Bad Financial Moon Rising

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Bad Financial Moon Rising

By William White (short bio at end of article)

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A decade after the collapse of Lehman Brothers, global debt levels are higher than in 2008, lending has moved into the opaque realm of asset management and private equity, and the dollar is surging. Given the proliferating risks, another financial crisis and downturn could be in store.

BASEL – No one should over-estimate economists' powers of understanding. Just as the magnitude of the global downturn that began in mid-2008 took most economists completely by surprise, so did the sclerotic nature of the recovery. Similarly, economic forecasts today appear to be nothing more than hopeful extrapolations of recent growth.

In reality, all is not well beneath the surface. Should another financial crisis materialize, the subsequent recession might be even costlier than the last one, not least because policymakers will face unprecedented economic and political constraints in responding to it.

Some take comfort in post-crisis improvements to global financial regulation, on the assumption that these measures will prevent financial distress from spilling over into the real economy. This is an ill-advised stance. The analytical foundations of many of these "improvements" appear shaky, and the challenges of implementing the new regulatory regime have proven formidable.

Perhaps most important, ultra-easy monetary policies have encouraged precisely the risky financial behavior that regulations were supposed to limit. With monetary policy firmly on the accelerator, and regulatory policies firmly on the brake, the likeliest result is heightened instability.

The most worrisome side-effect of recent monetary policies has been a continuous increase in the ratio of non-financial debt to global GDP. Although the 2008 crisis offered an opportunity for deleveraging, the opposite has happened. Debt has piled up worldwide, with the biggest increases found in emerging-market private sectors.

The recovery in emerging-market economies was supposed to be part of the post-crisis solution. Now, these economies are part of the problem. The fact that much of this dollar-denominated debt has been issued by non-U.S. residents means that another costly currency-mismatch crisis could be in store.

In addition to ballooning global debt levels, sky-high property prices seem to be heading for a turn, and "risk-free" long-term rates remain unusually low in many countries. Very low credit risk and term spreads, along with record-low measures of volatility, have invited still more risky behavior. Should these spreads normalize, the risks would come home to roost.

The record-high percentage of "covenant-lite" new loans (lacking many basic protections for the lender) further attests to excessive risk-taking. Of course, it also implies that recovery rates on bad loans (and associated collateralized loan obligations) could be unexpectedly high. The fact that asset-management companies and private-equity firms have increasingly displaced regulation-constrained banks as lenders has made it increasingly difficult to see what is actually going on, and to anticipate how future financial retrenchment might play out, particularly with respect to emerging markets.

Should financial markets begin to tighten, either spontaneously or in response to tighter monetary conditions, there is reason to worry about overshooting. Owing to major central banks' unconventional monetary policies over the past decade, the process of "price discovery" in financial markets has long been curtailed.

At this point, even "efficient" financial markets would struggle to adapt to normalization. And there have been many indications of financial-market *inefficiency* in recent years, including continuing anomalies such as the violation of covered interest parity conditions in foreign-exchange markets, bouts of reduced liquidity (partly owing to new regulations), and recurrent flash crashes. And to these "known knowns" we must add the "known unknowns" associated with algorithmic trading and passive investing.

A final major risk to the global economy is US President Donald Trump's administration, whose protectionist policies are threatening to slow real (inflation-adjusted) growth and drive up inflation. And while fiscal expansion in the United States might temporarily offset growth impediments, it, too, will exacerbate inflationary pressures and undermine longer-term debt sustainability. Moreover, both protectionism and fiscal expansion are strengthening the dollar, and thus squeezing U.S. exporters and foreigners who have borrowed in dollars.

Complicating matters further, Trump's statement that he is not "thrilled" at the prospect of higher interest rates points to the risk of a too-compliant Federal Reserve ending up behind the inflationary curve-ball. When that happens, a recession typically follows.

Lastly, the Trump administration is increasingly using the dollar – and access to dollar clearing and funding – as a geopolitical weapon, risking retaliation and perhaps even jeopardizing the future of the dollar-based global monetary system.

All of these risks are raising the likelihood of a mass “hunkering down” in the face of future shocks. Worse, should the global economy experience another significant downturn, policymakers will find it much harder to respond than they did before. Initially, low policy rates mean that central banks will have very little room for traditional monetary easing.

As for unconventional monetary policies, there is still much disagreement about their effectiveness. At any rate, new measures would imply further increasing central banks’ balance sheets, which many (not least in Central Europe) already consider to be a potential source of future inflation.

Likewise, regardless of their merits, fiscal policies will almost certainly be constrained by leaders’ fears of rapidly-rising sovereign debt, especially in the major advanced economies. Another bank bailout would, of course, produce a severe political backlash. But, even if the Fed was willing to risk it, provisions in the 2010 US Dodd-Frank financial reform legislation explicitly limit its discretion in such matters. Whether those provisions apply to the Fed’s technical capacity to provide dollars to foreign central banks – as it did on a massive scale in late 2008 – remains to be seen.

An even bigger political constraint has emerged in the last decade. Whereas the 2008 crisis was a global phenomenon that elicited a global response, the growth of nationalist sentiment in many countries would likely impede similar cooperation. Would the U.S. Congress now allow the Fed to lend trillions of dollars to “freeloading foreigners”?

Add to that the rise of China and India, and the U.S. role in global leadership is less clear-cut than it was a decade ago. If another economic downturn were to fuel further nationalist gains and faster erosion of international cooperation, we could find ourselves on an old, familiar, and extremely dangerous path.

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BW: See About the Author on the following page.

About the Author

Writing for Project Syndicate since **2013**

William White is a former deputy governor of the Bank of Canada, a former head of the Monetary and Economic Department of the Bank for International Settlements, and the former Chairman of the Economic and Development Review Committee at the OECD.