Bank for International Settlements Sees Economy Near 'Tipping Point'

By PAUL HANNON and NINA KOEPPEN
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BASEL, Switzerland — The global economy may be close to a "tipping point" that could see it enter a slowdown so severe that it transforms the current period of rising inflation into a period of falling prices, the Bank for International Settlements said Monday.

In its annual report, the central bank for central banks said the impact of rising food and energy prices on consumers' incomes, combined with heavy household debts and a pullback in bank lending, may lead to a slowdown in global growth that "could prove to be much greater and longer-lasting than would be required to keep inflation under control."

"Over time, this could potentially even lead to deflation," it said. (See the text of the 2008 report.)

For central bankers from around the world gathered in Basel for the BIS annual meeting Sunday and Monday, the report made for chastening reading. Not only does it highlight the difficulty of the dilemma facing central banks confronted with slowing growth at a time when inflationary pressures are rising, it also lays much of the blame for their predicament at the feet of the central banks themselves.

The BIS said that in the early part of this decade, central banks had failed to set interest rates high enough to restrain unsustainable credit booms. It added that if a repeat of the current financial crisis is to be avoided in the future, central banks must be prepared to keep interest rates high even when there are no obvious signs that inflation rates are about to pick up. It also suggested that regulators make banks set aside more capital during boom times -- an approach that could curb their risk-taking and lessen their need to pull back on lending during busts.

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To be sure, the BIS regards a slide into deflation as an unlikely outcome, and for now rising inflation is a more imminent danger than a severe slowdown. "These threats differ in their immediacy, in that inflation is actually rising, while significantly slower growth only offers a possibility in many parts of the world," the BIS said. The BIS said that although rising energy and food prices have been at the heart of the pickup in inflation rates, "inflationary pressures are now being seen across a broader front."

It therefore urged most central banks to raise their key interest rates. "With inflation a clear and present threat, and with real policy rates in many countries very low by historical standards, a global bias towards monetary tightening would seem appropriate," the BIS said, but advised against a "one size fits all" response.

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impact of such fire sales on prices, and on the capital of financial institutions, could be substantial," it said.

Tighter credit conditions could also hit non-financial companies and households hard, increasing defaults on bank loans and placing financial institutions in even greater difficulty.

The BIS said the U.S. economy is most at risk from problems in the financial system. But it added that there are "suspicions that a number of other countries with low household savings rates might be similarly, if less significantly, affected."

And it warned that while the U.S. dollar's depreciation against other major currencies has so far been "remarkably orderly," that might not continue to be the case. "Foreign investors in U.S. dollar assets have seen big losses," it said. "While unlikely ... a sudden rush for the exits cannot be ruled out completely."

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