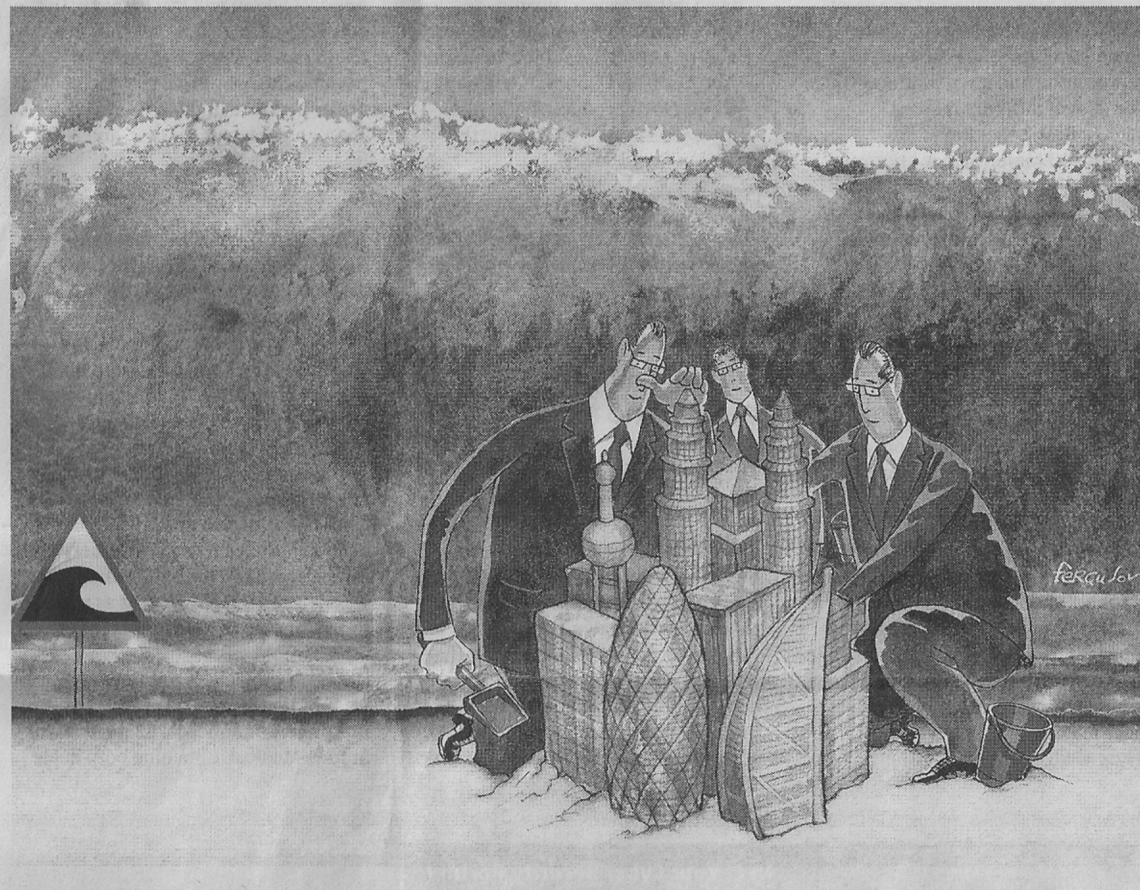
Echoes of 2008 as danger signs are ignored



FINANCE

Gillian Tett

Ten years ago when the world's central bankers gathered in Jackson Hole for their annual retreat in the majestic Teton Range in Wyoming, their community was marked by an intellectual divide. This was not between "left-" and "right-" wing economists; instead, the crucial faultline was whether the mandarins did or did not care about finance.

Back then, while many participants happily debated in the highlands of macroeconomic discourse, some central bank officials — such as William White, chief economist at the Bank for International Settlements, or his colleague Claudio Borio — were deeply worried about what was happening down in the the weeds of global finance. In particular they feared excesses were building with newfangled instruments that many traded but few truly understood, such as credit default swaps. However, those Cassandras were a minority; most central bankers were so obsessed with seemingly benign "real" economy issues such as inflation, unemployment or growth rates.

A decade later this intellectual split has closed — a little bit. For after the financial crisis exploded in 2007, it become painfully clear to policymakers that finance sometimes can hurt the "real" economy. What was happening in those seemingly arcane derivatives markets in 2006, for example, was fuelling a mortgage and corporate borrowing binge — and when that imploded it tipped the wider economy into recession. So after 2008, central bankers implemented reforms that are supposed to force them to try to understand how the finer details of financial markets might end up damaging the global economy again.

In the US, the Federal Reserve has created a Financial Stability Oversight Council, which is supposed to take a joined-up view of finance. An Office for Financial Research has been established to use Big Data techniques to track how money moves around the world with far greater accuracy than before. Meanwhile in the UK, the Bank of England has established a Financial Policy Committee to track the financial system; this complements its interest rate-setting Monetary Policy Committee, which tends to watch what is happening in the real economy. And in the academic sphere, the study of finance is no longer relegated to business schools; it is creeping into high-status university economics departments too.

But this revolution was never wholesale — and may now be going into retreat. Consider, for example, Jackson Hole. This year's gathering featured some debate about "real economy" issues. There was also extensive discussion about whether central banks need new tools to boost growth and fight deflation.

But what was notably absent from the agenda was a full-blown discussion about the issue that is on the minds of most financial practitioners: namely some of the peculiar distortions that are developing in the weeds of modern finance. Anybody who deals with financial markets on a micro level today — as a banker, asset manager or corporate treasurer — knows that many asset prices are extraordinarily elevated.

Never mind the most obvious headline-grabbing points, such as the record-high levels of US equities or the fact that more than $13tn worth of global government and corporate bonds carry negative rates. What is equally striking are the numerous tiny signals that tend to go ignored: the fact that in Denmark mortgages now carry negative interest rates; or that in Japan, the central bank has gobbled up so many equities that it owns about 15 per cent of the free float of companies such as Fast Retailing, and is committed to buying ¥6tn worth more exchange traded funds this year.

> Absent from Jackson Hole was a full-blown discussion of issues on the minds of financial practitioners

These peculiarities are creating headaches for pension funds, insurance companies and banks, to name but a few. But the Jackson Hole tribe barely mentioned these at all. The only voice in the central bank community that has been shouting loudly about these numbers is the BIS; its latest annual report issues a chilling indictment about the unsustainable nature of these peculiarly low rates and the dangers of "debt-fuelled growth". But, this has largely been ignored — as in 2006.

This is ominous. In the short term, those sky-high asset prices seem unlikely to produce a full-blown 2008-style crisis; there is less leverage in the western financial system today than in 2006 and banking is more robust because of post-crisis reforms. Moreover, it seems that those rock-bottom low rates reflect long-term structural issues — such as ageing demographics and falling productivity — as much as central bank interventions. This suggests they could endure for a long time.

But just because policymakers have become inured to a deeply peculiar financial world, that does not mean that it is "normal" or healthy; or not any more than it was in 2006. We had all better hope that by the summer of 2017 a debate about finance gets a proper billing at Jackson Hole. And that the BIS keeps shouting loudly about this distorted system — and is finally heard.

gillian.tett@ft.com