BIS Sees Risk Central Banks Will Raise Interest Rates Too Late

By Global Research
Global Research, July 21, 2009
Bloomberg 29 June 2009

Region: USA
Theme: Global Economy

The Bank for International Settlements said there's a risk central banks will raise interest rates and withdraw emergency liquidity too late, triggering inflation.

History shows that policy makers "have a tendency to be late, tightening financial conditions slowly for fear of doing it prematurely or too severely," the BIS, which oversees central banks, said in its annual report published today in Basel, Switzerland. "Because their current expansionary actions were prompted by a nearly catastrophic crisis, central bankers' fears of reversing too quickly are likely to be particularly intense, increasing the risk that they will tighten too late."

Central banks around the globe have lowered borrowing costs to record lows and injected billions of dollars into the financial system to counter the worst recession since World War II. While some policy makers have stressed the need to withdraw the emergency measures as soon as the economy improves, the Federal Reserve, Bank of England, and European Central Bank are still in the process of implementing asset-purchase programs designed to unblock credit markets and revive growth.

"The big and justifiable worry is that, before it can be reversed, the dramatic easing in monetary policy will translate into growth in the broader monetary and credit aggregates," the BIS said. That will "lead to inflation that feeds inflation expectations or it may fuel yet another asset-price bubble, sowing the seeds of the next financial boom-bust cycle."

'Heroes'

The BIS, known as the central bank for central banks, holds currency reserves on behalf of its members and provides policy makers with a forum for discussion. Attendees at the BIS annual general meeting in Basel today include ECB President Jean-Claude Trichet, Fed Chairman Ben S. Bernanke, People's Bank of China Governor Zhou Xiaochuan and Bank of Japan Governor Masaaki Shirakawa.

"If central bankers succeed in adopting exit strategies at the right time without fueling inflation or chocking the economic recovery, they'll be heroes," said Joerg Kraemer, chief economist at Commerzbank AG in Frankfurt. "It will be a challenge."

The Fed, which has cut its key rate to close to zero, is spending $1.75 trillion on mortgage debt and Treasuries, while the Bank of England, which has lowered its benchmark to 0.5 percent, has pledged to purchase 125 billion pounds ($206 billion) of government and corporate bonds.

The ECB has reduced its main rate to 1 percent and last week loaned banks 442 billion euros ($620 billion) for 12 months. It will hold two further 12-month tenders this year. Next month the ECB will also start buying 60 billion euros of covered bonds.

‘Comfort Zone’

“Central bankers are operating well outside their comfort zone,” the BIS said. In addition to the risk of stoking inflation, the unprecedented policies “may be insufficient to put the economy on the path to recovery,” it said.

The global recession will be deeper than initially expected, the World Bank said on June 22. It predicts the world economy will contract 2.9 percent this year, more than its previous forecast of 1.7 percent, before returning to growth in 2010.

The Fed on June 24 refrained from specifying when it will wind down its emergency programs, saying only it will alter them “as warranted.” Inflation will remain “subdued for some time,” giving policy makers room to keep the benchmark rate at “exceptionally low levels” for an “extended period,” it said.

Deflation Pressure

Shirakawa on June 16 said Japan’s central bank will make a decision on its exit strategy “by the end of September” amid signs the recession is bottoming out. Since then, deflation risks have increased. A June 26 report showed consumer prices fell 1.1 percent in May from a year earlier, the sharpest decline since comparable data were first compiled in 1971.

Bank of Japan board member Seiji Nakamura said on June 24 the bank should maintain its extraordinary policies “for the appropriate amount of time.”

In Europe, policy makers may also struggle to decide on the right time to exit non-standard measures. ECB Executive Board member Juergen Stark said on June 25 the bank will “swiftly” withdraw its stimulus when the economy improves. By contrast, council member Ewald Nowotny said on June 19 the ECB should continue to fight Europe’s “deep recession” with “all possible means.”

“At some point the economy will recover and monetary and fiscal easing will have to be reversed,” the BIS said. Still, “identifying when to tighten is difficult even at the best of times, but even more so at the current stage.”

With banks reluctant to lend to each others and companies cutting jobs and output to weather a slump in exports, the global economy may struggle to gather strength. The BIS said there’s a “significant risk” that monetary and fiscal stimulus will lead only to “a temporary pickup in growth, followed by a protracted stagnation.”

“True, one risk is exiting too early,” BIS General Manager Jaime Caruana said at a press conference in Basel today. “But experience suggests that the bigger risk is exiting too late and too slowly.”

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