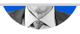
Opinion

What to be anxious about

The ending of low interest rates and the on-going quantitative tightening might not be a smooth ride. Central banks should not be deterred from bringing inflation down and getting rid of the excess liquidity, but in doing so, they implicitly accept risks to financial stability.



Publiziert: 26.01.2023, 10:59

Much of the discussion about the macroeconomic outlook in the developed countries has been focusing on whether the landing will be soft, how far interest rates will go up and what will happen with large public debts. These are valid concerns, of course, some very real risks may lie elsewhere, and they are largely indiscernible.

Right now, we worry about the impact of the end of the failed zero-Covid policy in China and about what is happening in Ukraine. The combination of a fast Chinese recovery and of the end of Russia's sales of oil and gas to the West could trigger another energy crisis, compounded with primary commodity price increases, worsening inflation just as we hope that it is receding.

This would challenge central banks. In principle, they should not react to a pure supply-side shock, but they will find it hard to explain yet a new apparent strategy shift as they let a new inflation surge run its course because it is temporary. Likewise, governments, which have sought to protect fragile citizens and firms, would feel compelled to deepen again their budget deficits. The toxic mix of rising interest rates and public debts is bound to dissipate the currently growing feeling that the worst is behind us.

Interets rates could rise further and remain high

And what if an unhinged US House of Representatives refuses to lift the federal debt ceiling, prompting a default? Maybe hell is just at the corner, but maybe not. Strong demand from China could deliver a soft landing. Russia's oil and gas may keep flowing cheaply to the West, courtesy of India, Turkey, and other embargo breakers.

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My own anxiety lies elsewhere. I assume that interest rates will rise further than often anticipated, stay there for quite a while, and not return to the low levels of the past decade. Even Larry Summers now admits that secular stagnation is gone, he only has to take the next step and concede that it never happened. Interest rates have been historically low – even that assertion is being disputed – because cent banks kept them too low for far too long. And that is where the danger lies.

For many years, investors have sought ways to keep their returns high despite low interest rates. To do so, they have taken big risks, that is what the risk-return curve tells us. You can depend on them for having been innovative. The result is that a myriad of clever strategies are about to turn into overly risky bets on the continuation of low for long policies promised by the central banks. Large losses are the unavoidable corollary of excessive risk taking when optimistic bets fail to materialize. The question is what happens next.

Remember the British pension funds

In principle, we should not worry about individual investors losing their shirts, as long as it does not affect systemic banks. That a myriad of them rediscover that risk-taking may mean total failure is a useful reminder of basic finance theory and practice. Right now, they are still trying to convince us that the struggle against inflation is mission accomplished and that central banks should stop raising their interest rates. Central banks seem determined to squash that bet and, hopefully, they will keep at it, unless the darkest predictions materialize, which will not save the investors anyway. The famous cleansing process is likely to run its course. But two problems remain.

The first problem is that not all investors are individuals, many of them are institutional. We had a glimpse of that when the British pension funds started to shake in late September as the Bank of England was proceeding with interest rate increases and quantitative tightening. A narrow segment of the markets ran out of liquidity, directly threatening pension funds, which simply cannot be left to go bankrupt.

The second problem is that the bleeding of a myriad of investors may end up hurting banks. Here the relevant example is the Global Financial Crisis of 2008 when it emerged that presumably smart instruments, the mortgage-based securities built upon subprime lending, had populated the books of banks, both small and huge. In both cases, the fine dividing line between systemic and non-systemic was dissolved.

Tail risk is a permanent danger

New bank regulation has been put in place in order to enhance the resilience of systemic banks. Most observers seem reassured that today's banks are safe enough because they have built large loss-absorbing capacities. But how large must these capacities be to be branded as safe enough? Surely, an unusually big shock stands to overwhelm the loss-absorbing capacities of the most resilient banks. Tail risk is a permanent danger, and its probability of materializing can never be exactly zero.

This is when we need to turn to the financial supervisors. Today, they well understand tail risk. The hope is that they are aware of what lies in the darkest corners of the balance sheets of banks, pension funds and other possibly systemic financial institutions. To that effect, they need to better understand all the financial innovations of the last decade than their predecessors did about the subprimes and, more recently, about the liability-driven-investing assets used by British pension funds. This is the familiar story of the dog that does not bark, until it bites.

Unfortunately, there is no magic bullet. No matter how hard they try, financial supervisors will always be lagging innovations. At this stage, probably the best they can do is to try and detect potentially toxic instruments, as just happened in the US with the «collateralised fund obligations» amassed by insurance companies, which are also systemic. Realistically, however, even a massive and urgent effort in this direction is unlikely to be exhaustive.

This leaves us with the real possibility that the ending of low interest rates and the on-going quantitative tightening will not be a smooth ride. Central banks should not be deterred from doing what they are meant to do, bringing inflation down to target and getting rid of the excess liquidity previously created for good or bad reasons. In doing so, they implicitly accept risks to financial stability. The recent British example shows that they should stand ready to promptly but temporarily backtrack until some modicum of financial stability is restored.

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