

## Bubble and squeak

Sep 26th 2002  
From The Economist print edition

### Central banks need to keep a closer eye on credit and asset prices

AMERICA'S current economic woes—from the collapse in share prices to the surge in bankruptcies—can all be traced back to the biggest credit boom in its financial history. Private-sector credit surged at an unprecedented pace in the late 1990s (see chart 9). Without easy credit the stockmarket bubble could not have been sustained for so long, nor would its bursting have had such serious consequences. And unless central bankers learn their lesson, it will happen again.

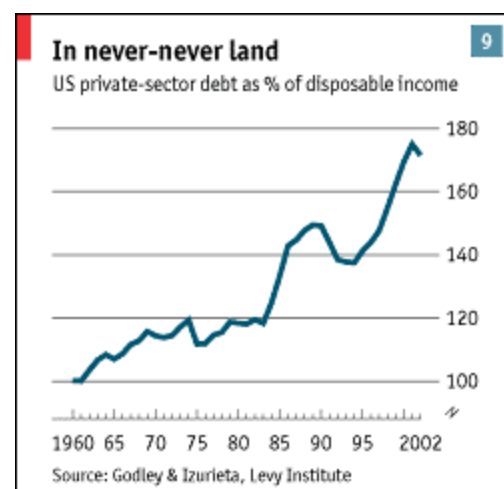
Central banks' main task over the past two decades has been to defeat inflation. But now they face an even tougher challenge: preventing ever bigger booms and busts in economic activity caused by increasingly large swings in asset prices and credit. Low and stable inflation was supposed to promote financial stability, yet greater stability in inflation and output has not been reflected in greater asset-price stability. Instead, the prices of assets, such as shares and property, have been subject to bigger swings over the past two decades. It now seems clear that low inflation does not guarantee financial stability. The three biggest bubbles this century—America's in the 1920s and 1990s and Japan's in the 1980s—all developed when inflation was low.

Indeed, low inflation may even encourage a build-up of financial imbalances. It can heighten the excessive optimism that helps to fuel unsustainable booms in credit and asset prices. If people believe that central banks are fully committed to price stability, inflation will be held down even as demand pressures mount, removing the need to raise interest rates sharply. That encourages a bigger build-up of debt and higher share prices as firms and households come to believe that the expansion will continue indefinitely—as they did in America in the 1990s.

A paper by Claudio Borio and Philip Lowe, economists at the BIS, suggests that a useful way of gauging the vulnerability of a monetary regime to financial instability is to consider its "elasticity": its potential to allow financial imbalances to build up unchecked during a boom. Compared with the early part of the 20th century, today's financial regulation and supervision helps to curb banks' ability to lend recklessly. On the other hand, the external constraint on credit imposed by the gold standard has gone. Central banks now virtually ignore the pace of credit expansion so long as inflation is under control. As a result, the "elasticity" of private credit creation has increased significantly.

Until the 1980s, in most economies the growth of credit was constrained in some way. After the gold standard collapsed, this discipline had been provided by tightly regulated financial markets. Most countries had some sort of credit controls that restrained the financial cycle, but at a severe cost to resource allocation. Since then governments have set their financial systems free. In the 1980s money-supply targets helped to curb credit, but these, too, were abandoned as the various measures of money sent out confusing signals.

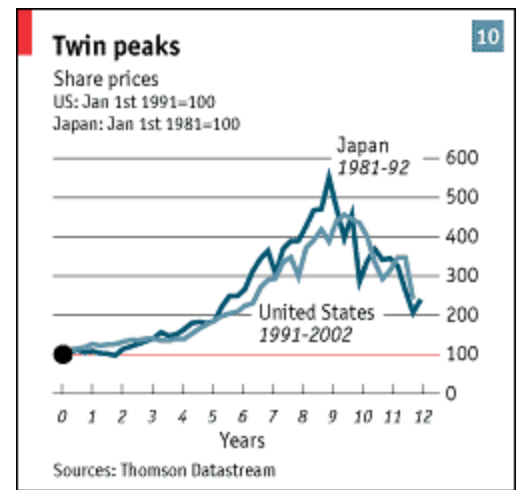
Messrs Borio and Lowe argue that today's combination of a liberalised financial system, a money standard with no exogenous anchor such as gold, and a monetary policy focused only on short-term inflation increases



the risk of longer and bigger build-ups in credit. That makes asset-price and debt bubbles more likely.

Swings in credit growth and asset prices have always played an important part in business cycles, but their role seems to have increased of late. Financial deregulation and innovation have increased the scope for more pronounced financial cycles which, in turn, can amplify the business cycle. For instance, rather than holding loans on their books, banks now bundle loans into securities and sell them on the secondary market. The resulting stream of liquidity allowed the banking system to lend more during the boom. New financial instruments and greater competition in the mortgage market have made it easier for households to borrow.

The increase in debt since financial liberalisation is not necessarily a bad thing: savings are better channelled to borrowers with profitable investment opportunities than lying idle under the mattress. However, easier access to credit can encourage overborrowing, which leaves the economy more vulnerable to a recession. Over the past decade the deepest downturns have tended to be in countries that had previously seen big increases in debt. Now it is America's turn.



Cycles in credit and asset prices usually occur in tandem, reinforcing one another. Rising asset prices boost growth and make it easier to borrow by raising the value of collateral. Faster growth in credit and output then feeds back into higher asset prices. When asset prices fall, the process goes into reverse. More households now own houses and shares, so swings in asset prices have a bigger effect on the economy.

## Riding the risk cycle

In its 2001 annual report the BIS argued that the financial system tends to be too pro-cyclical because of a misperception by banks and markets about how risk moves over the cycle. Lenders tend to underestimate risk during booms, when collateral values are rising and profits are strong. They reduce their lending spreads and loan provisions, and extend too much credit. In recessions, lenders' perception of risk rises too late as borrowers default, so they tighten their lending standards and raise provisions. All this amplifies the business cycle, extending booms and increasing the depth or length of downturns.

Some economists worry that the new Basel Accord on banks' capital standards could make things worse. From 2006 banks will have to adjust their minimum capital requirements over time, in line with changes in measured risk. The danger is that banks' internal risk assessment will vary more than it should over the course of the cycle, leading to undesirable reductions in capital cushions during booms and increases during recessions. That would make the financial system even more pro-cyclical than at present.

Should central banks try to curb unsustainable credit and asset-price booms? The usual answer is that policymakers are unlikely to make better judgments about risk and sustainability than does the private sector. But as Keynes once wrote, "A 'sound' banker, alas!, is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional way, along with his fellows, so no one can really blame him." Central bankers are less likely to run with the herd. They have longer time horizons and different incentives, as well as a better understanding of the feedback between the financial sector and the real economy, so they may respond differently to the same information.

One policy option is for capital requirements to be increased during a boom if supervisors see a potential increase in risk. Or, to cool a housing boom, regulators could restrict the maximum mortgage as a percentage of a property's value. But it would be tricky to identify exactly when this should be done. If regulators got it wrong, they might undermine the efficiency of the banking system.

The alternative is to raise interest rates to check an unsustainable rise in credit and asset prices. However, not only is it difficult to identify financial imbalances early enough to act, but central banks do not have a mandate to prick bubbles. They already do take account of rises in share or house prices to the extent that these feed into higher spending and hence future inflation, but asset-price and debt bubbles can build up with little immediate effect on inflation. Higher interest rates would be hard to explain to the public if today's inflation were well under control.

Moreover, there are doubts about the effectiveness of higher interest rates in containing share prices. Interest rates are more like a blunderbuss than a laser-guided weapon. A small rise in rates might be counterproductive if it increased confidence in the central bank's anti-inflation commitment and so boosted asset prices further. A big rate rise would probably work, but it might lead to a deep recession.

Because of these uncertainties, most central bankers believe they should not raise interest rates to stop a boom in asset prices and credit, but wait to see if the asset-price bubble bursts and then respond to the adverse consequences. That is what the Fed did last year. But prevention is surely better than cure. The BIS concludes that although caution is required in tightening monetary policy or adjusting supervisory instruments, this should not rule out the occasional use of such policies when serious financial imbalances threaten economic and financial stability.

"Identifying a bubble in the process of inflating may be among the most formidable challenges confronting a central bank," said Alan Greenspan in 1999. It is impossible to determine a share's fundamental value, so, it is commonly argued, central banks should ignore asset-price booms other than where they have a direct effect on inflation.

But the emphasis on asset prices alone is wrong. It is when a boom in asset prices is combined with a big increase in debt that it becomes really dangerous, because when house prices or share prices fall, borrowers get squeezed. There is therefore a stronger case for tighter monetary policy when a surge in asset prices goes hand in hand with rapid credit growth. In their study, Messrs Borio and Lowe, looking only at information available to policymakers at the time, concluded that a simultaneous explosion in both credit and asset prices usually provided a useful warning of financial problems ahead.

The argument that central banks should act only when they are absolutely certain that they are dealing with a bubble does not stand up. Central banks have to deal with uncertainty all of the time. For example, the uncertainties over the size of the output gap are also large. The real issue is whether central bankers are prepared to start arguing the case for raising interest rates in response to serious financial imbalances, and whether they are prepared to live with unpopularity if they burst a bubble in equities or house prices. Mr Greenspan would not be so revered today if he had intentionally pricked America's stockmarket bubble.

With hindsight, the Fed should have raised interest rates much sooner in the late 1990s. Its failure to do so is an understandable mistake, because with inflation so low it would have come under political attack. Less forgivable was Mr Greenspan's irrationally exuberant endorsement of the "new economy", which contributed to the euphoria. Productivity growth has increased, but an official at another central bank argues that it would have been wiser if he had remained more agnostic, rather than acting like a fireman-turned-arsonist.

Views about how the economy works and what role monetary policy should play have changed many times in recent decades. From the 1950s to the 1970s the main objective of monetary policy was full employment. Once inflation took off, governments abandoned full employment to make the control of inflation their number one priority. Persuading the public that credit and asset-price bubbles are just as bad for them as inflation is surely no harder than making the switch from fighting unemployment to fighting inflation.

During the past century, every monetary rule has broken down in the face of changing economic circumstances: the gold standard, the Bretton Woods system of fixed exchange rates, and monetary targeting. Now it seems that strict inflation targeting is not the promised panacea either. Central bankers' fixation on short-term price stability can blind them to other important signs of financial imbalance. In turn, those imbalances can cause deeper recessions and even a future risk of deflation. Without some redesign of monetary policy to take more account of swings in credit and asset prices, economic booms and busts could well become more disruptive in future.