Addicted to Central Bank Painkillers?

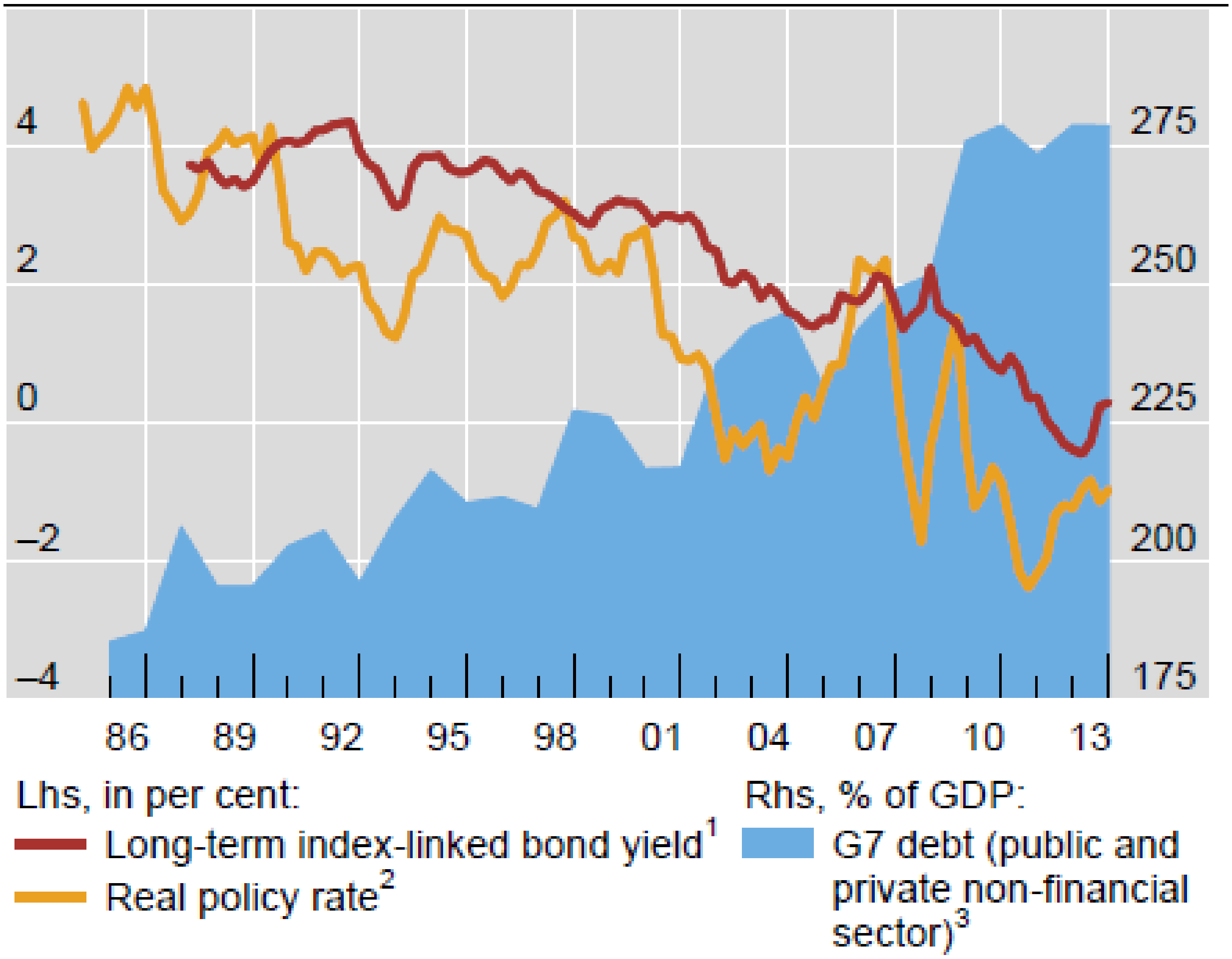
By Antonio Fatas , INSEAD Professor of Economics

The argument that low interest rates during boom times creates debt bubbles and financial instability is potentially misleading.

Using an argument that has been put forward many times by the Bank for International Settlements (BIS), Claudio Borio, the head of the organisation’s monetary and economic department, along with Piti Disyatat, head of forecasting and macro surveillance at the Bank of Thailand, warn about the dangers of low interest rates in an **article at VoxEU**. Central banks need to be aware of the cost of low interest rates.

The authors, while accepting the idea that low real interest rates might be the outcome of low growth and secular stagnation, argue that central banks cannot simply be seen as passive agents adapting their policies to the macroeconomic environment; they are responsible for low interest rates. In their words "money and finance are not neutral".

To support their claim, the authors produce a chart that shows how debt (public and private) has increased dramatically during the years where interest rate were falling.



[1] From 1998; simple average of France, the United Kingdom and the United States; otherwise only the United Kingdom. [2] Weighted averages for G7 economies based on 2005 GDP and PPP exchange rates. [3] Sum across G7 countries converted to USD at market exchange rates.

Their conclusion:

"*More stimulus may boost output in the short run, but it can also exacerbate the problem, thus compelling even larger dosages over time. An unhealthy dependence on painkillers can be avoided, but only if we recognise the risk in time.*"

I have no objection to the idea that money and finance are not neutral and that central banks can have an important role in financial markets. But the analysis above is too simplistic and potentially misleading.

The logic it puts forward is that arbitrarily-low interest rates set by the central bank generate an unsustainable behaviour in terms of accumulation of debt that is behind the bubbles we built in the good years and the crisis that resulted from the bursting of those bubbles.

What’s wrong with this picture?

What is always missing in this analysis is the fact that the world is a closed system. The debt that appears in the chart above has to be bought by someone. Those liabilities are assets for someone else. Who are the buyers? And who "forces" them to buy those assets at that price/yield?

Before we continue any further let's rule out the hypothesis that it is the central bank who is buying those assets. The easiest way to understand that it cannot be the central bank is that the chart above starts a lot earlier than the time when central banks' balance sheets started to increase (the second reason is that for every asset that the central bank buys it issues a liability but this will get us into a more complicated argument).

There is a simpler way to explain the chart above. A shift in the supply of saving by some agents/countries resulted in a decrease of interest rates and an increase in borrowing by the rest of the world. Some of this happens within countries, some happens across countries. This could still be an unsustainable development as borrowers go too far and lenders do not understand the risk involved but it is not simply caused by the irresponsible policies of the central bank.

It could also be that we have seen a significant increase in gross flows of assets and liabilities that do not result in a change in equity or net wealth but that they lead to an increase in the size of balance sheets across agents (i.e. increased leverage). The simplest example is households buying real estate with mortgages but it can also be financial institutions increasing leverage. This increases debt but it increases assets as well. This, once again, can generate instability but the borrowing that we see must come from somewhere else in the economy (not the central bank). Understanding that side of the balance sheet is important to have a complete story of what caused the crisis and what it takes to get out of it.

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