Global risks from rising debt and asset prices

Wolfgang Schäuble, the outgoing German finance minister, warned in an FT interview last week that ‘economists all over the world are concerned about the increased risks arising from the accumulation of more and more liquidity and the growth of public and private debt.’

This follows an assessment by the Bank of International Settlements, whose chief economist, Claudio Borio, has tied inflated asset values to loose monetary policy: ‘We do not fully understand the factors at work. But surely the unprecedented gradual pace of monetary policy normalisation has played a role. Another factor could be market participants’ belief that central banks will not remain on the sidelines should unwarranted market tensions rise. All this underlines how much asset prices appear to depend on the very low bond yields that have prevailed for so long.’

Risks posed by rising debt and asset prices

The first question of the latest CFM-CEPR expert survey asked panel members about the risks that debt poses to the world economy.

QUESTION 1: Does the world economy face heightened risks arising from an excess of public and private debt and/or inflated asset prices?

Sixty panel members answered this question. A strong majority of 65 per cent either agree or strongly agree, 15 per cent neither agree nor disagree, 18 per cent disagree, nobody strongly disagrees and 2 per cent have no opinion. Leaving out the respondents who neither agree nor disagree or have no opinion, the majority increases to 78 per cent. The outcome is similar when answers are weighted with self-reported confidence levels.

Despite the broad consensus, several participants point out that this is not an easy question. Jonathan Portes (King’s College London) argues that: ‘It is of course almost impossible to call ‘bubbles’ ex ante … (*LSEBR note: based on forecasts rather than actual results*) And it is even harder to predict precisely how a sharp reversal would manifest itself and how large any negative consequences would be.’

But he and several others also think that the warning signs are there. In fact, more than a few panel members point out that debt levels and asset prices are at historically high levels. Roger Farmer (University of Warwick and National Institute of Economic and Social Research), who strongly agrees (and is extremely confident), is especially worried and writes: ‘PE [price-earnings] values are close to all time highs. They can go up further. But they WILL eventually crash with very bad consequences.'

Morten Ravn (University College London) points to a particular reason why we should be more worried now, specifically: 'Large gross asset and liability positions are a risk especially since households and firms might have got used to a low interest rate environment.'

Ricardo Reis (London School of Economics) reminds us of the reason to be concerned about high debt levels, namely: 'Increases in credit seem to be predictive of financial crises, and likewise for the level of public debt and sovereign debt crises'; although he qualifies this statement by adding: 'But the associations are weak, not very stable, unclear if causal, and there are lots of false positives.'

Several panel members point to particular current risks. Sweder van Wijnbergen (Universiteit van Amsterdam) warns that: 'German banks are loaded up with German debt to the extent of almost three times their capital value.'

Pietro Reichlin (Università LUISS G. Carli) thinks that it is 'mainly a public debt problem. … Low interest rates in these countries and loose monetary policy reduce governments' incentives to make fiscal consolidations and banks' incentives to dispose of non-performing loans.'

By contrast, Andrew Mountford (Royal Holloway, University of London) thinks that the current risk 'is not due to a build-up of public debt but due to a failure to address the bias in the financial system towards the taking of excessive risk. Fundamentally the financial system hasn't significantly changed since 2007.' Similarly, David Miles (Imperial College London) argues that: 'The agents who are still least able to withstand shocks, given their enormous leverage, are banks.'

The panel members who disagree argue that the financial system has become safer. For example, Ray Barrell (Brunel University London) writes: 'Private debt increases in the advanced economies are less worrying now we have a better capitalised banking system than in 2007.' And Francesco Giavazzi is confident that 'we have the tools to address a problem if one were to arise.'

Franck Portier (Toulouse School of Economics), who also disagrees, takes a step back and argues that: 'As often, when thinking in normative terms, we need to identify the market imperfections at play.' He continues that economic agents are not 'forced' to hold public and private debt, except possibly banks regarding public debt. He concludes that: 'Excess of public and private debt is mainly a consequence of this saving glut.'

The role of loose monetary policy

The second question of the survey inquired into the causes of elevated debt or asset prices.

QUESTION 2: Is the loose monetary policy of major central banks responsible for the recent increase in global leverage and/or asset values?

Sixty-one panel members answered this question. A strong majority of 62 per cent either agree or strongly agree, 18 per cent neither agree nor disagree and 20 per cent disagree or strongly disagree. Leaving out the group that neither agrees nor disagrees, the majority increases to 76 per cent. The outcome is similar when answers are weighted with self-reported confidence levels.

A frequent comment made is that increased leverage and higher asset values are a natural consequence of lower interest rates. Several panel members who agree with the statement go one step further and agree with a view well summarised by David Miles, who writes: 'To a large extent this [higher leverage and/or asset values] was its aim [of expansionary monetary policy] because in raising asset values and leverage it raised demand.'

Several experts expand on the underlying reasoning. Stefan Gerlach (BSI Bank) explains: 'Monetary policy, in the form of lower interest rates, works by increasing asset prices and stimulating interest-sensitive spending, in particular on private and commercial real estate. … Much of what commentators now worry about are thus the predictable effects of expansionary monetary policy – this is how monetary policy works.'

Simon Wren-Lewis (University of Oxford) expands on this reasoning when he writes: 'Asset values yes – that was the inevitable consequence of QE [quantitative easing].'

In the reasoning used so far, the word 'responsible' in the question is interpreted as meaning 'being caused by'. But a related interpretation is whether the recent increase in global leverage and/or asset values is the 'responsibility' of central banks' monetary policy. Panel members who disagree focus on this related issue and point out that, as mentioned by Martin Ellison (University of Oxford), 'if there are problems here then it is up to macroprudential policy to sort it out.'

John Hassler (Institute for International Economic Studies, Stockholm University), who neither agrees nor disagrees, writes: 'The major factor behind the rise in asset values and leverage is the long trend towards lower real interest rates. This trend has nothing to do with monetary policy. In the shorter run, however, central banks do affect real rates which recently has come on top of the trend.' Other panel members echo this view.

Although not an explicit part of the question, several panel members reason that the expansionary monetary policies put in place across different countries were the right responses despite possible negative side effects. David Cobham (Heriot-Watt University) asks 'why monetary policy has had to act in this way, and the answer is obvious: the refusal of governments (notably Schäuble's!) to use fiscal policy in an appropriate manner, which has been based on a range of incorrect arguments for austerity.'

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Notes:

- *This post is based on Global risks from rising debt and asset prices, a survey of the Centre for Macroeconomics.*
- *The post gives the views of its author, not the position of LSE Business Review or the London School of Economics.*
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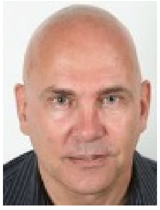

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