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BIS Annual Report: arguing for policy changes

BIS ANNUAL REPORT appears to admonish policy makers in the three ‘Poles’ to adjust their policy menu:

IN US, concurs with forceful Fed response and watchful attitude as tax cut impacts

IN JAPAN, suggests price level and/or inflation targeting against a counterpart guarantee to the BoJ for its own independence if the BoJ’s balance sheet is impaired by such actions

IN EUROLAND, suggests that an upward currency valuation of the EURO would be in the interests of European macro and world financial re-balancing.

The BIS appears to be taking on an enlarged role as a ‘coordinator’ of international economic policy around the world in its new Annual Report. The key to its views is found in Chapter VIII of the report entitled “Conclusion: the recent past as prologue?”

The BIS cites three paradigms of contemporary global macro:

- 1) the “new era” story—increased growth potential of the US, underlying profits justifying higher asset prices and the greater capacity of firms to prevent large inventory swings—ergo Soft Landing implying a V shaped recovery.
- 2) the ‘demand-oriented’ story (modern Keynesian approach) that asserts that despite supply side improvements, aggregate demand has grown too fast and for too long, even when measured inflation was not high. Unwinding the excess leads to a longer period of sub-par growth
- 3) Austrian cycle theory approach that suggests accelerating credit expansion and excessive optimism justified by new technology followed by overinvestment and an ultimate collapse of profits feeding back into stock prices. The collapse in stock prices creates conditions for a harder landing because of the inability to support new spending. Again, no requirement for excess inflationary pressures prior to the hard landing.

Whichever view one takes, some elements can be recognized as central to all of the above.

A) Huge impact of what is going on in the U.S. on the rest of the world through enlarged trade and direct investment links; increased M&A and an enlarged role for multinational firms in the context of widening global supply chain management.

B) Enlarged scope for international capital markets that increase linkages between different parts of the Global Economy--increasing the impact of a ‘failure’ in a single ‘pole’ on the rest of the global economy. This has a bearing on the ability of firms and policy makers to diversify risk on a global basis. Cross border bank expansions mean that ‘upsets’ in particular markets can cause impacts in the host (bank) countries. This suggests another channel for the **transmission of financial shocks**.

The upshot of this for the BIS is 1) that the “domestic policies” within the major regions are a legitimate subject

for international debate between domestic policy makers and 2) there needs to be more international cooperation among the domestic policy authorities on an international basis.

Implicit in this conclusion is a warning to each of the three major poles not to be excessively concerned with their own domestic policy issues: Washington and Tokyo are largely focused on ‘domestic affairs’ while the EU is excessively pre-occupied with enlargement and not current performance! This is not conducive to the world regaining financial equilibrium

Ironically, the BIS is suggesting to each of the Poles some major re-orientation of their own domestic policy:

- 1) In the US, the BIS is implicitly endorsing the Fed’s very active role in promoting a recovery together with the tax cut (whose outline were not quite fixed when the BIS report went to press). The key is the recovery of profits but the BIS concern is that the U.S. does not recover so strikingly as to set off an inflationary impulse.
- 2) In Japan, the BIS explicitly notes the major impediment for appropriate change is the ‘special interest political system’ and the ‘culture of mutual obligation.’ It recommends that the Bank of Japan extend the range of assets it is willing to purchase even including ‘unsterilized’ purchases of assets denominated in foreign currencies. The BIS even goes as far as suggesting that a policy change toward price level or inflation targeting could be of help for Japan in getting out of its deflationary spiral and then suggests that the Bank of Japan be given explicit guarantees of its independence if in the process of carrying out such an activist monetary policy, its own credit is impaired.
- 3) In the Euro area, the BIS focuses on the mild nature of the problems facing the Euro area with no major financial imbalances affecting consumers, corporations or governments. However, the BIS is explicitly forceful in suggesting that policy authorities could afford to be more aggressive---perhaps even suggesting that the inflationary pressures now evident in Europe could be mitigated by an increase in the value of the Euro! Implicitly, this would require an international consultative framework.

