.

In the short run, Yellen is correct. But the BIS has a valid long-term point.

MOHAMED A. EL-ERIAN
Chief Economic Adviser, Allianz

Both Janet Yellen and the Bank for International Settlements have valid arguments. It is a matter of timing and sequencing; and, I suspect, the two could well be proven right over time. Let me explain.

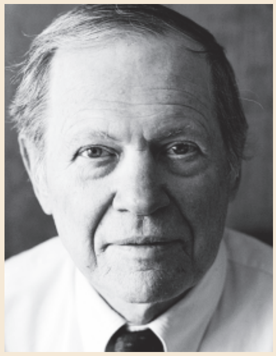
Yellen is correct in stating that exceptional monetary policy accommodation is needed to help the Fed meet its dual mandate of maximum employment and price stability. Like many others, she regrets that a heavy burden is being placed on central banks around the world as a result of the political polarization and dysfunction that frustrates the deployment of a comprehensive policy response. And like Ben Bernanke, her predecessor at the Fed, Yellen recognizes that the institution she leads is navigating a tricky and uncertain combination of "benefits, costs, and risks."

One of these risks is that of future financial market instability, a threat that worries the BIS and many others—especially after the 2008 global financial crisis almost tipped the world into a multi-year depression.

The BIS is correct in worrying that central bankers who have inevitably been forced to use imperfect policy instruments for the task at hand are now excessively reliant on financial markets to meet the economic objectives. They have bolstered valuations to artificially high levels in the hope that this will encourage more consumption and investment that, in time, would validate market prices.

Yellen is being proven right over the short term. Having brilliantly overcome the global financial crisis, the continued application of unconventional Fed policies has helped—and is helping—to create more jobs and counter the threat of deflation. But due to political circumstances that inhibit other government entities from stepping up to their responsibilities, the policy-induced economic recovery has fallen short of "escape velocity," and will continue to do so absent a change in the political environment. Meanwhile, many investors have been encouraged to take on lots and lots of risk, comforted by the notion that the Fed is the markets' best friend, and will effectively remain so.

If other government entities remain on the sideline, today's market valuations could—down the road—prove not just excessive, but also irresponsible and harmful to the economic wellbeing of current and future generations.



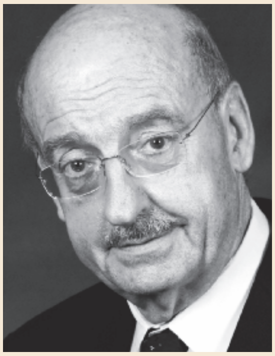
The advantages of the Yellen position outweigh the disadvantages pointed out by the BIS.

RICHARD N. COOPER
Maurits C. Boas Professor of International Economics, Harvard University

Policy involves choices among feasible alternatives. (Strategic policy alters the range of the alternatives.) Most possible actions typically have both advantages and disadvantages. Not surprisingly, there is some merit both to the Yellen position and to that of the Bank for International Settlements (which historically has given warnings about monetary policy and credit conditions whatever they were).

In the current conditions in the United States and in the world at large, I believe the advantages of the Yellen position outweigh the disadvantages pointed out by the BIS—with the important caveat that the Federal Reserve is not now deciding policy "for the coming years." The Federal Open Market Committee, which determines most dimensions of monetary policy for the United States, meets every six weeks—more often if necessary—and evaluates both the state and the direction of the U.S. economy afresh, as it should do. If conditions warrant, policy will be changed, as it should be. Despite its forward guidance, the Federal Reserve is not, and should not be, writing contracts for the coming years. It is determining monetary policy on the basis of its collective judgment about what will be desirable in the coming months, knowing that if conditions turn out to be significantly different from those foreseen at the time of each decision, it can subsequently change course.

It may be correct, as former Treasury Secretary Lawrence Summers has suggested, that private investment now and in the years ahead falls short of the desired levels of savings around the world, leading to a stagnant world economy and historically low long-term interest rates. Endorsing financial bubbles is surely not the best way to overcome deficient global aggregate demand, especially given the extensive and widely acknowledged need to build new and even to maintain existing infrastructure around the world. If private capital cannot do the job unassisted, surely there is a case for expanding the lending (and associated borrowing) of the World Bank and of the regional development banks to help finance infrastructure. In this respect, the new China-initiated infrastructure bank is to be welcomed, not least as providing a constructive outlet for China's outsized reserves. In his recent book, however, William Janeway suggests a different role for financial bubbles: some irrational exuberance may be necessary to finance zany new ideas, leading to the Schumpeterian creative destruction that provides the basis for modern progressive capitalism.



The BIS view is not without merit, but an abrupt Fed tightening is too risky.

JOHN H. MAKIN
Resident Scholar, American Enterprise Institute

The biggest question facing investors, producers, and households in today's low volatility, yet largely trendless, global economy is this: Will we witness the bursting of the "mother-of-all-bubbles" that creates global economic chaos as the Bank for International Settlements suggests in its June report? Or, alternatively, will the current Yellen Federal Reserve path of holding the federal funds rate at zero for a "considerable period" after the asset purchase program ends enable the Fed to successfully exit its extraordinarily easy money policy?

It is important to approach this question with humility. At the very least, deciding between the stances of Yellen and the BIS on correct policy now, almost six years after the Lehman bubble, requires understanding what happens in markets when a bubble bursts.

The main result of a bursting financial bubble and attendant falling prices of financial assets is a surge in the demand for cash/liquidity among households, producers, and financial institutions, many of which are experiencing runs on their deposits. Cash means unconditional liquidity which is quite scarce at all times but virtually unobtainable after a bubble has burst. In monetarist terms, where the growth of money plus the growth of velocity equals the growth of nominal GDP, velocity collapses as less liquid assets are dumped to raise cash. The result is the equivalent of a collapse in the money supply just as the money supply itself is being cut by a surge in disintermediation as depositors flee banks.

Therefore, a bursting bubble, and the ensuing collapse of liquidity, creates an unstable, self-reinforcing downward spiral in asset prices and economic activity. Absent aggressive money printing by the central bank, financial panic ensues. The United States faced financial panic after the September 2008 collapse of Lehman Brothers. The Fed responded by printing money and by March 2009, financial markets began a strong recovery. The real economy would not have achieved sustained growth absent large doses of fiscal and monetary stimulus.

Now, six years later, the fiscal stimulus has been over for nearly two years and monetary stimulus is being reduced by way of a "tapering" of Fed asset purchases and the Fed signaling that the federal funds rate will start to rise in a year or so.

Yellen is betting that growth will rebound before a rise in inflation forces a Fed tightening to cut the inflationary excess supply of cash. Lacking evidence of inflation, the BIS view is that too much cash has already boosted prices of risky assets too high so that when/if fighting inflation forces the Fed to tighten, asset markets will collapse as the demand for cash resurges. The Fed, under this scenario, will be seen to have created a bubble that bursts once a predictable rise in inflation forces it to tighten.

Alternatively, the Fed, facing a collapse of asset prices, may delay tightening even in the face of rising inflation. The result would be a rise in inflation expectations, accompanied by a further surge in the demand for risky assets and for goods and services. The economy would boom for a time, but the bubble would grow even larger, only to create even more chaos once the Fed is forced to tighten to avoid a potential inflation spiral.

First, we need to admit that we still don't know how to exit the extreme monetary accommodation required to avoid a financial and economic collapse after a crisis like that which hit the U.S. financial market in September 2008.

Second, the most formidable exit problem lies with timing and pace. Yellen critics say that the time to have begun exiting has already passed, but persistent sub-trend growth and sub-target inflation raises serious questions.

Third, the Yellen approach obeys a basic rule of policy. When you don't know what will follow from an attempt to employ monetary policy to deflate a bubble, proceed with extreme caution unless/until rising inflation forces your hand. BIS's suggestion that asset prices are too high and thereby suggesting an even larger future bubble is not without merit, but an abrupt Fed move toward more tightening risks a sharp drop in asset prices, creating even more instability than that felt during the May 2013 "taper tantrum."

Going forward, humility and caution are crucial. A Schumpeterian "cold shower" market cleansing could just be too risky, especially given that U.S. demand (final sales) growth averaged a very weak 0.65 percent during the first half of 2014. Based on what we know about cold showers during the Great Depression, the pain for a weak economy from an abrupt cold shower could exceed that from an overextended warm bath of monetary accommodation.

A huge body of evidence supports the BIS. The Fed is a cheerleading squad for the Obama Administration.

CHARLES W. CALOMIRIS
Henry Kaufman Professor of Financial Institutions, Columbia University Graduate School of Business

There is a huge body of evidence from academic studies backing up the BIS view. Detailed and highly credible academic studies of many countries, including the United States, conclusively show that accommodative monetary policy of the kind being pursued in the United States today results in thin yield spreads, high prices of risky assets, excessive bank lending, and low equity risk premia. In the United States, it is likely that we are already experiencing bubbles in commercial real estate, farmland, and corporate bond markets, and possibly in equity markets and variable annuities. Insurance companies are leading the charge in the search for yield, as they arbitrage their regulatory capital standards with clever new techniques invented by…you guessed it…Goldman Sachs.

The convoluted logic of Yellen's and Summers' far-fetched justifications is best seen as rhetorical cover for the imprudent actions of the most politicized and dovish Fed in several decades, and for its cheerleaders in the Administration. The road ahead likely will see continuously rising asset price bubbles, rising inflation (as the Fed, under political pressure, will probably fail to contract its bloated balance sheet fast enough as bank lending expands), and eventually a denouement of asset price falls, persistently higher inflation, and financial and macroeconomic instability as market participants run for cover from a feckless and discredited Fed. The Fed no doubt will use the next wave of bad news, as in the past, to argue that it needs more power so that it can ensure stability.

Buy gold.

The BIS position is a counsel of despair.

J. BRADFORD DELONG
Professor of Economics, University of California at Berkeley

I do not really understand where the Bank for International Settlements is coming from. Its view seems to have some similarity to Larry Summers' "secular stagnation" thesis—but while Summers' argument calls for higher interest rates and also calls for more aggressive regulatory oversight and for not fiscal austerity but instead substantial fiscal expansion, the BIS does not go there. But if the BIS is not Summers, what is it? Another possibility is that the BIS position is a counsel of despair: that since for rent-seeking and regulatory capture reasons the risk regulators will not do their job to guard system stability, the monetary authority dares not do its job of balancing the supply of liquid assets to demand at full employment. But if that is what the BIS position is, it could say so much more clearly.

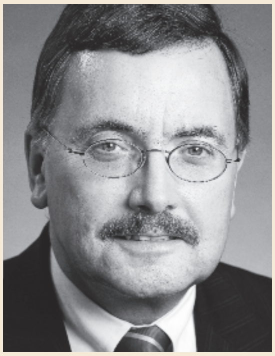
History is not likely to be kind to the Fed.

PETER R. FISHER
Senior Fellow, Center for Global Business and Government, Tuck School of Business at Dartmouth

Chairman Yellen may be correct that short-term interest rates are likely to be at the lower end of historical experience. But this does not justify the Fed's policy of pinning the risk-free rate at zero.

The Fed's actions continue to be premised on the reasoning that only current evidence of excessive inflationary pressures or of financial instability should limit its use of interest rates to stimulate current demand in pursuit of maximum employment. But if demographic and other headwinds have put us on the path of declining propensities to consume and to borrow, and we continue to borrow consumption and investment from the future as the Fed intends, when we get to the future we are likely to find less consumption, investment, and income and more debt and output than we expect—exactly a prescription for deflationary pressures. The Fed is simply assuming a favorable intertemporal trade-off and ignoring the possibility that their actions are contributing to deflationary pressures rather than avoiding them.

We won't know for some time whether this will end in another episode of financial instability or, less dramatically, in a future with a lower potential growth path, lower net savings, and a tragic decay in the capital–output and capital–labor ratios. With their eyes apparently shut to the risk of these perverse consequences of their policies, history is not likely to be kind to the Fed.



The BIS is right on the mark.

JÜRGEN STARK
Former Member of the Executive Board, European Central Bank

The Bank for International Settlements has repeatedly warned of the consequences of continuing a low interest rate phase too long and of abundant global central bank liquidity. It was the only international institution to have already pointed out the potential consequences of monetary policy being too accommodating prior to 2008. The BIS saw too great an appetite for risk, inadequate pricing of risks, and exaggerations in some financial market segments. And it demanded a policy correction.

The IMF and OECD continue to argue the case for continuing the ultra-loose monetary policy that western central banks have been pursuing since 2008, particularly after 2009. At most, they recommend an extremely careful exit from this policy. The BIS is again the only international institution that considers current monetary policy inadequate and has pointed to the consequences of the continuing extremely loose monetary policy.

It was to be expected that the western central banks would not share the BIS's thesis. This is because the BIS questions the rationale of the monetary policy the central banks have been following since 2009–2010. Western central banks' criticism of the BIS's stance therefore was and is fundamental in nature. In particular, the BIS thesis is accused of lacking a convincing theoretical and analytical foundation. Right now, they say, the central banks need to stimulate aggregate demand and thus economic growth with negative real interest rates.

But this policy approach itself stands on very dubious analytical foundations. None of the mainstream econometric models predicted the development of the bubble before 2008 or the consequences of the collapse of Lehman Brothers, particularly the deep global recession. Moreover, the models used in monetary policy today cannot be used either to predict or to check the effectiveness of central bank decisions.

What western central banks did in 2008 was completely justified. But in 2009 and 2010, the central banks changed both their role and their objectives. They started an unparalleled monetary policy experiment. With innovative measures, the Federal Reserve and Bank of England demonstrated that they are not powerless to practice extremely loose monetary policy after reaching the zero lower bound. The European Central Bank took on the role of lender of last resort for countries in the euro area.

Short-sighted experimentation in crisis management supplanted monetary policy rules and strategies. The western central banks have thus lost their compass that is supposed to give them reliable medium-term orientation in monetary policy. "Forward guidance" is no replacement for this. The repeated changes of objective signify how arbitrary monetary policy has now become. Every argument is used to justify a continuation of ultra-loose monetary policy.

The BIS is right, the supply side is crucial. The return to sustainable growth requires a broad policy approach with a stronger focus on correcting balance sheets and economic reforms. Structural problems cannot be solved using loose monetary policy and fiscal stimulus. The decreasing effectiveness of monetary policy is proof of that. Growth at all costs through inflation is not the solution. It just encourages new imbalances and exaggerations. In order to achieve a self-sustaining economic recovery in the crisis countries and strengthen growth potential, barriers to growth need to be removed.

The central banks have fed the illusion that they alone can solve economic problems through further experimentation. They have fueled expectations and are thus overextending themselves. Although central banks can alleviate problems in the short term, they are laying the foundations for new crises with their short-sightedness. As the influential economist Ludwig von Mises said, "[T]he task of economics is to foretell the remoter effects [of a measure], and so to allow us to avoid such acts as attempt to remedy a present ill by sowing the seeds of a much greater ill for the future."

I side with the BIS.

WILLIAM R. WHITE

Chairman, Economic Development and Review Committee, OECD

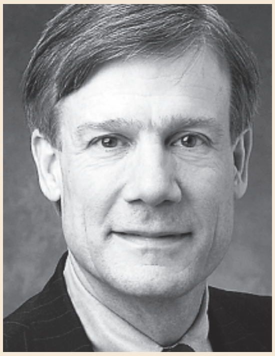
This year's BIS Annual Report was widely interpreted as an attack by the BIS on the easy monetary policies being followed by major central banks. This is unfortunate since there is much more that unites the BIS and their shareholders than divides them. All parties have stated repeatedly that monetary policy alone cannot restore "strong, sustainable, and balanced growth." They echo John Maynard Keynes' *General Theory* as he repudiated his earlier policy proposals in the *Treatise on Money*. Prominent central bankers have repeatedly stated that monetary policy can only "buy time" for governments to implement policies that will directly address the fundamental problem of over-indebtedness. We collectively face a solvency problem that the provision of liquidity by central banks simply cannot solve.

Differences do arise when it comes to evaluating the risks associated with today's unprecedented monetary measures. The BIS, rightly, stresses that the ratio of non-financial debt to GDP in the G20 is now 20 percent higher than in 2007. As well, the prices of many financial assets and sometimes property prices have risen to levels reminiscent of 2007. Should global growth not rebound to justify these valuations, more likely given the headwinds of increased debt, a period of significant financial instability and potentially deflation awaits. Less likely, global growth could accelerate as desired, but this raises the possibility of a disorderly exit path for monetary policy threatening inflation and then recession.

In sum, the BIS is concerned about the medium-term risks of tightening policy "too late," whereas a number of central banks worry more about the shorter-run implications for demand of tightening policy "too early." I side with the BIS in suggesting that the former set of concerns have been systematically underestimated for years by shortsighted economists, politicians, and financiers alike. That is why we are in our current uncomfortable position in the first place. More of the same cannot be the answer.

What should governments do then? First, thoughtfully planned increases in public sector investment would simultaneously raise demand, increase supply potential, and possibly induce more private investment in the advanced economies. Second, government measures to support consumer spending are clearly warranted in a number of countries, China and Germany in particular. Third, orderly debt restructuring and outright forgiveness must be used much more aggressively to avoid disorderly and more costly outcomes. Legal reforms must support this objective, not least on a cross-border basis. Finally, supply side reforms, including in the services sector, should be systematically pursued. This will over time increase growth, raise debt service capacity, and potentially lower trade imbalances.

Governments will find these policies hard to implement. Indeed, that is precisely why monetary policy has become "the only game in town." Yet, as the benefits of these monetary policies diminish, and their risks rise with time, governments must eventually do what only they can do. The sooner they face this unpalatable truth, the better.



The BIS ignores a broad sweep of financial history.

JAMES GLASSMAN

Managing Director and Head Economist of the Commercial Bank, JPMorgan Chase & Co.

Calls for central bankers to explicitly consider financial instabilities in monetary (interest rate) decisions broaden a valuable effort to seek lessons from the housing crisis. But calls for central banks to widen their monetary agenda are more theoretically appealing than they are practical.

The BIS position ignores challenges policymakers face *ex ante* to determine what constitutes financial instabilities, which usually are more obvious with the benefit of hindsight. Proposals like that of the BIS, which seem to reflect an underlying belief that markets are inherently unstable, assume that a handful of central bankers are better equipped than market participants to discern financial instabilities. They ignore a broad sweep of financial history showing the housing crisis to be more the exception than the rule. They forget that modern finance didn't invent speculation. They ignore the non-monetary causes of real estate speculation. And they imply that central bankers are distracted by their commitment to employment and inflation mandates.

Fed Chair Janet Yellen wisely argues that the central bank ought to rely on macroprudential—regulatory—tools as the first line of defense against financial instabilities, and that interest rate policy has its hands full with its aim to promote the Fed's dual mandates. Her view builds on a philosophy about the proper conduct of monetary policy that has evolved over the decades at the Federal Reserve.

Two recent financial episodes are instructive. The 1990s bull market in equities could have been seen at the time as a looming financial instability. Many pundits claimed the market was a giant bubble. Price-earnings ratios doubled. That was unprecedented. But had the Fed hiked interest rates in an effort to prick what was asserted to be a stock market "bubble," it would have been a colossal mistake. It didn't take long for business profits to triple and validate the equity market's run.

The 2000s real estate crisis gives Janet Yellen's position more support. The Fed began to hike interest rates in 2004—what advocates of interest rate policies to check financial instabilities now propose. The market understood what was coming and immediately priced in a sequence of tightening moves that would push the funds rate up to 6 percent by 2006. The Fed did just that. But the hike in rates did little to head off real estate speculation. Why? Most of the poorly underwritten subprime adjustable rate mortgages were issued in 2006 and 2007, after the Fed had removed its stimulus. The most popular subprime mortgages were 2/28 and 3/27 hybrid securities—mortgages that locked in low financing costs up front, for two or three years, respectively, with the help of teaser rates. That decoupled borrowers' costs from prevailing market rates and insulated them from the Federal Reserve's rate hikes. The failure to apply prudent regulatory tools—what Yellen's prescription would have been—allowed the crisis to develop. An even more aggressive Fed tightening would not have affected subprime borrowing costs for activities financed by the new exotic products but it would have inflicted more economic distress and would have been analogous to using a sledge hammer to swat flies.

Calls for the Federal Reserve to make financial instabilities more prominent in its interest rate decisions would have distracted the Fed's focus from its principal mandates and probably would have added to economic volatility.

I sympathize with the Fed, but intellectually favor the BIS position.

JIM O'NEILL
Former Chairman, Asset Management, Goldman Sachs International

I have stronger intellectual sympathy with the Bank for International Settlements but in practice, those that are charged with operating monetary policy are bound by the mandates set by their parliaments or governments, and in the case of the Fed, that is the U.S. Congress. So in reality, I sympathize with the Federal Reserve.

Let me explain further. If you analyze the global credit crisis in hindsight or in some cases, thought carefully about the challenges in advance, it seems to me that there is a strong argument to be made that inflation targeting is necessary but not sufficient for monetary policy objectives. Of course, in the case of the Fed, they are mandated to target economic growth consistent with low unemployment also, which means already monetary policy has two targets and arguably only one instrument. Before the crisis for other central banks, many were simply mandated to achieve a certain low inflation target.

But if we are in an economic environment where structural forces lead to persistent downside pressures on inflation, such as the appearance of China as a major player in international trade, it is possibly the case that monetary policy might need to be thought about slightly differently. While some would regard theoretically such an impact as a one-off that will fade with time, I often believed that central banks would be better off having two major foci of monetary policy: inflation targets supplemented by indices of financial conditions, the latter usually including some kind of representation of financial markets such as long-term bond yields and equity performance, as well as an index of house prices. In many economies, such financial condition indices are both a leading lead indicator of future economic activity and, of course, an ongoing indication of possible financial excess. It seems to be that in principle this would allow central banks to keep a closer eye on potential bubbles and the consequences that otherwise may emerge of bubbles bursting.

In reality however, just as we discovered that the demand for money was less stable than monetarist academics believed, there are times when financial condition indices don't hold to their stable predictive relationship either. In addition, unless central banks are mandated to include such indices in their formal objectives, they have a duty, as is the case with the Fed, to primarily pursue the targets they are legally mandated to do.

One way of at least trying to move beyond this dilemma is to consider how regulatory policy and other forms of administered guidance over banking behavior and other forms of finance might help to maintain a greater control over overall financial conditions while at the same time having the prime goal of monetary policy sticking to its role of maintaining low and stable inflation.

As for the notion of lower productivity resulting in a lower permanent level of real interest rates than previously believed, I don't really understand that this requires a more active role from the central bank to keep short-term interest rates low and monetary policy accommodative, as lower productivity and with it, lower long-term economic growth would indeed suggest lower real interest rates, but it is unclear to me why this means anything for monetary policy unless they are trying to deliberately raise real interest rates back to some preconceived historic level, when they should, and usually do, concentrate on nominal interest rates.

The Fed got it right.

LAURENCE M. BALL
Professor of Economics, Johns Hopkins University

The financial crisis and recession of 2008–2009 have done severe damage to the U.S. economy. Today the employment–population ratio is four percentage points below its 2007 level, and output is around 10 percent below the path it was following before the crisis. The priority for macroeconomic policy is to reverse as much of this damage as possible and push the economy toward full employment.

Monetary policy, therefore, should be highly accommodative. It is not clear whether the Fed can provide as much stimulus as the economy needs, given the constraint of the zero bound on interest rates. What *is* clear is that the Fed should not reduce the level of stimulus by raising interest rates any time soon. A premature tightening would likely mean that the ongoing economic slump, already six years old, persists well into its second decade.

The financial crisis has taught us to be wary of unsustainable increases in debt. I do not, however, understand the BIS's view that low interest rates worsen the dangers of debt. In standard economic analysis, low interest rates are benign for debt dynamics. In any case, the BIS's Annual Report points out that, among the possible ways that debt can be contained, "the least painful channel is through output growth." It would be perverse to respond to worries about debt by choking off growth with a monetary tightening.

It would be far better to attack debt problems directly. The financial crisis occurred because of reckless lending practices such as no-documentation and no-down-payment mortgages, which allowed people to take on mortgage debt that they could not repay. To avoid another crisis, we need financial regulators who are vigilant in thwarting the next generation of dangerous lending gimmicks.

We also need regulation that reduces the fragility of financial institutions. A big increase in capital requirements, for example, would reduce the risk that a future upswing in loan defaults is a disaster for the financial system and the economy.

The BIS is exaggerating the dangers.

MARTIN NEIL BAILY
Bernard L. Schwartz Chair in Economic Policy Development and Senior Fellow and Director of the Business and Public Policy Initiative, Brookings Institution

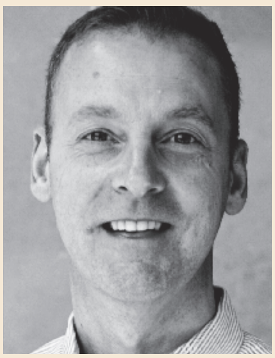
The use of fiscal policy to aid the U.S. recovery has been hobbled by political resistance and budget deficits, deficits that even preceded the recession. The Federal Reserve decided it had to act forcefully, so it held short-term interest rates at zero and also purchased financial assets in an effort to lower longer-term interest rates. Has it worked? Low rates have helped the two key interest-sensitive sectors, housing and autos. Housing construction remains very weak but home prices are recovering. Autos are booming, a bright spot in the economy, adding to growth and investment. Low interest rates also weakened the dollar (relative to what it would otherwise have been), helping exports a little. And perhaps in the worst of the recession it was essential for the Fed to take strong actions to reassure people, otherwise there might have been a much deeper recession.

As of 2014, the risk of a second recession in the United States is pretty low and it is reasonable to ask whether continuing the policy of low interest rates is justified. What are the costs? The immediate cost is that those people and institutions dependent on interest income have been squeezed. Asset managers who buy bonds, such as insurance companies and money market funds, are struggling to earn enough to cover their costs and pay returns to customers. Banks in Europe have seen their interest margins squeezed. Retirees who invested in bonds have seen their incomes diminished.

The cost identified by the BIS is that investors may take on extra risk in an effort to avoid the low-interest-rate squeeze. This is a real concern, but the BIS exaggerates the danger. Following the global crisis, almost all investors became more conservative and bank regulators became extremely conservative. Are there examples of excessive risk-taking today? Certainly. But there is no evidence that the U.S. financial system is in danger of another crisis. Within reason, we want investors to take risks.

The BIS says that low interest rates do not solve the problem of excessive debt. To the extent that low rates help the recovery, they do contribute to a solution to the debt problem by raising both GDP and tax revenue. In the United States, much of the needed household deleveraging has already taken place, with about two-thirds of the adjustment through debt default.

The BIS is correct that monetary stimulus has not been as effective as we would have liked, but it did play an important positive role at a time when fiscal policy was inadequate or perverse. In the United States, we are approaching the time when the cost-benefit balance favors a gradual return to more normal interest rates. The Fed may not get the timing exactly right, but it has done a very good job so far.



The Fed approach makes sense.

JOSEPH E. GAGNON
Senior Fellow, Peterson Institute for International Economics

Janet Yellen is right to resist diverting monetary policy from its primary objective of stabilizing economic activity and inflation.

Everyone agrees that it is essential to fix the flaws in financial regulation and supervision that allowed a dangerous bubble to form, and central banks are uniquely placed to help in this regard. Governments need the right tools to do the job, including the ability to place limits on leverage and to raise capital standards.

Where there is disagreement is over the role of monetary policy in enhancing financial stability. Even if it were clear that loose monetary policy feeds asset bubbles (and my colleague Adam Posen has argued convincingly that it is not), it does not follow that tighter monetary policy is necessarily the right response to a bubble. The damage caused by a bursting bubble arises from the deadweight costs of bankruptcy and the panic engendered by the fear that a counterparty may go bankrupt. The solution is to reduce debt and increase equity throughout the economy and to ensure that systemically important financial institutions are well capitalized.

During the housing bubble, restrictions on leverage needed to be tightened dramatically. But limits on private borrowing would have reduced spending. To prevent the economy from falling into recession, the Fed would have needed to lower interest rates, not raise them, in order to encourage firms and households with healthy balance sheets to spend more.

BIS economists point to historically low interest rates as a sign that policy is dangerously loose. However, there are many reasons why returns on safe instruments should be low or even negative now in real terms. These include deleveraging and heightened risk aversion after the financial crisis, slower growth of working-age populations, continued large capital inflows into advanced economies from governments in emerging markets, and possibly a slower rate of technological progress. (Larry Summers has been making similar points.) When the equilibrium required return on assets is at a historical low, then asset prices of necessity will be historically high. This does not imply that we are experiencing a risky bubble.

Sweden recently provided a clear test of the dangers of diverting monetary policy from its primary function to fight a perceived bubble. Despite inflation below target and no signs of an overheating economy, the Swedish Riksbank raised its policy rate in 2010–2011 out of concern that the debt burden of Swedish households was too high. But the Riksbank was forced to reverse its actions to prevent outright deflation, recently returning its policy rate to essentially zero. Lars Svensson has pointed out that the Riksbank raised the real burden of household debt by undershooting its inflation target, so that its policy tightening may have been counterproductive even in terms of its original financial-stability motivation.

Bottom line, there is no tradeoff between macroeconomic stability and financial stability. Setting monetary policy on any basis other than the stabilization of employment and inflation is more likely to harm financial stability than to help.

Control bubbles with regulatory tools.

JOSÉ DE GREGORIO

Professor of Economics, University of Chile, Nonresident Senior Fellow, Peterson Institute for International Economics, and former Governor, Central Bank of Chile

The global financial crisis was triggered by the bursting of a housing bubble in the context of a highly exposed banking system. The deterioration of lending standards and a process of unfettered financial innovation left the banking sector excessively exposed to the real estate sector. The sharp drop in house prices inflicted serious damage to banks' balance sheets. The combination of rapid credit expansion with soaring asset prices was a key factor in causing the eruption of the biggest financial meltdown since the Great Depression. Its consequences are still being felt in most advanced economies and policies to prevent catastrophes like this continue to be discussed. One highly debated proposal to fight bubbles is to tighten monetary policy.

Let me start by stating that financial stability should be a priority in central banking. Indeed, it has been at the core of action by many central banks in emerging markets, which have dealt with massive financial crises in the past.

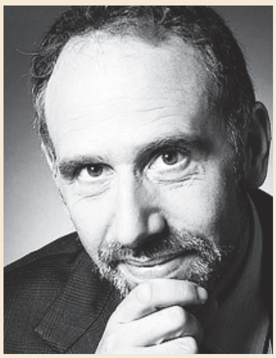
Two issues are at stake. The first is whether central banks should fight bubbles, and second is whether this should be done with monetary policy. Regarding the first question, central banks cannot take the role of bubble-busters, since it is always unclear whether asset prices are responding to fundamentals or to pure speculation. Central banks should be aware of the consequences of sharp fluctuations in asset prices, above all, and possible repercussions on the financial system. Central banks should communicate their views on asset price developments and financial stability, and if necessary apply corrective measures. Action is certainly required when the asset is highly leveraged.

The bursting of the dotcom bubble of the early 2000s caused substantial wealth effects, but its financial repercussions were limited since the banking system was not exposed. Bubbles together with financial fragility are the dangerous combination.

Regarding the second issue, interest rate policies cannot do the job of financial stability. The increase in interest rates required to burst asset price bubbles could be too large, creating unemployment and an unnecessary decline in output and inflation.

This is precisely what advanced economies that have not recovered from the crisis should avoid. A substantial slowdown could actually magnify financial fragility. Therefore, using monetary policy to affect asset prices may be ineffective and deteriorate monetary policy credibility, reducing its ability to secure price stability and smooth the business cycle. This is particularly important in many emerging markets, where the conquest of inflation and the use of monetary policy as an effective countercyclical tool are too recent to spoil.

Central banks should pursue both price and financial stability, but more than one tool is needed to achieve both. If concerns about financial fragility arise, central banks and regulators must apply macroprudential instruments such as changes in credit risk provisions, capital and liquidity requirements, and changes in loan-to-value ratios, among others. Monetary policy should concentrate on price. There is a serious concern about financial vulnerabilities created by low interest rates for too long and the consequent search for yield, but this should be addressed with regulatory tools.



Bubbles are a danger, but hiking rates should be the last option.

DEAN BAKER

Co-Director, Center for Economic and Policy Research and co-author (with Jared Bernstein),* Getting Back to Full Employment: A Better Bargain for Working People *(2013)

To those of us who warned loudly and frequently of the dangers of the stock and housing bubbles, it is striking to see the newfound concern over bubbles at places like the Bank for International Settlements. Bubbles can indeed pose serious dangers to the economy, but for precisely this reason, are they are not difficult to detect.

It was amazing that central banks could not recognize a bubble that pushed house prices in the United States to more than 70 percent above their trend levels at a time when rents were flat in real terms and vacancy rates were at record highs. All this information was readily available from public data sets. And the bubble was having an obvious effect on the economy, with construction at almost 50 percent above its normal share of GDP and the housing wealth effect pushing the saving rate to near zero. It should not have been hard to recognize this bubble, and that its collapse would have a serious negative effect on the economy.

The same was true of the stock bubble in the 1990s. What possible rationale was there for a price-to-earnings ratio that was more than twice its historic average? Did anyone think that stockholders in the late 1990s expected real returns equal to the Treasury bond rate?

The bubbles that move the economy are easy to spot and they can be countered with a range of policies besides raising interest rates. The Fed in particular has enormous regulatory power. It can and should use it to try to stem the growth of a bubble.

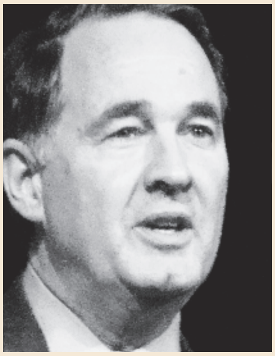
It should also do exactly what Janet Yellen did in her recent congressional testimony. It should use its enormous megaphone to warn of dangerous bubbles, providing solid data and arguments, as opposed to offhand comments about "irrational exuberance." The Fed can force investors to think carefully about the risks they are taking.

Raising interest rates is always an option, but it should be the last option. Slowing growth and needlessly throwing people out of work should never be a casual decision.

There is a fundamental point that does need emphasis. We have seen a prolonged period in which lack of demand is a serious constraint on the economy. This goes against the deeply held conviction of mainstream economists that lack of demand should not be a problem.

We need some serious thinking on how to counter weak demand that goes beyond just monetary policy. Obviously governments can do it with deficit spending. However, a major problem in this period has been the reversal of the textbook story with developing countries becoming major exporters of capital to the wealthy countries. There is no easy mechanism to replace the demand lost from the resulting trade deficits. Reversing these imbalances should be a priority.

Finally, we should be considering measures to reduce supply such as increased vacation time and shorter workweeks. In a world that is demand constrained, we can get to full employment by more evenly sharing the work. If our fundamental economic problem is excess supply rather than scarcity, we should not allow abundance to be a cause for suffering.



The Yellen approach, while successful, will have to change.

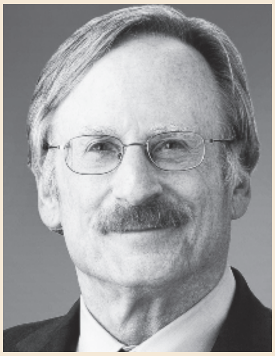
DAVID D. HALE

Chairman, David Hale Global Economics

The divergent views on central bank policy expressed by the Bank for International Settlements and Janet Yellen are temporary. The central banks have boosted asset markets as a way to promote output growth at a time when final demand is weak. This policy has enjoyed some success in the United States and the United Kingdom. Bernanke's monetary policy helped to produce a $26 trillion wealth gain for the household sector through rising equity and residential real estate prices. The Bank of England's policy of boosting property lending has helped to encourage a recovery in the residential real estate market which is boosting consumer spending by driving down the household savings rate.

The boom in financial markets has also had some self-reinforcing effects. The U.S. corporate sector sold $2.3 trillion of bonds after 2009 and used 89 percent of the proceeds to repurchase shares. Capital spending in the United States has suffered from management's obsession with maximizing share prices during a bull market. Yellen's forward guidance suggests that monetary policy will stay accommodative indefinitely, but as the Bank of England's Mark Carney has already demonstrated, forward guidance has to give way to economic reality when circumstances change. He had once promised not to raise interest rates until 2016, but may now have to act before year end because of the boom developing in the British property market.

The U.S. economy has sufficient momentum that the Fed will also have to consider raising interest rates as early as the first quarter of 2015 despite recent forward guidance from the chair. Unemployment will be well below 6 percent and there should be incipient signs of wage escalation. When the market begins to price in this risk, there will be greater volatility in asset prices. As the Fed will probably tighten at a gradual pace, there will not be a bear market but there could be a correction at least as great as the one which followed Bernanke's tapering talk last May. Yellen has been correct to defend the central bank's decision to allow robust asset markets, but this policy has been successful enough that it will have to change next year.



The policy path to stronger growth does not run through monetary policy.

MICHAEL J. BOSKIN
Tully M. Friedman Professor of Economics and Hoover Institution Senior Fellow, Stanford University, and former Chair, President's Council of Economic Advisors

The relative weight to give to the Yellen and BIS arguments should be based on facts and circumstances in the economy and financial markets, including expectations and policies. I am usually dubious about claims that economic relationships have been permanently changed, whether that is the equilibrium real interest rate, productivity growth, or anything else. During the tech bubble, mature large-cap tech stocks were trading at fifty times earnings, and people claimed it was sustainable because real interest rates were permanently lower and/or there was a large productivity growth increase that would last for decades. More recently, the Fed thought it could keep real interest rates negative, without considerable risk, as the economy grew at a robust 4 percent. Finally, I recall how often it was said that housing prices always go up.

I strongly supported the Fed's initial lowering of rates and initial quantitative easing (though the implementation was sometimes ugly). Since then, the continued expansion of its balance sheet has been subject to substantial diminishing returns which have likely been close to zero for some time. On balance, monetary policy is closer to firing blanks than cannon. Meanwhile, the exit strategy and efficient deployment of private capital have been made considerably more difficult. There has been too little even conditional guidance on monetary and balance sheet policy beyond the taper.

A sizeable move of velocity and the money multiplier toward pre-crisis levels would presage higher inflation. The Fed suggests that if the economy picks up enough steam, it can prevent future inflation by raising the interest rate it pays on reserves. But if a considerable increase is necessary, the Fed will be giving the banks many billions of dollars, which is not politically sustainable.

I believe it is appropriate for the BIS to draw attention to financial risks. It is likely that some are beginning to mirror excesses of the last bubble, that is, banks making private equity loans with no covenants.

The tendency is to fight the last war rather than anticipate the next problem. Unfortunately, it is difficult to ascertain in real time when economic and financial relations are out of line and when there might be a damaging correction. Monetary policy has been subsidizing borrowing for some time. That is less dangerous in a sluggishly growing economy—I agree with Yellen that the decline in the headline unemployment rate overstates the improvement in the labor market. But it will take stronger growth to ease the eventual cost of cleaning up private and public mistakes made as a byproduct of the recent stance of monetary policy.

And my judgment is that the policy path to stronger growth does not run through monetary policy, but rather through a more sensible fiscal policy, emphasizing pro-growth tax reform and gradually slowing the growth of entitlements. Also, streamlining and modernizing regulations is needed, with much more stringent cost- and risk-benefit tests, along with a regulatory budget and trade liberalization, which has been stalled for too long.

It is appropriate for the BIS to raise the alarm.

HOWARD DAVIES
Professor of Practice, Paris School of International Affairs, Institut d'études politiques de Paris, former Chairman, UK Financial Services Authority, and former Deputy Governor, Bank of England

True believers in efficient markets know that there is no information in past correlations, and that analysts who seem to be consistently right are just lucky. So when reading this year's alarming annual report from the BIS, perhaps we should not be influenced by their economists' past record. But the fact is that Bill White and his successor Stephen Cecchetti were remarkably prescient about the build up of leverage pre-crisis. Now they warn that if central banks keep their monetary policies lax, there is trouble ahead.

Janet Yellen and Mario Draghi were quick to dismiss their analysis, in blunt terms. Martin Wolf agreed. His pink pen dripped with disdain for their advocacy of preemptive monetary and fiscal tightening. Anyone who unites these three giants deserves serious attention.

They make two big points. By far the most important, which Yellen and Draghi have so far avoided, is that if we are to guard against a repeat of the global financial crisis, developed economies must find a way "to shift away from debt as the primary engine of growth," and that there has so far been "a collective failure to get to grips with the financial cycle." Not only has nothing been done to correct the bias in favor of debt in the tax system, but a policy of ultra-low interest rates and QE buttressed with forward guidance is encouraging another build-up of leverage. Developments in mortgage markets in the United Kingdom, or in auto finance in the United States, are striking real-world examples.

They point out, too, that monetary authorities persist in ignoring the spillover effects of their policies: "the own-house-in-order doctrine still dominates," and argue strongly that there is an urgent need "to adjust policy frameworks to make growth less debt-dependent."

This diagnosis seems to me to be entirely correct. Central banks continue to argue that they must focus exclusive attention on short-term price stability. Macroprudential policy, still in search of a clear definition, is a grubby job to be done by financial regulators. At the Bank of England, a separate committee has been set up for the purpose, to avoid corrupting the work of the Monetary Policy Committee.

The most important message of the BIS annual report is that central banks must, in Charlie Bean's phrase, "put credit back at the heart of their policy." It is surprising that this observation remains controversial.

Their secondary point, that now is the time to begin tightening, is clearly more debatable. I tend to think they are right, and that there are growing signs of another dangerous debt bubble inflating. Certainly it is appropriate for the BIS to raise the alarm, and provoke a rerun of the "leaners *vs.* cleaners" debate of seven years ago. Then, the cleaners union won out. Let's hope the leaners do better this time.

The BIS's concern over ultra-easy monetary policy seems somewhat premature.

RICHARD C. KOO
Chief Economist, Nomura Research Institute

I must first thank the BIS for acknowledging that the West is suffering from balance sheet recessions that make monetary policy largely ineffective. As the person who developed the concept of balance sheet recession, it is nice to note that someone in official circles has finally recognized its usefulness in understanding the post-Lehman West.

That said, the BIS's concern that the continuation of current ultra-easy monetary policy would soon re-ignite financial imbalances seems somewhat premature. The private sectors of virtually all developed countries except Australia are still in financial surplus, that is, saving money or paying down debt, in spite of zero interest rates. This means that they are still minimizing debt instead of maximizing profits in order to repair their balance sheets. It is difficult to imagine having a major bubble when the private sector as a whole is still deleveraging. The post-1990 Japanese experience and post-Great Depression U.S. experience also indicate that the private sector may develop a strong aversion to borrowing even after their balance sheets are repaired.

There will be mini-bubbles, however, as fund managers in balance sheet recessions are typically flooded with newly saved as well as deleveraged funds and those funds from the central bank in the form of quantitative easing. With the private sector as a group not borrowing money and a large portion of new government debt bought by the central bank, these managers only have a few asset classes left to place their funds. This means mini-bubbles can form in equities, commodities, and emerging market assets, but those bubbles are probably containable with macro-prudential policies as mentioned by Fed Chair Yellen since the real economy is still struggling with deleveraging.

For a different reason, however, I agree with the BIS's conclusion that the Fed should unwind quantitative easing as soon as possible. This is because there are enough reserves in the banking system to expand the U.S. money supply twenty-fold. The only reason we have not faced a 2,000 percent inflation rate is because the U.S. private sector has not been borrowing money, which has kept the marginal money multiplier extremely low. But that will change.

The only way to reduce the excess reserves is for the Fed to sell its bond holdings or for the Treasury to sell new-money bonds to pay for maturing bonds in the Fed's portfolio. If this is attempted when private sector borrowers are back and inflation rates are going higher, long-term interest rates can go sky-high with devastating consequences for the world economy and markets.

But if the Fed starts unwinding QE now, when the demand for funds is still weak and inflation is low, there will be limits to how far the long rates can rise. And if they do rise, the Fed should respond by extending its zero-interest rate policy on the grounds that the higher (than warranted) long rates would keep inflation in check. The possibility that the ZIRP would be extended as a fallback position for the Fed will also limit the increases in long-term rates.

The BIS says the unconventional monetary easing has not been particularly effective, so the time to unwind it in the United States, United Kingdom, and Japan is now. ◆