Trapped by the bubble

WHEN The Economist described America’s economy as a bubble in April 1998 and advised Alan Greenspan, the Federal Reserve’s chairman, to raise interest rates to pop it, many people dismissed our warnings. Today, the Dow is even higher than it was, the economy is enjoying robust growth and the core rate of consumer-price inflation has fallen to a 33-year low. So were we wrong? Sorry to be party-poopers, but America’s economy still looks horribly bubble-like. A drop in share prices this week, as central bankers and finance ministers gathered for the annual meetings of the IMF and the World Bank, was a timely reminder that a collapse on Wall Street remains the biggest threat to the world economy.

Not convinced? Consider the three most common criticisms of the idea that there is a financial bubble. First, it is argued, higher share prices are justified by improved fundamentals. In a month that has seen the publication of three books with progressively ambitious titles—“Dow 36,000”, “Dow 40,000” and “Dow 100,000”—it seems churlish to quibble. But the climb in share prices over the past year proves neither that the market is correctly valued nor that the bubble is a figment of our imagination. History shows that markets do overshoot and that bubbles can persist for some time—indeed, that is their nature. It also shows that the bigger a bubble gets, the greater the excesses it creates in the economy—and the bigger the bang when it eventually pops.

It is, in truth, impossible to know whether share prices are overvalued right now. But over the past year or so, evidence of a bubble has mounted with every sign of excess elsewhere in the economy. Households and firms are on a borrowing spree. The private sector’s financial deficit has risen to an unprecedented 5% of GDP (in the previous 50 years it has never exceeded 1%). Money-supply growth is rapid. And America’s current-account deficit is heading for a record 4% of GDP this year. These are all classic symptoms of a bubble.

When assets become liabilities

What about the second objection: that even if shares are overvalued, why should the Fed worry? America’s inflation rate is low, so there seems no case for higher interest rates. But inflation has been held down by many one-off factors—such as a strong dollar and, thanks to weak demand in the rest of the world, low commodity and import prices—which may already be going into reverse. But
more important, central banks should not ignore another sort of inflation: in the prices of assets, such as shares and property. Our survey of the world economy in this week’s issue argues that many central banks have focused too narrowly on consumer-price inflation. Excessive rises in asset prices can be as dangerous as conventional inflation. Sudden surges in wealth can, for example, encourage excessive borrowing, which, when borrowers are forced to readjust their finances, can cause a painful hard landing.

In its latest World Economic Outlook, published this week, the IMF argues that conventional inflation can sometimes be a poor gauge of whether an economy is overheating, and urges central banks to pay more attention to other signs of imbalance, such as rising asset prices, rapid credit growth, private-sector financial deficits and current-account deficits. The IMF suggests that overheating in asset markets may call for monetary tightening not only when it threatens an increase in product-price inflation, but also when asset prices increase to unsustainable levels that threaten to destabilise the economy.

This does not mean that the Fed should adopt a target for the Dow. But it should take more account of the impact of asset prices on the economy. Mr Greenspan has worried long and hard about share prices since his “irrational exuberance” speech in December 1996, but he seems to have concluded that there was nothing he could do. Why? Partly, perhaps, because of the third popular criticism of our bubble thesis: that it is too risky, both economically and politically, for a central bank to prick a bubble by raising interest rates. It is hard to tell when and by how much rates should be raised. And the Fed, like other central banks, has a mandate only to deliver stability in consumer prices. If the Fed deliberately tried to push down share prices, it would quickly come under fierce attack.

Deciding when to prick a bubble is indeed devilishly hard. But that is no reason for inaction. Instead, it argues for acting pre-emptively to prevent a bubble inflating in the first place—as the Bank of England recently tried to do by raising interest rates in response to rising house prices, even though inflation was below its target. The Bank sensibly wants to prevent a repeat of the late-1980s housing bubble. And its action also belies the claim that it is politically impossible to raise interest rates without hard evidence of rising inflation.

In recent years, Mr Greenspan has been taking a big risk by not having tightened policy when he first thought a bubble might be forming, or subsequently. There were plenty of signs of overheating, such as rampant consumer borrowing, that he could have used to justify higher interest rates. His second risky move was to cut rates three times last autumn in response to financial turmoil, when policy was already lax, and then to fail to take back this easing as soon as financial markets had stabilised. The Fed has thereby fostered the impression that it will slash interest rates when share prices fall sharply, but not increase rates when they shoot up. This apparent asymmetry has created a form of moral hazard that encourages investors to take bigger risks.

What should the Fed do now? Trapped by the bubble, Mr Greenspan’s room for manoeuvre is limited. Perhaps Wall Street will slide slowly downwards, letting
air gently out of the bubble. But history suggests that this is unlikely. America’s economy shows no sign of slowing; July’s record trade deficit confirms that strong consumer spending is sucking in imports. Unless share prices collapse, the Fed should raise interest rates again to cool things down and to signal that it is not underwriting the market’s value. If it does nothing, the Fed runs the risk that, when Wall Street does eventually fall, inflation will be rising and the dollar falling, making it harder to ease monetary policy to offset the effects of a crash.

One bonus is that the rest of the world economy is in a much healthier state now than it was a year ago. By the same token, a sharp fall on Wall Street may be less of a worry. Even so, if America’s stockmarket and its economy dive, it is vital that policymakers in Europe and Japan ensure that their economies pick up the extra slack. If the Bank of Japan, for instance, were to persist with its refusal to ease monetary policy even as America’s economy stalled, the world economy would take a nasty tumble. It would be best if we were wrong about America’s bubble. But prudent central bankers should not assume that we are—for the downside risk is huge.

LINKS

Information about Morgan Stanley Capital International’s market data is available on its website.

Top of page