Project Syndicate

The Moral Hazard of Lower Interest Rates

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LONDON – When interest rates decline and stabilize, financial-market participants tend to take on greater leverage and risk. The challenge for regulators, then, is to prevent those risks from becoming systemic and causing a broader economic crisis.
Capital markets believe that interest rates are indeed on a downward path, for three reasons. First, inflation is moderating in the United States, the United Kingdom, and Europe, and there is even evidence of deflation in China. Second, global economic growth is projected to remain low over the next decade, with growth in advanced economies over the next five years falling to its lowest level in four decades. Moreover, China's contribution to global demand is set to abate, owing to unfavorable demographic trends such as a shrinking working-age population.

Lastly, many expect artificial intelligence to boost productivity, which could lead to job losses and slack in labor markets. That would cap wage inflation and strengthen expectations of lower interest rates over the long term.

Of course, other factors may still lead to upward pressure on interest rates. Deglobalization and the return of protectionist trade barriers could push up the prices of many goods and services; and many central banks may be inclined to keep interest rates high to deter governments (especially G7 members) from increasing their borrowing and increasing their fiscal deficits. Finally, though inflation has fallen far from its pandemic peak, it remains sticky above the 2% target in the US, the UK, and Europe.

As matters currently stand, financial-market forecasters are projecting two rate cuts this year in both the UK and the EU. When rates do finally start moving down, investors will reallocate capital, which will have major implications for already elevated asset prices. With the Dow Jones Index and the FTSE 100 (UK) hittingnew highs in recent weeks, moral hazard is a pertinent concern. After all, when borrowing costs fall and become more predictable, governments, corporations, and households tend to borrow more. Between 2010 and 2022, when US interest rates were effectively zero, US corporate debt rose 70%, reaching $94 trillion.

Public debt has been on an even more worrying trajectory. In the US, the nonpartisan Congressional Budget Office projects that federal debt will grow from 99% of GDP at the end of 2024 to 116% – a new record – by the end of 2034. This raises concerns beyond fiscal sustainability, because growing government debt issuances may "crowd out" private-sector borrowing and raise everyone else's borrowing costs.
Lower, stable interest rates also raise the risk of asset bubbles, by creating a "wall of money" in the

financial system. As retail and institutional investors borrow more and seek higher yields, they will place ever-riskier bets on speculative assets such as venture capital and cryptocurrencies. And when more cash chases relatively fewer investment opportunities, the result is asset-price inflation. That is why the S&P 500 quadrupled between 2009 and 2021, when interest rates were near zero.

History is littered with examples of higher leverage leading to asset bubbles, and then to full-blown economic crises. This was what led to the 1929 Wall Street crash and Great Depression; Japan's crisis in the 1990s; the dot-com collapse in 2000; and the 2008 global financial crisis.

In the current context, two areas of regulatory concern are worth mentioning. First, multi-manager hedge funds today are larger, more systemically important, and possibly more leveraged than the funds of 20 years ago. Should a major hedge fund fail, it could have far greater spillover effects than in the past.

Second, the growth of the private credit market in recent years warrants closer scrutiny, since it is well known that leverage has been migrating away from the banking system, where regulators still have direct oversight. Consider, for example, that approximately 69% of mortgages and 70% of leveraged loans in the US are being originated outside of the banking system.

Regulators can take three pre-emptive steps to address these risks. First, they can limit risk-taking by retail investors with collateral requirements on leverage to discourage borrowing and excessive speculation. Second, they can curb institutional risk-taking in the regulated financial system by requiring global systemically important financial institutions to hold more capital against speculative investments. While capital requirements were tightened after the 2008 crisis, we may now need to go further to curb bubbles. There is also an opportunity to update accounting rules to reflect financial realities (for example, replacing held-to-maturity accounting with mark-to-market accounting for banks).

Third, regulators can impose stricter rules on the unregulated ("shadow banking") segments of the financial system. For example, hedge funds could be classified as "dealers" of government securities, which would subject them to more oversight and transparency rules. This change would echo new rules unveiled by Gary Gensler, the chair of the US Securities and Exchange Commission, in January.

On a more general note, regulators need models that better reflect and replicate the effects of the whole financial sector – both the regulated and unregulated parts – on the real economy. The 2008 crisis showed what excessive risk-taking in financial markets can do to growth and prosperity. A loss of GDP is felt widely across society – whether in the form of rising unemployment or lower tax revenues to fund public goods such as health care and education – and it also harms future generations by undercutting investment in innovation.

The moral hazard of lower interest rates could turn out to be enormously consequential. The fate of the economy – not only of capital markets – is in regulators' hands. They would do well to get ahead of the next speculative cycle while they still can.

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