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Costly capital and the risk of rare disasters – speech by Ben Broadbent

In a speech delivered at Bloomberg in London, Ben Broadbent – External Member of the Monetary Policy Committee (MPC) – argues that investors' fears about downside risks and the possibility of an extreme economic outcome has driven a rise in the premium for risky investment, however it's financed. He suggests that those fears, in turn, have affected the growth of UK activity, investment and productivity

Ben Broadbent observes that the risk-free interest rate in the UK has fallen steeply since the onset of the financial crisis, and that quoted rates on new bank loans have declined. This, on its own, should spur new investment. But anecdotal and empirical evidence suggests financial markets and firms are behaving as if the cost of funding new projects has actually increased. That is partly because credit is being rationed by banks, who may only be willing to extend new loans to firms who keep debt within certain limits or hold minimum amounts of cash. Consistent with this, there is evidence that larger firms have been switching away from bank debt towards issuing debt and equities. This suggests that quoted interest rates significantly understate the true cost of bank debt.

But the yield on those securities has itself gone up since the crisis and business investment, most of which is accounted for by these larger firms, has fallen sharply. This suggests that credit rationing alone is not sufficient to explain "…the continuing weakness of output and private-sector productivity growth" and that "…even if the crisis originated in the banking system there is now a higher hurdle for risky investment", however it's financed.

Ben Broadbent finds that the low level of risk-free interest rates and the higher return required by firms to persuade them to invest can be explained by the risk of a rare but very bad economic shock. "And we have, in the shape of the on-going financial crisis and the possibility of serious disruption in the euro area, a very plausible candidate for such a risk." Even if such an event does not occur, the mere threat of it is enough to have significant effects on risk premia, expected returns, and firms' decisions to invest.
Ben Broadbent goes on to point out that fears of rare but very bad outcomes will have particularly marked effects on hurdle rates for irreversible, sunk-cost investments. This will include many projects, such as spending on intangibles, that are necessary to improve productivity. As such, high risk premia may be inhibiting not just demand but the economy's supply capacity as well.

He says “It would be nice to think that these worries are unfounded…Unfortunately, I doubt that’s the case. Markets and businesses possess “animal spirits” and can over-react to events. They may have done so again. But there’s probably a premium on risky investments because there is genuine economic risk.”

Equally though, notes Broadbent, “...one important implication of this thesis is that, if fears of downside risks were to recede, this could have pretty powerful effects on output – potential as well as actual – in a positive direction.” Nor is domestic policy powerless to affect things in the interim. Broadbent argues that the dramatic easing in monetary policy after 2008, in the UK and elsewhere, was crucial in helping to prevent what might have been a much deeper downturn. “And, were the (still unlikely) worst-case risks in the euro area actually to be realised, then our own monetary policy would again play its part in mitigating the impact.” That said, for Ben Broadbent these domestic interventions have their limits and “It remains the case that, for the time being at least, the most important policy decisions affecting the UK are being taken in other parts of the continent.”

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