Fear of bubbles hides the danger of stagnation

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If it turns out the US Federal Reserve has inflated an asset price bubble in recent years then we can breathe a sigh of relief. It would be a hideously embarrassing mistake for the Fed and other central banks, of course, but it would suggest that more dismal fears, including those that go under the label of “secular stagnation”, are wrong as well.

Those who think there is a bubble believe that central banks have kept interest rates unjustifiably low. By buying bonds in the name of quantitative easing, they have created a false boom in asset prices. Rising inflation will soon expose this miscalculation, and rates will rise.

But that is actually the cheery scenario. It suggests that generating enough demand to keep economic resources fully employed will not be as hard as central banks expect – and thus they have already gone a bit too far with their stimulus.

In that case, we can expect interest rates to rise and asset prices to fall. The economy would suffer in the short term, and it would be painful for investors. But, since the private sector is no longer burdened with unmanageable quantities of debt, the fallout should look more like the bursting of the internet bubble in 2000 than the financial crisis of 2008.

The gloomier alternative is that interest rates are low for good reason, and likely to stay that way. In that case, high asset prices make sense, because demand for new investment is miserable and unlikely to accelerate. Investors will not suffer upfront losses on their portfolios, but returns will stay low for a long time. If this is what is going on, mistaking the situation for a bubble would lead to bad policy.

Which assessment is correct? The cheery one, in which interest rates are too low but the economy is fundamentally healthy? Or the bleak one, in which central bankers have written the right prescription, but the patient’s condition remains perilously weak? No one knows for sure. But there are several reasons to think it is a version of the latter.

One of these matches the rationale that central banks gave when they embarked on exceptionally loose monetary policy in the aftermath of the crisis. The idea was that financial turmoil had lingering effects. Tight credit standards were making it hard for households and businesses to borrow money, holding up their spending plans. Businesses were starting up at a slower rate, which also held back demand.

If this is correct then impediments to recovery should gradually fade away. In that case, asset prices will behave roughly as central banks forecast when they launched QE. The Bank of England went so far as to draw its expectation on a chart in 2011. It shows a jump in asset prices when QE begins, as markets anticipate the period of low interest rates. Eventually, as the economy returns to normal and inflation picks up, the value of investment assets falls back.

According to this view low interest rates are justified by a weak economy, but the condition is temporary. Asset prices will be stagnant for a while, until the economy catches up. After that, interest rates and investment returns will return to more normal levels.

Another possibility, which would also justify low interest rates, is still more discouraging. Perhaps the advanced economies have suffered a permanent fall in their potential growth rates. Population ageing means this is almost certainly true to some degree. The problem would be exacerbated if productivity growth were falling, as some believe.

Another disquieting scenario is the "secular stagnation" hypothesis put forward by Lawrence Summers. He suggests that the relationship between interest rates and output may have changed permanently. Whatever the underlying cause – whether it be greater income inequality or the mercantilist policies of China – this would mean significantly lower interest rates are needed to keep the economy at full employment. Again, that would imply high asset prices and permanently lower returns.

According to these pessimistic hypotheses, it makes little sense for central banks to alter policy just to bring asset prices down. That would be tantamount to changing course because QE had the result they expected. But they should stay alert, for even if there is no bubble now, an environment of high asset prices makes it easy to inflate one. Investors have come to expect double-digit returns from the stock market; they will not easily accept it could struggle to deliver 5 per cent in future. Regulators will need to watch insurers, pension funds and others to make sure they are not assuming implausible future returns.

Some markets, such as high-yield debt and London property, do look frothy. The crucial thing is that high asset prices not be compounded with growth in debt. That means making macroprudential policy work. The Fed has tried to crack down on leveraged loans but so far the party continues. It needs to do more.

There are also implications for investors. In a bubble, the correct thing to do is steer clear, wait for it to burst, and then invest with the prospect of better returns. But if there is no bubble then returns will not improve. Investors will need to ponder how they can reach their financial objectives despite them – which probably means saving more.

Bubbles are frightening. But constant warnings about them are distracting people from the real danger: that investment returns will not be high enough to meet their needs. If the reality turns out to be secular stagnation, we may envy the day when all we worried about was the risk that a bubble could pop.