Risk and Return: The Search for Yield

Low rates of return tempt investors to take risks, which can cause economic and financial instability

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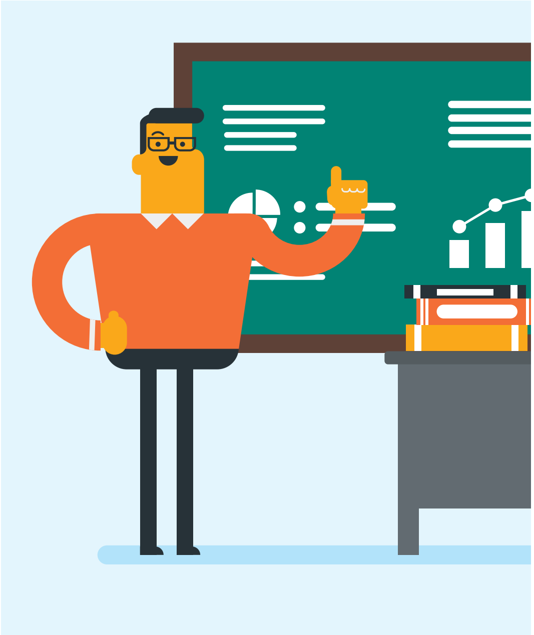

WHEN INTEREST RATES are high and inflation is low, investing is a cinch: savers can earn easy returns by simply parking their funds in Treasury bills or similar safe assets. But it becomes much harder when interest rates are low, as they have been in most advanced economies since the global financial crisis of 2008–09 and in some of them for longer still. Fed up with zero or near-zero interest rates, savers may be tempted to experiment with riskier assets or strategies in the hope of higher returns. Economists call this the search for yield.

Individual investors may shift money out of savings accounts and into stock markets. Firms might seek to boost income through speculative investments financed by debt because borrowing is cheap. Financial institutions such as banks and insurance companies may make risky bets to maintain profits or even to survive. But riskier portfolios increase the likelihood of loss. Higher indebtedness means firms are in a more precarious position when confronted by adverse shocks. The result is greater institutional vulnerability and increased likelihood of economic and financial instability.

Safe assets, risky assets

The ability to take risks and the appetite for doing so vary: households, firms, and financial institutions all act differently. Yet they are influenced by common forces. Especially important is the Treasury bill equilibrium interest rate (the rate of interest at which the amount of money demanded is equal to the amount of money supplied). This safe asset return influences the return on other investments, including long-term government bonds, bank deposits, and company bonds and shares. Returns on these riskier assets tend to rise and fall in line with the safe asset return.

The temptation to search for yield rises when the safe asset return falls to very low levels over a long period of time, as has been the case in Japan and several European economies for the past two decades. For households, this translates into a low return on savings and slower wealth accumulation. It makes it more difficult to fulfill life cycle ambitions such as buying a home, saving for a secure retirement, or passing on wealth to children.

Households will try to compensate by saving more and spending less. (An important exception is Japan, where older and wealthier households, with less of a need to increase precautionary savings and a greater capacity to search for yield, have invested in high-risk emerging market bonds and stocks.) Lower household borrowing and consumption reduce demand for goods and services sold by firms. Corporate sales and profits slide as a result. The financial sector suffers, too. Bank lending to households declines. As interest rates fall to very low levels, the difference between banks' lending and deposit rates is squeezed. It all combines to drive down profits.

Search-for-yield strategies

Firms typically attempt to compensate for the consumption deficit caused by higher household saving by opportunistically taking advantage of low interest rates and borrowing to finance high-risk, high-return investments. This usually happens in one of two ways. Firms may invest in higher-yielding financial

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securities. Or they might expand into new sectors or countries by creating a subsidiary company or buying an existing one. The debt component of such transactions tends to be higher, and the contribution of a firm's own retained earnings or other resources is lower than would be the case if expansion were the natural outcome of strong economic growth and corporate profits.

Like firms, financial institutions deploy different search-for-yield strategies. Large banks may expand abroad to countries where growth and investment returns are brighter. Mid-sized banks may expand domestically, across sectors or regions, taking business from smaller local lenders. Smaller banks, for their part, may merge or partner with mid-sized banks, or with each other, to fend off the competition.

Economists do not oppose risk-taking to boost returns per se: some individuals and institutions are better at managing risk than others, and risk-taking does not necessarily imperil economic growth and financial stability. However, search-for-yield strategies can have system-wide consequences if they are widely adopted by firms and financial institutions. This would concern policymakers.

Risks to the economy

The search for yield can increase the likelihood of deeper and longer recessions. When confronted with adverse economic shocks, firms with a lot of debt would be forced to make larger and longer cuts to investment than if they were debt-free. This decreases national income and economic growth. Some of them would default on loans, which would pressure banks' profits, curbing their ability to extend credit, and so lower economic growth even further. Some banks might not even survive.

Firms that use debt to fund risky acquisitions face new risk exposures that are difficult to manage. A firm from the United States that borrows at home to expand abroad, or an emerging market firm borrowing in the United States to expand at home, may face significant risk from a change in the exchange rate. Since they repay loans and interest in dollars and their earnings are in a foreign currency, an appreciation of the dollar could increase the repayment burden substantially. Firms use financial markets to hedge such risk but find it too expensive to do so entirely. When losses do occur, they can be large.

Since the dollar is a global funding currency, the search-for-yield incentives arising from long periods of low interest rates in the United States are not limited to American banks and firms. Firms from other countries may also borrow in the United States to invest at a higher rate of return at home. This carry trade is financially risky since any tightening of monetary policy in the United States (or a domestic shock) could result in a loss-inducing appreciation of the dollar. The "taper tantrum" of 2013 was one example where large emerging market firms experienced carry trade losses due to dollar appreciation. These losses were significant enough to materially dent firms' market valuations. In some cases, losses increased volatility in domestic financial markets.

Banks that expand abroad may face losses if they do not adapt to new challenges of risk management. A bank's head office may, for instance, find it most effective to expand into a foreign country by delegating operational decisions to local managers. But

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the bank then faces the more difficult challenge of providing effective performance incentives. It may be tempted to make pay and promotion contingent on returns that are unrealistically high and so push local managers to take too many risks.

Finally, consolidation of the banking sector through mergers of small banks or their acquisition by larger ones can stifle competition. This may increase borrowing costs especially for households and small businesses, which would find it more expensive to consume and invest—a serious setback for inclusive growth.

The search for yield can have benefits. When risky bets pay off, they increase income from savings and investment when interest rates are low and it is hard to earn a return. They also spread capital to new markets. But policymakers must be alert to the dangers—of speculative debt-financed investment especially. Some bets will inevitably go sour. The consequences for economic and financial stability can be severe when they do. FD

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