Countdown to the next crisis is already under way

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We did not need to wait until the Dow Jones Industrial Average hit 10,000. It has been clear for some time that global equity markets are bubbling again. On the surface, this looks like 2003 and 2004 when the previous housing, credit, commodity and equity bubbles started to inflate, helped by low nominal interest rates and a lack of inflation. There is one big difference, though. This bubble will burst sooner.

So how do we know this is a bubble? My two favourite metrics of stock market valuation are Cape, which stands for the cyclically adjusted price/earnings ratio, and Q. Cape was invented by Robert Shiller, professor of economics and finance at Yale University. It measures the 10-year moving average of the inflation-adjusted p/e ratio. Q is a metric of market capitalisation divided by net worth. Andrew Smithers* has collected the data on Q, a concept invented by the economist James Tobin.

Cape and Q measure different things. Yet they both tend to agree on relative market mispricing most of the time. In mid-September both measures concluded that the US stock market was overvalued by some 35 to 40 per cent. The markets have since gone up a lot more than the moving average of earnings. You can do the maths.

The single reason for this renewed bubble is the extremely low level of nominal interest rates, which has induced people to move into all kinds of risky assets. Even house prices are rising again. They never fell to the levels consistent with long-term price-to-rent and price-to-income ratios, which are reliable metrics of the property markets' relative under- or over-valuation.

But unlike five years ago, central banks now have the dual role of targeting monetary and financial stability. As has been pointed out time and again, those two objectives can easily come into conflict. In Europe, for example, the European Central Bank would under normal circumstances already have started to raise interest rates. The reason it sits tight is to prevent damage to Europe's chronically under-capitalised banking system, which still depends on the ECB for life support. The same is true, more or less, elsewhere.

Now, I agree there is no prospect of a significant rise in inflation over the next 12 months, but the chances rise significantly after 2010.

Once perceptions of rising inflation return, central banks might be forced to switch towards a much more aggressive monetary policy relatively quickly – much quicker than during the previous cycle. A short inflationary boom could be followed by another recession, another banking crisis, and perhaps deflation. We should not see inflation and deflation as opposite scenarios, but as sequential ones. We could be in for a period of extreme price instability, in both directions, as central banks lose control.

This is exactly what the economist Hyman Minsky predicted in his financial instability hypothesis.** He postulated that a world with a large financial sector and an excessive emphasis on the production of investment goods creates instability both in terms of output and prices.

While, according to Minsky, these are the deep causes of instability, the mechanism through which instability comes about is the way governments and central banks respond to crises. The state has potent means to end a recession, but the policies it uses give rise to the next phase of instability. Minsky made that observation on the basis of data mostly from the 1970s and early 1980s, but his theory describes very well what has been happening to the global economy ever since, especially in the past decade. The world has witnessed a proliferation of financial bubbles and extreme economic instability that cannot be explained by any of the established macroeconomic models. Minsky is about all we have.

His policy conclusions are disturbing, especially if contrasted with what is actually happening. In their crisis response, world leaders have focused on bonuses and other irrelevant side-issues. But they have failed to address the financial sector's overall size. So if Minsky is right, instability should continue and get worse.

Our present situation can give rise to two scenarios – or some combination of the two. The first is that central banks start exiting at some point in 2010, triggering another fall in the prices of risky assets. In the UK, for example, any return to a normal monetary policy will almost inevitably imply another fall in the housing market, which is currently propped up by ultra-cheap mortgages.

Alternatively, central banks might prioritise financial stability over price stability and keep the monetary floodgates open for as long as possible. This, I believe, would cause the mother of all financial market crises – a bond market crash – to be followed by depression and deflation.

In other words, there is danger no matter how the central banks react. Successful monetary policy could be like walking along a perilous ridge, on either side of which lies a precipice of instability.

For all we know, there may not be a safe way down.

**Wall Street Revalued: Imperfect Markets and Inept Central Bankers, Wiley 2009; ** Stabilising an Unstable Economy, McGraw-Hill, 2008*

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