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Fed Policy Fails to Tamp Down on Risk-Taking, Group Says

Bank for International Settlements says interest-rate increases haven't slackened investors' appetite for risky instruments

The Bank for International Settlements said asset prices suggest that investors are just as willing to take on risk as before the Fed's rate increases. PHOTO: ARND WIEGMANN/REUTERS

By Paul Hannon

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The Federal Reserve's rate increases don't appear to have cooled financial markets and may not therefore be having much impact on the U.S. economy, the Bank for International Settlements said Sunday.

In its quarterly report, the club for central bankers said that despite the four increases in short-term policy interest rates since the end of 2015, asset prices suggest that investors are just as willing to take on risk as before, if not more so.

Financial markets are a key channel through which the Fed's changes in policy affects the economy. Usually, central bank rate rises are accompanied by an increase in broader borrowing costs for households and businesses. Equity prices usually fall or at least stall, again making it more costly for businesses to borrow. But the BIS said that hasn't happened yet.

"If financial conditions are the main transmission channel for tighter policy, has policy, in effect, been tightened at all?" asked Claudio Borio, head of the BIS's monetary and economic department.

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The worry at the BIS is that companies and households continue to pile up debts that may weigh on economic growth in the future, as well as make the financial system vulnerable to a repeat of the 2008 crisis.

"The longer the risk-taking continues, the higher the underlying balance sheet exposures may become," Mr. Borio said. "Short-run calm comes at the expense of possible long-run turbulence."

The BIS has long warned that interest rates are too low, fueling a dangerous buildup of debt.

The institution, based in Basel, Switzerland, highlighted similarities between the current episode and the Federal Reserve's rate rises from 2004 through 2006. Ahead of the financial crisis, broader financial conditions also eased, a development then Federal Reserve Chairman Alan Greenspan described as a "conundrum."

One possible reason for the equanimity with which participants in financial markets have greeted both series of rate rises is that they have been gradual and clearly telegraphed.

"If gradualism comforts market participants that tighter policy will not derail the economy or upset asset markets, predictability compresses risk premia," said Mr. Borio.

Over recent weeks, some international central bankers have warned that future rises in interest rates may not be as gradual as market participants assume. Late last month, Germany's Bundesbank cautioned that a sudden increase in interest rates could "seriously affect" the country's banks.

On the same day, the European Central Bank said it sees the potential for large corrections in global asset prices as investors load up on risky investments even as major central banks dial down their postcrisis stimulus policies.

But such warnings have yet to have a clear impact on risk-taking, and the BIS's report suggests something more dramatic may be needed to shock market participants out of their complacency.

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