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Economic Narratives for 2018 Are Too Simplistic

By Antonio Fatas , INSEAD Professor of Economics

Concerns about rising debt and asset prices driven by central bank liquidity are overstated.

In 2017, GDP growth picked up, solidifying a global expansion phase that had previously been slow and erratic. The number of countries growing at rates consistent with their potential increased to levels not seen since prior to the global financial crisis. As expansion gathers pace and, in some cases, becomes long by historical standards, it is time to wonder where the next crisis will come from and how we will deal with it.

Among the many potential reasons why the world might fall into another recession, there is one that is often repeated and linked to the narrative we created after the 2008 crisis. Once again, it is said, we find ourselves at a point where debt levels are at record high, asset prices are in bubble territory and the only reason we have growth is due to the artificial support

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of central banks.

For example, **Stephen Roach's** worried view of 2018 is: "Real economies have been artificially propped up by these distorted asset prices, and glacial normalisation will only prolong this dependency. Yet when central banks' balance sheets finally start to shrink, asset-dependent economies will once again be in peril. And the risks are likely to be far more serious today than a decade ago, owing not only to the overhang of swollen central bank balance sheets, but also to the overvaluation of assets."

Another critic of central banks, the **Financial Times** opines about global debt levels: "In two respects, the global economy is living on borrowed time. First, global economic growth is so debt-addicted that no big economy can cope with a rapid tightening in monetary conditions…Second, central banks need to reverse their policies, since continuing low rates and excessive leverage may well result in an explosive cocktail of multiple asset price bubbles."

These are just two examples of the same narrative that sees central banks as responsible for generating "artificial" growth which has led to imbalances in the form of overvalued asset prices and excessive debt.

This narrative is not without merit. Many of the past crises were preceded by excessive credit growth and asset price bubbles. However, there are many nuances that matter in this analysis. Not every debt is bad and judging risk through the lens of record-level values of the stock market is not enough.

Details matter

Here is a non-exhaustive list of arguments where details matter for this narrative:

1. **Central banks are not that powerful.** The notion that a (select) group of central banks has managed to create artificial global growth and reduced interest rates across all maturities in (almost) all countries without creating any inflation cannot be right (at least I have not seen any economic model that can generate this prediction). The idea that liquidity created in some central banks is traveling across the world and propping asset prices everywhere is not right, that's not what central banks do. Central banks issue liquidity (which becomes an asset for someone else) by removing a different type of asset. For every liability there is an asset.

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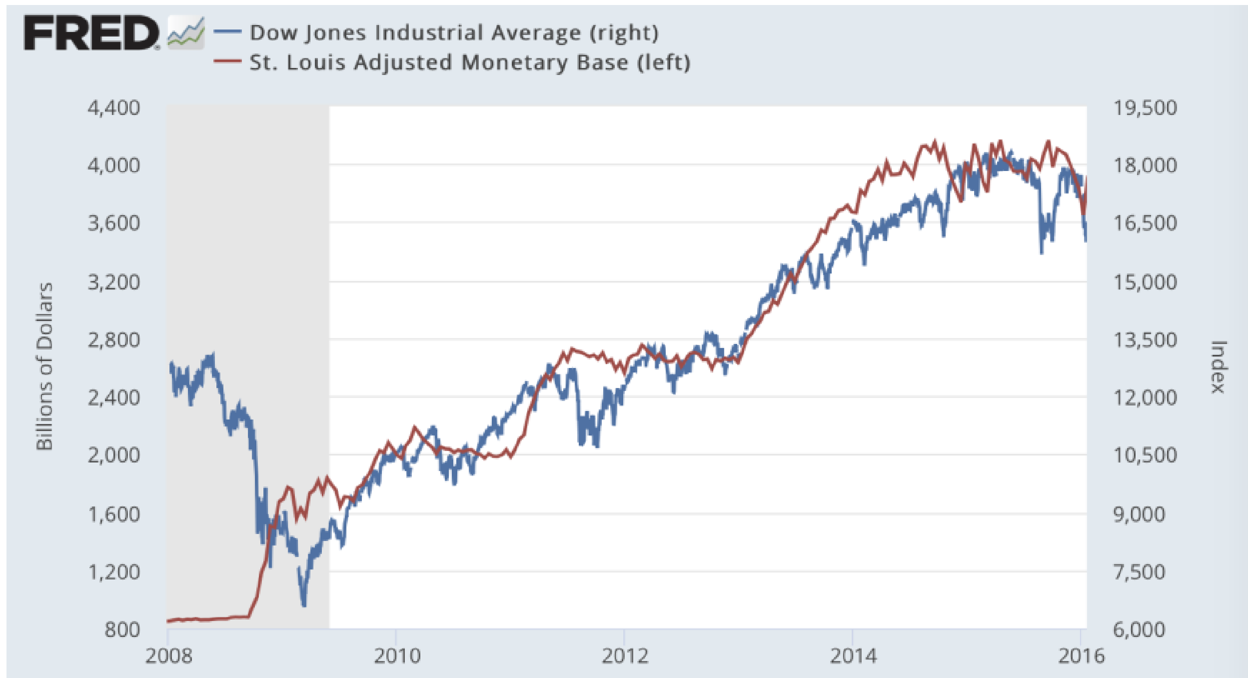
The narrative of very powerful central banks sounded reasonable when the United States' stock market seemed to be driven by the size of the balance sheet of the central bank [see Figure 1]...

Figure 1



...until the central bank stopped growing its balance sheet and the stock market went up by another 40 percent [see Figure 2].

Figure 2

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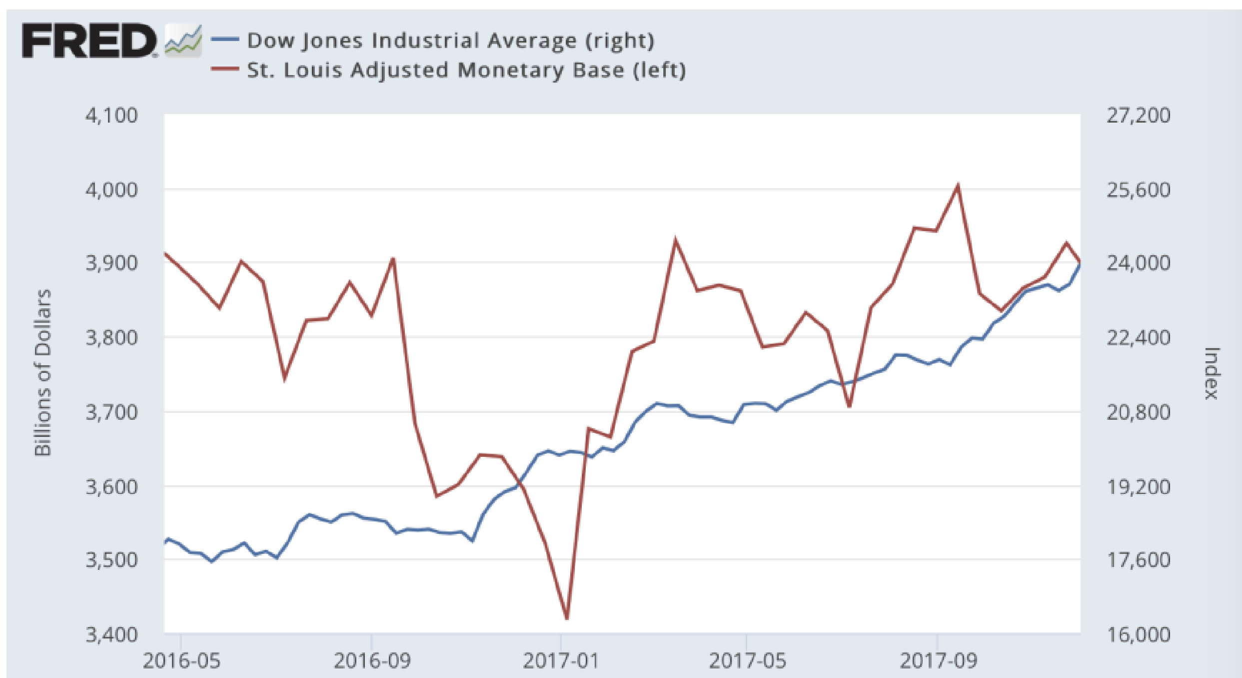

2. **Not all debt is bad**. There are two obvious points here. First, as much as we like to criticise financial markets for their excesses, we cannot forget that financial development is key to economic development. There is a very strong correlation between GDP per capita and measures of financial development. And a common measure of financial development is the ratio of debt to GDP. Higher debt means financial transactions that could not have occurred otherwise. For example, buying a house with a mortgage means you can own a house today instead of having to save the full value of the house before you can own it. This does not mean excessive spending. In fact, you might not be increasing your housing expenditure at all. Instead of renting a house, you own the asset and pay rent to yourself. The risk goes in both directions. If you own it and prices go down, you will be unhappy. But if you are renting and prices go up, consider yourself poorer.

Second, one cannot forget that the world has no (net) debt. For every liability, there is an asset. It cannot be that we (all citizens of the world) are living beyond our means as we bring future consumption to the present. Once again, details matter and we need to look for specific imbalances within parts of the economy; it can be countries, different economic agents (governments, the private sector, households, or a particular set of companies) or a combination of both.

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3. **Yes, asset prices are high but this does not imply the bubble is ready to burst.** The difference between this episode and previous bubbles is that this time *all* asset prices are high. In the run-up to the 1990s stock market bubble, stock prices climbed to levels previously never seen before. But at that time, compared to other assets like bonds, those prices looked utterly out of sync with reality. The implied stock market risk premium in the late 1990s in the U.S. was probably as low as 1 percent. That makes no sense. In contrast, today's stock prices are high (measured against earnings) but so are bond prices. The implied stock premium is likely to be around 4 to 5 percent. Slightly below historical averages but not at all close to the bubble levels of the 1990s. These overvalued asset prices across many asset classes fit better with the narrative of a different balance between global saving (high) and global investment (low). As long as those forces do not change, high asset prices and low interest rates are here to stay.

If my arguments are correct, why is it that the simplistic narrative of debt and excesses remains so present in today's economic analysis? I think that it makes for a simple, yet convincing, story along the lines of Robert Shiller's **argument** that when it comes to economics, storytelling and powerful narratives dominate our perception of reality.

A final thought before we look forward to a great 2018: There are plenty of risks to be worried about for the coming year, so there should be **no room for complacency**. But the focus on debt, bubbles and the negative influence of central banks is overemphasised. If we look only to this story for a clue about when the next crisis will come, we might just miss it.

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