TIE's contributing editor Klaus Engelen interviews Malcolm Knight, the new General Manager of the Bank for International Settlements.

Knight Vision

TIE: Do you share the view of other central bankers and economists that the global economy is recovering?

Knight: I think we are seeing signs of a strengthening and broadening out of the recovery in the world economy. Of course, the degree of uncertainty that existed a year ago at the geopolitical level and the concerns about the risks associated with corporate disclosure scandals and the profitability of fixed investment have dissipated. In line with these developments, there are signs of strengthening not only in the United States but also in other countries. In the United States, some of the factors that led the growth of economic activity to accelerate to a very high rate by the third quarter may not necessarily endure. These include the impact of recent U.S. tax reductions and refunds on consumption spending, the additional cash that consumers obtained from home equity withdrawals in the early part of the year, the continuation of large financial incentives to purchase automobiles, and so on. The effects of these factors on consumption should dissipate in the U.S. economy going forward. But on the other side, fixed investment in the United States strengthened in the third quarter. As regards stockbuilding, the latest indications are that inventory investment was positive in September. So the U.S. economy seems to be strengthening.

At the same time, there are also signs of strengthening in Asian economies. In China, for example, aggregate demand has grown more rapidly than output, so that the external current account surplus has declined markedly. In that sense, China has also been contributing to the strengthening of global demand. The same is true for a number of other Asian economies. And although the picture is still mixed in the euro zone, we are seeing signs there of an improvement in business sentiment and activity.

TIE: How sustainable are the forces of recovery in the U.S. economy?

Knight: I think the strengthening of activity in the United States is likely to prove durable into 2004 and 2005 as well. What we should see is a strengthening of investment spending that offsets the slowing of consumption growth. Government spending is also likely to remain strong, so that disposable in-

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Since April 1, 2003, **Malcolm Knight,** former Bank of Canada senior deputy governor, is running the Bank for International Settlements (BIS). As general manager of the BIS, Knight succeeded Andrew Crockett, who for almost a decade played a crucial role in broadening the membership and agenda of the "Bank of Central Banks." When a search committee chaired by Dutch central bank governor Nout Wellink rejected two European central bank governors for the job and opted for a 24-year IMF veteran who only had joined Bank of Canada in 1999, there was considerable unease at the "Tower of Basel" and in European capitals. (See *The International Economy,* Spring 2003.) Unlike his predecessor Crockett, Knight is not chairing the Financial Stability Forum, as the G7 finance ministers and central bank governors gave this important role to U.S. Federal Reserve Vice Chairman Roger W. Ferguson.

But in a quiet way Knight, age 59, is taking over the administrative reins at the Basel tower and putting the unique service institution for central banks and financial supervisors on a course of lesser expansion and more consolidation. As an insider of the IMF world and as a long-time economics professor—Johns Hopkins, Virginia Polytechnic, and London School of Economics—Knight brings to his Basel job two important assets: the ability to stay connected with those who are monitoring, reforming and stabilizing international financial markets, and the ability to mobilize the impressive research capacities of the BIS and its member central banks in order to enhance transparency and stability in the global financial system.

—K. Engelen

come growth will be quite rapid. All in all, demand growth in the United States looks like it will remain quite durable.

The other thing that is important to remember is that productivity growth in the United States has continued to be very strong over the past two years even in conditions of relative weakness in the global economy. And that means that a further strengthening of demand in the United States can be met by rising supply without putting a lot of pressure on U.S. prices.

TIE: **So are you saying that loose monetary and fiscal policies in the United States are doing the trick?**

Knight: I believe that accommodative fiscal and monetary policies can be quite effective in strengthening demand at times when the economy is weak and has a large output gap. If you take the last two years, the fact that monetary policy was relaxed significantly in a number of countries, so that interest rates came down markedly, was a key factor responsible for the strengthening of housing markets, and also for strong growth of demand for consumer durables. That helped to sustain economic activity during a period when investment spending was very weak. Likewise, although the recent shift towards higher fiscal deficits in the United States and several other industrial countries has strongly underpinned aggregate demand and economic activity in the short run, the key will be to ensure that macroeconomic policies operate in a sustainable fashion over the longer term. Monetary policy nowadays is unambiguously dedicated to maintaining low, stable, and predictable inflation. That means it can be relied on to stimulate activity when demand is weak. But it also means that monetary policy needs to tighten at times when economic activity is pushing against capacity. Similarly, as I said, in recent months fiscal stimulus has been quite effective in strengthening aggregate demand in the United States and other countries as well, but budgetary policy must also be set in a context where markets are convinced that fiscal sustainability will be maintained in the longer term.

The strengthening of activity in the United States is likely to prove durable into 2004 and 2005 as well.

TIE: **But is that a realistic assumption?**

Knight: Over the past several years, there has been a very large change in the fiscal position of the United States, from a small surplus—about one percent of GDP in 2000—to a substantial deficit at the present time. Part of that deficit has come from the fact that economic activity has been weak. But part of it is structural and is related to strong spending, including military spending and tax reductions. Over time, it will be necessary to bring this structural fiscal position into equilibrium in order to ensure that it is sustainable. And that will require policy measures going forward. But for the present, I think that the U.S. fiscal position has contributed positively to the signs of strengthening that we are currently seeing.

TIE: What does this mean for Europe's Stability and Growth Pact?

Knight: The spirit of the Stability and Growth Pact is to endeavor to ensure fiscal sustainability in the longer term, and that is absolutely essential for making good fiscal policy. The precise role of the Stability and Growth Pact is a matter for the EU countries themselves to determine.

TIE: Do you see any looming risks that could jeopardize recovery of the U.S. economy?

Knight: There are always downside risks. The first type of downside risk one worries about is that, while there has been some strengthening of fixed investment, it is not yet strong enough to push the economy back up towards full potential output—until very recently we have been looking for the kind of strengthening in business confidence that is needed to sustain fixed investment. Secondly, until recently inventories were still declining in the United States, even though they were already at low levels. So indications of inventory rebuilding, which are apparent in the September 2003 data, appear to be an important positive sign. And thirdly, another risk element is that the United States has a very large external current account deficit. In conditions where productivity growth is very rapid, that's not too surprising, because high productivity growth means high profitability and creates strong incentives to invest in an economy. These capital inflows help finance the current account deficit. This was broadly the pattern in the United States from the mid-1990s to the beginning of the slowdown in 2001. More recently, the financing of the U.S. current account has come mainly from net purchases of U.S. Treasury and agency securities. Going forward, international investors will be looking to see how sustainable those high rates of productivity growth in the United States are going to be.

Over the past year, financial institutions weathered sharp movements in interest rates and financial conditions very well.

TIE: Why then is the U.S. labor market deteriorating?

Knight: I would not agree that the U.S. labor market is deteriorating, although employment has been quite weak until recently. Productivity growth in the United States is high, partly because firms are actively cutting costs so that they can increase output without increasing their demand for labor commensurately. Over the last two years there has been some increase in the unemployment rate in the United States, which is the other side of the coin of being able to have reasonably strong growth without increasing labor input. In the longer term that is a good thing. Sustained increases in output eventually mean increases in real wages and higher disposable incomes. In turn, rising disposable income creates the conditions for stronger demand and employment growth over the longer term. And over recent months, we have seen employment starting to grow in the United States.

TIE: With the U.S. economy gaining strength, interest rates will have to go up eventually. What are the risks of rising interest rates?

Knight: We are likely to see that as economic activity strengthens around the globe, long-term interest rates gradually rise. That would be an indication that output growth is stronger and the demand for funds to finance investment to expand plant and equipment is more robust. So I think that, in general, a rise in longer-term interest rates going forward will be a reflection of a firming global economy rather than something that will slow it down. Now, that said, if fiscal positions were to remain in large deficit as economies strengthened, they could place upward pressure on real interest rates and exert a negative impact on investment, spending on consumer durables, and economic activity. So there is a risk to economic activity if interest rates rise, but the nature of the risk depends on what causes rates to move.

The wealth effects of a depreciation of the U.S. dollar would be widely spread around the world.

TIE: **Until recently, cash from home mortgage refinancing has provided a needed boost to U.S. consumption. What are the risks to the economy as the refinancing boom tapers off?**

Knight: The rise in interest rates in the United States that took place from June to August this year markedly slowed mortgage refinancing and the extraction of equity, which had been a key factor underpinning consumption. That should already be contributing to slower growth in consumption relative to the past six months or so. But on the other side, it looks as though fixed capital formation, government spending, and inventory restocking can offset the effect of gradually slowing consumption. What we are seeing in the United States is very strong productivity growth in the context of strong demand growth. In those conditions, upward pressure on prices does not appear to be a significant risk in the near term.

TIE: **Are the financial institutions strong enough to withstand sudden rises of interest rates?**

Knight: As I mentioned, there was a very large rise in market interest rates between early June and late August this year. Indeed, it was the sort of movement that could have exerted a severe effect on financial institutions, as was the case in 1994. But over the past year, and particularly during that episode, financial institutions weathered sharp movements in interest rates and financial conditions very well. I think this resilience is a reflection of the fact that financial institutions in a number of countries now have better risk management techniques and are more diversified in their revenue flows than they were some years ago.

TIE: **If the U.S. economy grows much faster than the European economy, will global imbalances increase further?**

Knight: External imbalances are large at this stage. The United States has a historically large current account deficit, both in dollar terms and as a percentage of its GDP. The euro zone countries have a current account surplus, as do the countries in the Asian region. One would like to see current account imbalances reduced by a strengthening of demand growth in those areas where activity has been weak up until now. This is one of the elements that would help to make the adjustment relatively smooth. We are seeing evidence of at least the beginning of a strengthening of demand in these areas. Demand growth is strong in Asia, and recent data for the euro zone show that business sentiment is improving, a likely harbinger of stronger activity going forward.

TIE: **But there is growing fear that the strong appreciation of the euro will dampen Europe's recovery.**

Knight: You have to look at that issue in the context of a large U.S. current account deficit that will need to be reduced at some point. As I've already said, one of the elements of the international adjustment process is the strengthening of demand growth in other regions relative to the United States. I've noted that if you look at the People's Republic of China, there has been a strengthening of demand growth. The same is true in a number of other Asian countries. So that's an element which should contribute to the adjustment of current account imbalances. The other mechanism by which current account positions could adjust would be an eventual depreciation of the U.S. dollar. If that depreciation occurred in conditions where a large number of currencies were rising against the U.S. dollar, the impact on the euro zone would be moderated. It seems likely that there will have to be some movements in real effective exchange rates going forward to adjust the situation. But the other thing that you have to keep in mind is that there has already been a substantial appreciation of the euro against the U.S. dollar over the past six months, and that should already be contributing to a reduction in payments imbalances.

TIE: **What should we do if there is a sudden further loss of confidence in the U.S. dollar causing foreign capital inflows to dry up?**

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Knight: That's a hypothetical question. As I said, there has already been a significant appreciation of the euro against the U.S. dollar. I think the wealth effects of a depreciation of the U.S. dollar would be widely spread around the world. While there are risks, central banks could respond to exchange rate movements they regarded as unsustainable by adjusting their monetary policy stance.

TIE: **The appreciating euro is bearing the brunt of the adjustment to the depreciating U.S. dollar. Is the G7 strategy of asking the Asian countries to allow their currencies to rise a failure?**

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Knight: Over time there can be changes in countries' real exchange rates relative to the United States, whether there are nominal exchange rate movements or not. The question is: how much do a given country's goods cost relative to those produced in the United States? A country's prices can rise relative to U.S. prices, either because its home country prices stay the same and its exchange rate rises against the dollar or because the exchange rate stays the same and its home country prices rise more than those in the United States. In either case, the competitiveness of the country's goods relative to goods produced in the United States will decline, helping the U.S. current account adjust.

Despite the fact that productivity growth in the United States is rapid, the current account deficit is very large. By historical standards it seems too large to be sustained over the longer term. We can expect that the adjustment of current account positions will come through changes in incomes, changes in prices, and changes in exchange rates in various parts of the world. It is not easy to predict where they'll come from, or in what combination, but they will come. The Asian economies are quite open. A number of them are recovering from the serious financial problems of 1997–98. Exchange rate policy is a major concern for them. At the same time, most of those economies already have more flexible exchange rates than they had before the Asian financial crisis. Exchange rate policies will be a part of the adjustment picture. How much I don't know. For those economies that continue to intervene in order to maintain their nominal exchange rate to the U.S. dollar, intervention purchases of foreign exchange mean that domestic liquidity and prices will eventually begin to rise, contributing to a reduction in their international competitiveness.

TIE: **Just to get this straight—why do we call rising home prices wealth creation?**

Knight: There has been an animated discussion in a number of industrial countries about the housing market, the role it has played in maintaining aggregate demand in various countries, and whether it carries systemic risks. In several industrial countries there has indeed been substantial wealth creation in the housing sector. In these countries, the strengthening of housing demand owing to declining interest rates was met by a strong supply response—a lot more new houses were constructed. And that is an increase in economic wealth. In those countries, we have not seen such a large rise in housing prices because of the strong induced increase in the supply of housing. The increase in the real stock of housing in these countries is an important factor that underpins the situation and means that there are not large systemic risks.

But there are other countries where the decline in interest rates has resulted in a marked increase in demand for housing but the stock of housing has not increased very much, so housing prices have climbed sharply. The examples are Britain, the Netherlands, and, to a lesser extent, Australia. In those countries, rising housing prices have been associated mainly with a redistribution of wealth to housing owners and sellers, rather than an increase in total wealth. Large changes in asset prices are developments that central bankers should watch. I believe that monetary policy should be focused on maintaining price stability over the longer term and keeping increases in the general price level low, stable, and predictable. If central bankers have that objective, they will be vigilant about developments in housing prices. And they will also look at the prices of other assets in the economy, because as people feel richer, they spend more and that can push up the prices of current goods and services.

TIE: **Are central bankers and financial market supervisors satisfied with the level of stability in global financial markets?**

Knight: The major message from central bankers and financial system supervisors is that most financial institutions weathered the recent period of weakness well. This is partly because central banks had been able to respond to the recent period of weak economic activity by lowering interest rates. Those actions helped financial institutions to finance housing construction and consumer durables with intermediation spreads that were relatively attractive. In addition, most financial systems have been able to diversify risks more effectively through the use of credit risk transfer instruments, securitization, and other instruments, and have coped with considerable interest rate volatility with few signs of stress. They also weathered a period of major declines in equity values and weak economic activity.

TIE: **Haven't efforts to improve prudential policies and to strengthen prudential standards made a difference?**

Knight: We have just gone through a period of significant disclosure problems in a number of firms in advanced industrial countries. But there is an agenda to strengthen the global financial system. The first strengthens the standards of risk management in banking. This is the proposed Basel II accord, which will likely be finalized around the middle of next year. Many commercial banks are working on implementing it, and financial supervisors are developing their techniques of oversight to meet the new Basel II environment. Through the Financial Stability Institute, the BIS is supporting this process. Second, we need a strengthening of international accounting standards. Here, the International Financial Accounting Standards Board is working on developing a set of principles-based accounting standards that can be adopted by a large number of countries.

TIE: **Isn't the BIS acting more and more as a sort of junior partner to the International Monetary Fund? Does the BIS have the freedom to set its own agenda?**

Knight: I think the work of the BIS is complementary to that of the IMF, the World Bank, and other international financial institutions. We each work in somewhat different spheres. At the BIS, we are concerned with assisting the committees of central bank experts that work here in Basel to develop standards for global financial stability. We are also very interested in the dissemination of those standards, for example through our Financial Stability Institute. The IMF, in its work, is concerned with surveillance of the macroeconomic policies of its member countries. As a part of this work, the IMF and World Bank assess how well their member countries are implementing financial stability standards. I think that, in these areas, the tasks undertaken by the BIS, the IMF and the World Bank are quite complementary.

TIE: **And what about the role of the BIS in crisis management?**

Knight: If you are talking about addressing financial crises in individual countries, that is the role of the IMF. It is not an area where we have an active involvement.

TIE: **The BIS has increased its membership in recent years to 55. How far will this "bank of central banks" go in broadening its global reach?**

Knight: By extending membership beyond the industrial countries to include a number of key emerging markets, the BIS has become a global institution, without striving for the universal membership that is characteristic of the IMF and the World Bank. In recent years we have offered membership to the central banks of key emerging market countries that have a banking relationship with us and are interested in international cooperation. These initiatives have expanded the dialogue on monetary and financial stability policy to a much broader group of countries in our globalized economy. But at the BIS we also try to reach out to non-member countries by undertaking analytical work that is relevant to them and organizing meetings in which they can discuss policy issues that are of mutual interest. In fact, the kind of international cooperation that we are trying to foster is very much directed not only at our member central banks, but at those in a wide group of countries, according to the problems they face.

TIE: **The BIS has a history as a service institution for central banks with a European/G10 focus. Isn't that role changing, considering the supporting role the BIS has assumed for the Financial Stability Forum—the forum of financial supervisors and central bankers?**

Knight: Our relationship has always been primarily with central banks. One key factor of mutual interest is that central bankers all over the world have a very similar job—the task of maintaining monetary and financial stability. For that reason, our natural focus of cooperation is with central banks. The discussions that take place here every two months among central bankers are very frank, very forward-looking, and, I think, very useful in assessing what the key economic developments are, and what are their implications for the conduct of monetary policy.

The other area where we have a strong interest is in achieving financial stability. While central banks also act as the financial supervisor in many countries, in other countries the financial supervisory agencies are separate from central banks. So it is very important for the BIS to work to strengthen international cooperation, not only in the monetary area but also between central banks and financial supervisors. This is why we actively support the work of the Financial Stability Forum, where representatives of central banks, financial system supervisors, and finance ministries meet frequently to address vulnerabilities and key risks in the international financial system.

TIE: **Considering the setbacks and political pressures affecting the Basel Committee on Banking Supervision as it tries to complete the Basel II accord, do you think that this Basel forum will have a future since it lacks the needed legitimacy from elected officials and parliaments?**

Knight: The Basel Committee on Banking Supervision was established by the central banks of the G10 countries. The BIS provides a home for the Basel Committee and secretarial support, as it does for other key committees of central bank experts. What is remarkable about the Basel Committee's work to prepare Basel II is how transparent the process is, and how willing the Basel Committee has been at all stages of its work to request and receive comments from the financial community, from governments and so on. Ultimately, I think, the standards for capital adequacy and risk management by banking institutions need to be established by experts who are familiar with the workings of their own national financial systems. The approach of the Basel Committee in making its proposals very public and asking for comment all the way along is the appropriate one in proposing comprehensive new international financial standards.

***TIE:* In terms of receiving comments from the financial community and fostering dialogue, hasn't the BIS set a precedent for central banks and international financial institutions in their dealings with market actors?**

Knight: Yes, I think that this is a very good way to proceed in making rules and standards for internationally active commercial banking institutions. The Basel Committee received about two hundred comments on its third consultative paper. Those comments were by and large supportive of what the Committee is doing, but raised a number of issues that the Basel Committee is currently dealing with. I think that is indeed an excellent model.

***TIE:* Now, as you are settled in the new job of General Manager of the BIS, one personal question: Did the new job, so far, turn out as expected? What were the pleasant, what the bad surprises?**

Knight: Before coming to the BIS, I had worked as an academic, as a senior staffer at the International Monetary Fund, and as the senior deputy governor of a central bank. So I was already familiar with a lot of the activities of the BIS before I arrived here. I also did my homework over a period of several months after my appointment. My predecessor, Andrew Crockett, and I discussed the functions, organization, and strategic direction of the BIS in detail. As a result, I wouldn't say that in coming here I was confronted with major surprises. But there is one exception: even with all the preparations that I had made before my arrival, I was still quite surprised at the volume of work that is produced by this organization with a rather small staff of 520, coming from 44 countries. It covers a very wide range in both its economic analysis and its monitoring of economic and financial developments around the globe. It also does a lot of work to organize the meetings sponsored by the BIS, where the goal is to help central bankers and financial supervisors do their jobs in the most effective way.

***TIE:* What personal agenda do you have for the BIS?**

Knight: No matter how well organized an institution is, it should always be striving to adapt to new conditions and to enhance its effectiveness. At the BIS, our banking operations and risk management are state-of-the-art. Nevertheless, we must continue to keep up with the latest innovations in financial instruments, financial markets, and risk control techniques. Looking at the inside of the institution, I think we also need to work on our internal communications and to make sure that we function in a flexible way as new issues come up. Most importantly, we need to continue to adapt our cooperation with central banks and financial supervisors, and the analytical work that underpins it, to the ever-changing demands of the global economy.

***TIE:* Will the BIS under your leadership open new offices in other parts of the world?**

Knight: At this stage, I believe that continuing to focus on developing the work of our Representative Office for Asia and the Pacific and our Representative Office for the Americas is the right strategy. With the members we have admitted since 1996, we now have a large and varied group of member central banks in both industrial and emerging market countries. We need to continue to develop the BIS to serve those members better.

***TIE:* And what will be the focus of BIS research?**

Knight: We are a small institution, so we have to concentrate our research. In all that we do—in our monetary and economic department, in our banking department and in our cooperation with central banks and financial supervisors—we need to continue to focus our analytical work on the nexus between monetary policy issues and financial stability issues. That means continuing to work on all aspects of monetary policy formulation and implementation, taking account of the implications of different exchange rate regimes, the differing economic structures of various countries and regions, and constantly changing cyclical conditions. It involves looking at how monetary policy actions and other developments impact on private financial institutions and financial systems over time as the business cycle evolves. It also means observing and analyzing developments in key global financial markets, particularly the foreign exchange markets, the fixed income markets and the derivatives markets that are associated with them. Despite its clear focus, this is a complex and fascinating field of analysis. And I think it's one where the BIS staff has a comparative advantage that can be of benefit to national policymakers. ◆