

# Bank for International Settlements voices concern over finance markets

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The Bank for International Settlements (BIS) has sounded a warning about the continued effect of low interest rates in bond and other financial markets in pushing up the value of stock markets and encouraging behaviour that could create new financial risks.

The warning was contained in the latest BIS Quarterly Review, published on Sunday just two days after Wall Street's S&P 500 index reached a record high of 2,500 points.

The BIS is concerned that the slow pace in normalising central bank interest rates and ending financial stimulus through quantitative easing is setting up financial markets for a shock when interest rates do begin to rise.

Volatility in the US share market, as measured by the VIX index, is at its lowest point since 2005. As a result, financial investors are engaging in short selling of assets, essentially betting that market volatility will remain subdued.

Speaking on the review's analysis, the head of the BIS Monetary and Economic Department, Claudio Borio, said the calm in financial markets was "remarkable." Not only was share market volatility low, but in a "departure from usual patterns," bond market volatility had also fallen dramatically.

"We do not fully understand the factors at work," he said in a frank admission that global financial authorities are flying blind. "But surely the unprecedented gradual pace of monetary policy normalisation has played a role. Another factor could be market participants' belief that central banks will not remain on the sidelines should unwanted market tensions arise."

In other words, if a rise in interest rates does lead to market stress, financial investors are confident the central banks will step in to ensure the continued flow

of ultra-cheap money that has sustained them since the global financial breakdown of 2008.

Borio said the financial market data underlined "just how much asset prices appear to depend on the very low bond yields that have prevailed for so long." A "defining question" for the global economy, he continued, was "how vulnerable balance sheets may be to higher interest rates."

Borio noted that since the 2008 crisis, "deleveraging," that is, the reduction of debt, had not really taken place. While private debt had fallen to some extent, public debt had risen, and the fall in private debt was mainly due to the reduction in debt held by households.

Corporate debt was "considerably higher" than before the crisis and corporate levels had "reached levels reminiscent of those that prevailed during previous corporate credit booms." Debt service ratios were low but this was only because interest rates have been falling so much.

"There is a certain circularity in all this that points to the risk of a debt trap: the protracted decline in interest rates to unusually low levels, regardless of the strength of the underlying economy, creates the conditions that complicate their subsequent return to more normal levels."

Borio said the increase in the percentage of "zombie" firms, that is, corporations unable to cover their interest payments with their earnings, "does not bode well."

The BIS review noted that US equity markets were being propelled by record levels of margin debt—debt subject to partial repayments if the value of the asset it financed starts to fall. The total had reached \$250 billion, substantially more than during the peak of the 1997 to 2001 dotcom boom.

At the same time, traditional market valuation

benchmarks, such as long-run price/earnings (P/E) ratios “indicated that equity valuations might be stretched.” They were above their long-run cyclically-adjusted levels in the US, and had increased in Europe and emerging market economies, though by a smaller amount than their American counterparts.

Interest rates in bond markets were “unusually compressed” in the US and drifting further into negative territory in Europe. This suggested that “equity markets continue to be vulnerable to the risk of a snapback in bond markets, should short-term premia return to more normal levels.”

In other words, should interest rates rise, the house of cards in equity markets, built on the basis of very low interest rates, could start to collapse.

The BIS also noted a significant increase in “covenant-lite” loans, which place “few to no restrictions” on the activities of the borrower. This could signal a “less discriminating attitude on the part of lenders while potentially fostering excessive risk-taking on the part of borrowers.” Moody’s has said the quality of these loans is at their lowest level since it started measuring this trend in 2011.

The BIS said this shift suggested that “in the event of the slowdown or an upward adjustment in interest rates, high debt service payments and default could pose challenges to corporates, and thereby create headwinds for GDP growth.”

The key determinant for setting official interest rates is the rate of inflation. Major central banks are keeping rates low because the inflation level has not yet reached the target of close to, but below, 2 percent.

With inflation as the “lodestar” for central banks, Borio said this put a premium on understanding the “missing inflation.” He asked: “Why has inflation remained so stubbornly low despite economies approaching or surpassing estimates of full employment and unprecedented central bank efforts to push it up?

“This is the trillion-dollar question that will define the global economy’s path in the years ahead and determine, in all probability, the future of current policy frameworks. Worryingly no one really knows the answer.”

Central bank monetary policy is determined to a significant degree by the so-called Phillips curve. This maintains that as the economy approaches full

employment, inflation should start to increase because wage levels begin to rise.

This model has been completely thrown awry since the global financial crisis. In the US, for example, as in a number of other countries such as Japan and Australia, the unemployment level, according to official data, remains low and growth is positive. However, wage levels are stagnating or even declining, and inflation remains at historically low levels.

The reason lies in the fact that the financial crisis was the occasion for a major restructuring of class relations in all the advanced economies, through the introduction of part-time working, the rise of casual employment and the decline of full-time working. This means that “full employment” bears little or no resemblance to what it signified in the past.

Borio’s admission that “no one really knows” why inflation remains so low is an indication of the utter bankruptcy of official policy.

Having poured trillions of dollars into the financial system with measures never undertaken in the past, in order to prevent a complete collapse of the banks and major financial institutions, the bourgeoisie is, as Karl Marx once put it, “like the sorcerer, who is no longer able to control the powers of the nether world whom he has called up by his spells.”



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