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Is another Financial Crisis around the corner ?

Introduction

The near-term outlook – say, over 12 months – looks favourable.

2017 was a "good year" : growth was back in line with long term pre-crisis averages, unemployment was generally lower and inflation subdued.

But, as I will stress later, financial vulnerabilities have been building up.

Before getting into this, let us look at the positive factors that have reinforced our financial system over the past decade.

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I – What has strenthened the financial system since the 2007-2008 crisis ?

Three significant – positive – changes have occurred.

1. The banking system is more resilient.

Banks capital requirements have been increased significantly (they have more than doubled since the crisis). To give you an idea, European banks capital, in terms of GDP, has reached 16% of GDP (against 12% before the crisis) – see **Graph 1**. It had taken a century to make such an increase before 2007.

The quality of capital has also been improved.

And the way risks are weighted has been significantly tightened.

Furthermore, banks have been submitted to liquidity requirements that did not exist before the crisis.

In fact, because of regulation, the most risky bank models have been changing (UBS, Credit Suisse have almost eliminated fixed income trading, and banks like Deutschebank, Royal Bank of Scotland and Barclays have massively reduced their volatile trading activities).

Globally, the bank leverage in advanced countries - which was one of the weak spots of the pre-crisis period - has significantly diminished (**see Graph 1**).

With the Basel III rules, bank leverage is around 10 while it often reached 20-25 before 2007.

2. The derivative markets have been strengthened.

The huge increase of derivatives and the way they were dealt with ("over the counter") have been recognized as a significant weakness and a source of global financial vulnerability.

The reforms introduced since 2009 are intended to channel most derivative transactions to transparent and organized platforms that are responsible for settlements in Central Counterparty Clearing Houses (CCP). These CCPs are in charge of gauging risks and imposing collateral accordingly.

The consequent decline of “over the counter” transactions is meant to reduce the vulnerabilities of the previous fragmented bilateral system in which the details of contracts as well as of their guarantees were scanty.

But we should not elude ourselves. Every reform has its drawbacks.

In imposing centralized platforms, the risk could be that CCPs be insufficiently capitalized in case of significant defaults of participants, or of a fall in the value of collateral.

One can add that regulation has made “market making” more difficult and has thus contributed to reduce liquidity.

3. The real estate bubble does not seem as dangerous as in 2007.

Usually, real estate exuberance by households is an unmistakable harbinger of financial crises.

We remember how the subprime market had got out of hand in the early 2000s and how, through contagious securitization, it brought havoc to world markets and triggered the crisis.

This is a reason to watch carefully the housing markets.

What do they tell us ?

- ✓ That households are globally slightly more indebted than in 2007 ;
- ✓ That very low interests rates have encouraged real estate borrowing ;
- ✓ But that price bubbles do not seem to have reached the US peaks of 2006 ;
- ✓ That securitization of poor quality assets is not as sizeable as it was.

Nonetheless we should watch things carefully :

- ✓ The ratio of household debt / net disposable income exceeds 200% in a number of countries (Denmark, Ireland, Netherlands, Luxembourg, Sweden, UK).

- ✓ The intensity of this phenomenon is variable and bubbles seem for the time being rather localized.

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II – In spite of these improvements, strong financial vulnerabilities have been building up.

In fact, as we have just seen, the main answers to the crisis, in terms of lessons learned, have been in the regulatory fields and have been focused on financial institutions. However we should not forget that the crisis was not caused primarily by the inadequacy of institutions, but rather by the macro-economic excesses of that time. In order to address this point the following factors should be stressed.

1. The global debt is increasing and has reached record levels, especially in emerging countries.

The rise in global indebtedness was the major fundamental cause of the crisis in 2007.

But in a very accommodative monetary environment (QE has been enforced **after** the crisis) global debt has continued to rise significantly.

According to IMF data, global debt has reached, at the end of 2016 : 164.000 Billion $, the equivalent of 225% of world GDP.

In real terms (points of GDP), global indebtedness has increased by 12% since 2009, which is huge.

The main part of the increase has concerned emerging countries and in particular China (+ 43% increase since 2007).

Graphs 2 (A and B) illustrate the magnitude of this evolution.

As I have just stressed, the size of indebtedness had been the major factor behind the crisis.

Debtors were over-stretched, assets were over-priced, risks were under-valued and credit availability looked as if it were unlimited. Then, when asset prices (first, in the real estate sector) started to fall, market liquidity – and confidence – broke down and debtors were left with dwindling collateral and huge credits to repay. Contagion was everywhere. We do not see that happening today in the same way.

Things are never an exact repetition of the past. But, aside the global debt figures just recalled, we see, this time, a rather different and awkward situation. Over the last two or three years, a number of emerging countries are displaying increasing current account deficits.

This is the case, in particular, of Turkey, Argentina, India, Indonesia, South Africa, which are thus more and more dependent on financial market availability in foreign exchange.

We are already witnessing capital flights out of some of these countries. And the "normalization" of Fed monetary policy, as well as US protectionist moves, are intensifying the problems of these economies (some of which, like Turkey and Argentina, are already in deep crisis with current account deficits exceeding 5% of GDP).

Graph 3 shows how dollar denominated debt (the most vulnerable) in a number of emerging countries has exploded over the last 5 years.

Although the three countries with the most serious current balance difficulties (Turkey, Argentina, South Africa) represent only 4% of the world GDP, the question is : "In such a fragile environment, could we see an amplification of balance of payment and debt crises that could, by contagion, destabilize global financial markets ?".

More generally, countries that borrow overseas ('frontier markets") are increasing their debt (that has topped 2,3 Trillion $ in Q1 2018). 170 Billion $ of their bonds and loans are to mature before the end of 2019, implying potential refinancing challenges in the present environment (IIF).

This should be seen as a warning and should be, in particular, a crucial element of IMF's surveillance policies.

2. The huge world imbalances have not been reduced.

Indeed, nothing has been done over the last ten years, to repair the faulty international monetary system that continues to operate and thrive on massive imbalances.

a) The current account imbalances are still daunting with a recent special focus on the German surplus.

		In GDP terms
USA	*- 466 Billion of US $*	*- 3%*
Germany	*+ 296 Billion of US $*	*+ 8,2%*
Japan	*+ 195 Billion of US $*	*+ 3,8%*
China	*+ 165 Billion of US $*	*+ 1,2%*

Source : IMF
World Economic Outlook – April 2018

b) This persistent pattern of large current account imbalances is accompanied by massive fiscal deficits.

Public sector debt in advanced countries has jumped from 70% of GDP in 2007 to 100% now.

Hence, the "fiscal capacity" of most deficit countries has considerably deteriorated since the 2007 crisis. The huge deficits embarked upon in the years after the crisis are responsible for this evolution.

Some tend to underestimate the issue.

But we should not delude ourselves.

Above certain levels, public debt becomes costly in terms of growth. The outstanding public debt is sensitive to higher interest rates notably in Europe. This is all the more serious that, in the meantime, private debt has not receded.

The present level of 5% of GDP reached by the US primary deficit (fiscal balance less interest expenses) is most unusual at this high point of the cycle in a period of strong growth and low unemployment. It shows the vulnerability of the US fiscal position at a time when interest rate expense is likely to rise[1].

Germany offers a counter-example. Because of its policy of fiscal discipline (which has not prevented it from growing faster than deficit countries), Germany is about to get below the Maastricht public debt threshold of 60% of GDP. It is thus re-creating a "fiscal margin" that should allow it to re-start public infrastructure expenditures. This would be convenient if growth were to slow down. Unfortunately it is an isolated case.

[1] Presently :

US Treasury 10 year rates	*3%*
Inflation	*2%*
Nominal growth	*5 ½%*
Real interest rate	*1%*

3. Debt quality is a matter that deserves attention.

Several factors are been observed :

- ✓ Since 2012 there has been a significant increase in high yield debt. 40% of world corporate ratings are at B levels or below.
  This is not worrisome in itself. Careful funds (like yours) have gained a recognized specialty in dealing successfully with high yield instruments. The question is more for undiscriminating funds. With the emerging vulnerabilities, defaults on some corporates will inevitably appear. The question is : how many will default ? What is clear is that we have been observing recently a significant deterioration of the financial situation of "small caps" in the US (their interest coverage ratio has become negative).

- ✓ Global leveraged loans, together with high yield bonds, have doubled since the crisis. They have reached a total of 2,6 Trillion $, mainly in the US (see BIS last quarterly review).

- ✓ Another evolution has to do with the increasing use of corporate debt to finance share buybacks at high levels[2].

  The danger here is that these funds remunerate shareholders to the detriment of investment. We should have in mind that investment is the long term guarantee of future growth and productivity gains.

- ✓ Collateralized loan obligations (CLOs) have also massively increased since 2012 while covenants have been weakened (BIS).

"Macro supervisors" should be watching carefully these evolutions.

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[2] *1 Trillion $ are estimated to be spent by corporates on share buy-backs in 2018 (FT Sept 21, 2018).*
To give an order of magnitude, this amount can be compared to total estimated US investment in 2018 (3 Trillion $).

4. “Shadow banking” is a subject that requires more and urgent surveillance.

With the strengthening of capital constraints on banks over the past years, and the resulting deleveraging of the banking sector, it is normal that funds are shifting toward the “non banking” sector.

Some parts of the non-banks are subject to precise oversight (insurance companies, management funds …). But others are less known, understood and regulated.

While having in mind the advantages that such funds can present in terms of providing liquidity to the markets, the question is nonetheless : Could such parts of the shadow banking system be subject to potential liquidity problems ? Can tensions, if they appear, be contained or could they spread to the rest of the financial system ?

The G20 has put this issue high on its agenda. But, my sense is that not much has been done by the Financial Stability Board to really cope with the problem.

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Conclusion

Let me conclude.

Things are still “conjoncturally” satisfactory.

But “the storm clouds continue to gather over international financial markets” as my friend Bill Rhodes is warning in a recent article. He goes on :

“While the situation is not as serious as directly before the last financial crisis, it is nevertheless of mounting concern”.

I would add that the conjunction of :

- ✓ High valued assets combined with low risk pricing and search for yields ;
- ✓ Emerging countries mounting balance of payments problems ;
- ✓ Threats on growth coming from US trade moves in a period of monetary normalization, of high imbalances and heavy leverage,

should be a cause for serious concern.

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More specifically, we could touch on the issue from the following angle :

"If a global recession were to emerge let us say in 2020, how would the financial markets react ?"

The possible reasons behind a slowing down of present growth are easy to detect :

- ✓ Levels of resource utilization are high ;
- ✓ Asset prices are in high territory (in the US, price-earning ratios are 50% above their historic averages) ;
- ✓ Credit is globally costly given the high level of corporate debt ;
- ✓ Trade frictions between the US and their partners could slow growth in a number of countries[3] ;
- ✓ Geopolitical tensions (China, Iran, Russia, …) - not to mention the Brexit - are in the background.

If the recession happens, the usual process will unfold :

- ✓ Markets will correct very high asset prices downwards ;
- ✓ and debt repayment will become more problematic in some sectors as collateral values fall.

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[3] *This is why the OECD has already reduced by 0,2% its May 2018 forecast for growth in 2019.*

But, this time, the usual policy tools will be somewhat impaired :

- ✓ fiscal leeway is less available than in 2007, given the present high degree of public debt and fiscal laxity ;
- ✓ monetary policy, notably in Europe, which is still very accommodative with low levels of interest rates, will have little margins to relax.

We can add that while the measures taken since the last crisis have improved the ability to deal with failures of individual institutions, they have reduced the flexibility to deal with a systemic crisis[4].
All in all, the global financial situation is not without risks.

Record high stock values are not sustainable (see **Graph 4** that shows how QE has fed into high financial asset values).

While it is true that global corporate debt is less heavily held in banks than in 2007, risks have not disappeared. If the present value of corporate bonds were to fall in an environment of rapidly rising rates, the issuing corporates could face difficulties in refinancing their huge debt as well as in issuing new stocks. Capital increases would be more problematic.

And this, particularly in Europe, could weaken further the real economy.

So, let us not delude ourselves :

- ✓ banks will probably not be the next trigger for the crisis,
- ✓ but debt and stock markets are the vulnerable spots of the system.

You might ask me the ultimate question :

“Which immediate policy implications do you draw from this analysis ?”

I would answer : “No complacency and better policies !” meaning :

- ✓ regaining urgently some fiscal room for manoeuvre in order to be able to face a future recession ;
- ✓ reinvigorating flagging structural policies ; in particular in the field of pensions ;
- ✓ normalizing monetary policy without yielding to political pressure.

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[4] *See : « Managing the next financial crisis » - G30 September 2018.*

Of course, all that requires leadership and can collide with the 2020 US Presidential election.

Financial vulnerabilities build up slowly. But one day they emerge. The temptation, then, is to "kick the can down the road" and to inject more and more money in the system. That could prove irresistible. But it is precisely **the** mistake that would impair the future.

The BIS has published its last quarterly report a few days ago (after I wrote the present intervention).

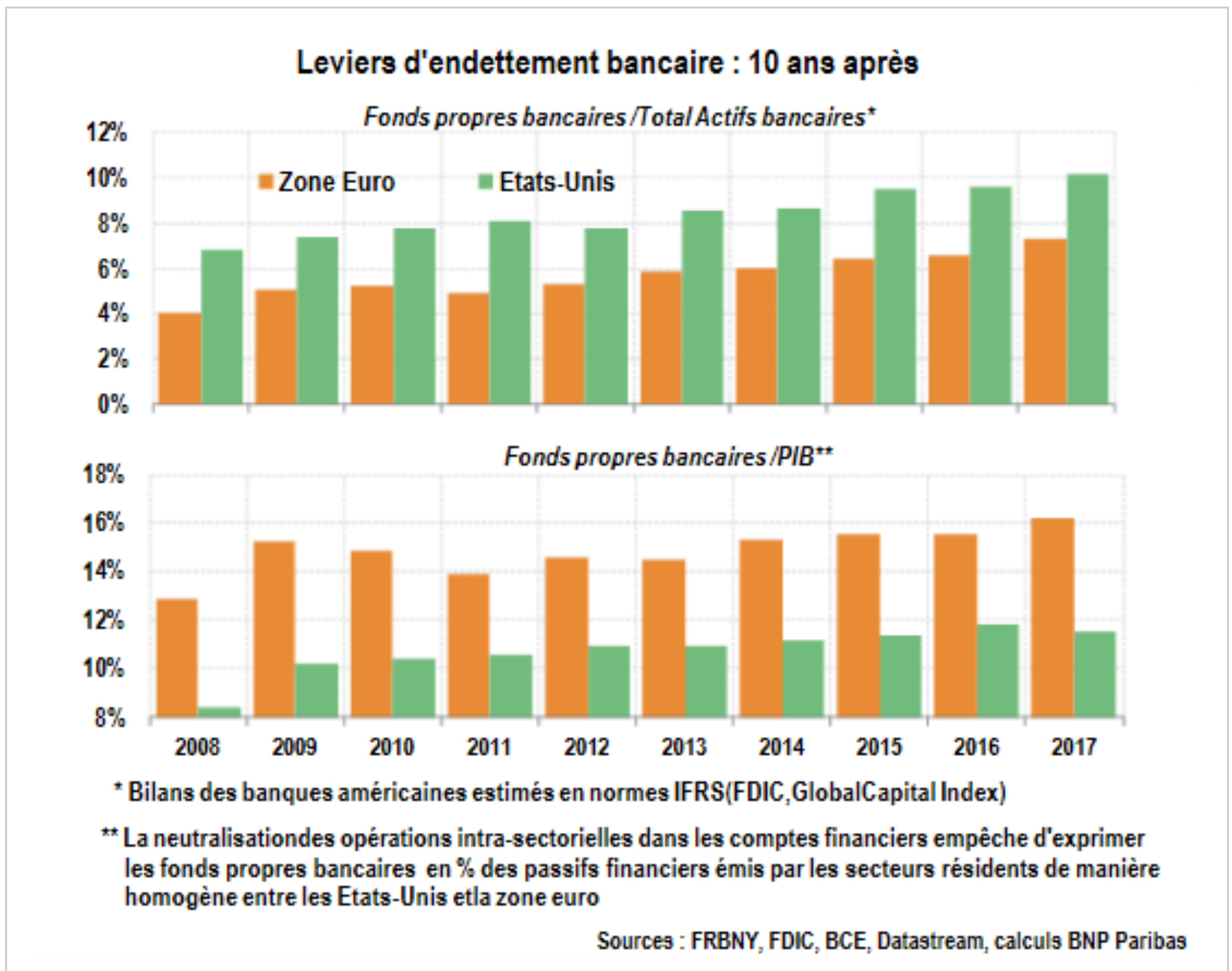
It stresses : "The advanced economies display excessively high valuations, financial conditions are too easy and global debt is too high"[5].

Jacques de Larosière

Annexe : Graphiques

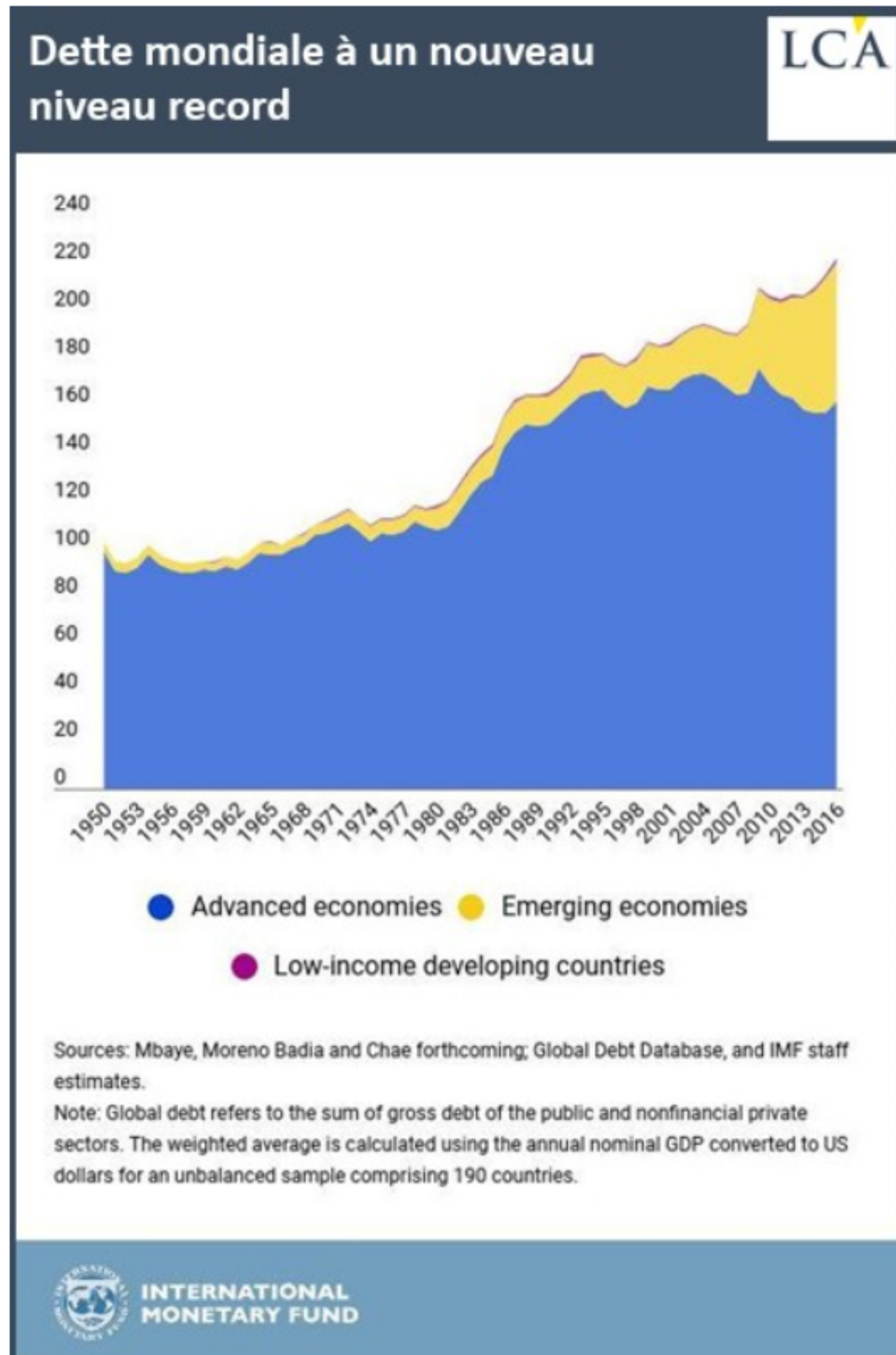
[5] *BIS Quarterly Report September 23rd 2018.*

Graph 1



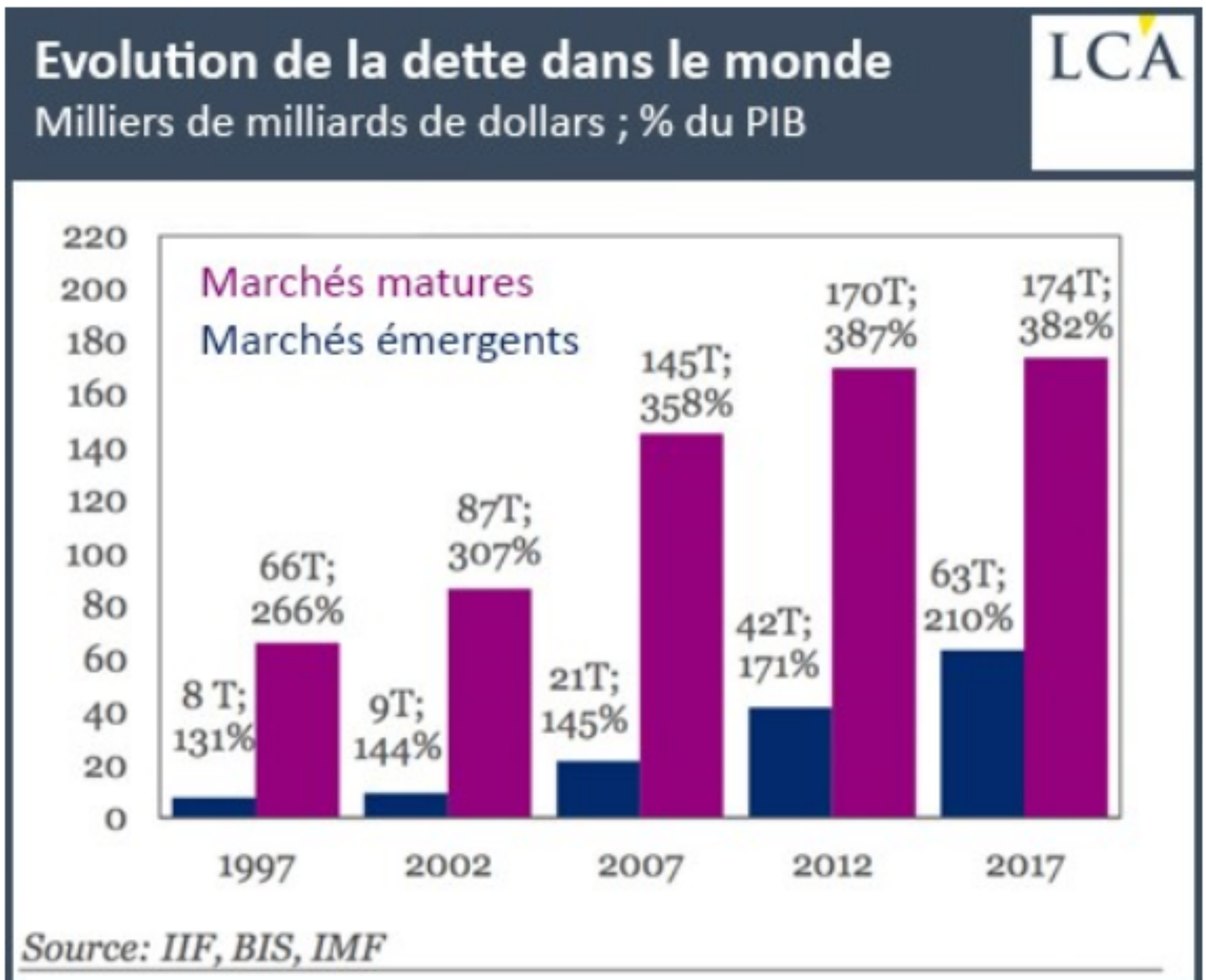
Bank leverage 10 years after

Graph 2A

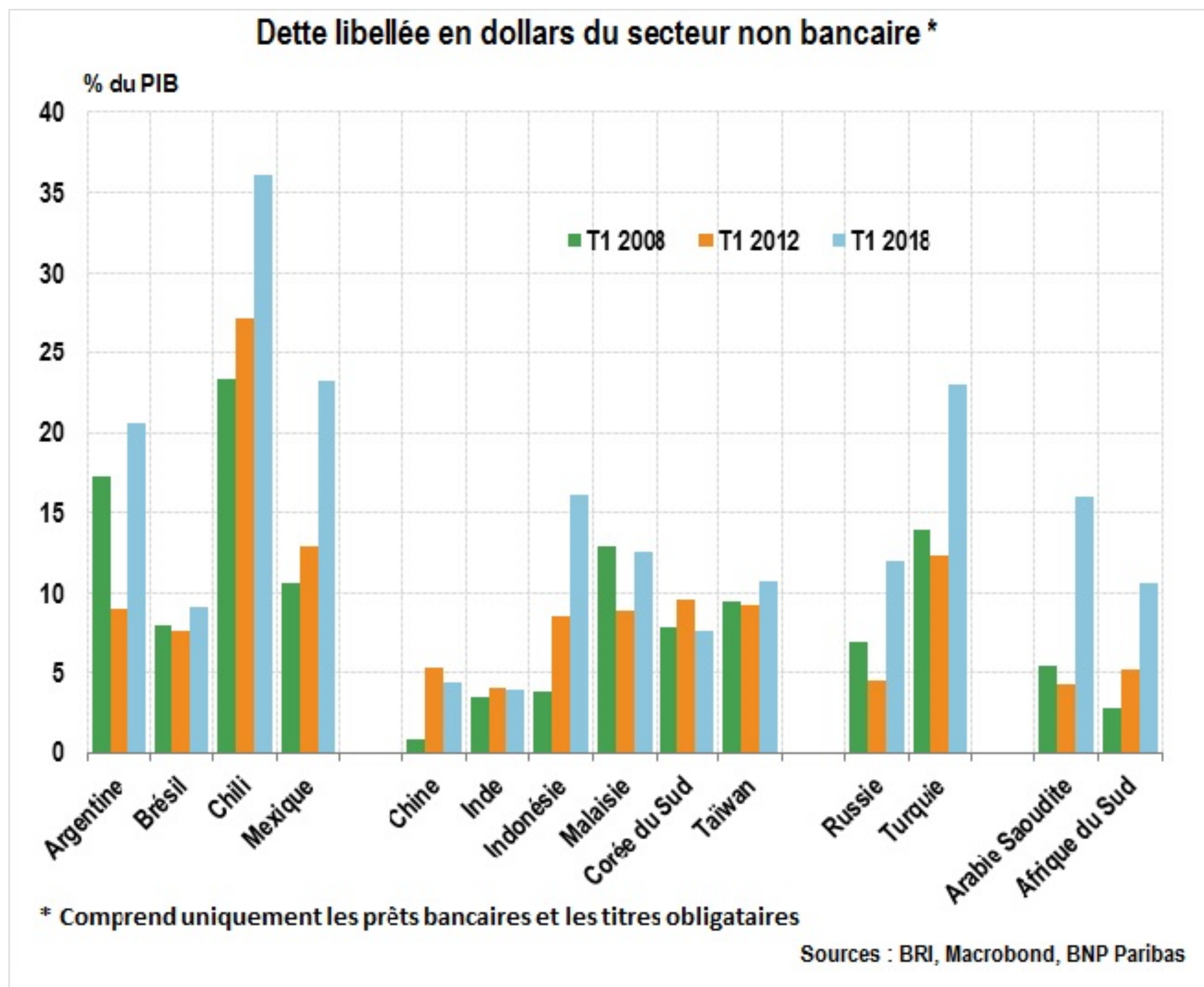


Global world debt reaches a new record

Graph 2B



Graph 3



Debt, denominated in US dollars, incurred by the non banking sector

Graph 4

The US stock market (S&P 500)

has reached a record high