Financial outlook ‘precarious’: IMF

A fair summary of the IMF’s Global Financial Stability Report 2019 is that the financial landscape is littered with minefields and there is little chance we can escape one or more of them exploding, with catastrophic global consequences. The impact of negative interest rates, negative yielding bond markets, declines in the productive sector, soaring corporate debt, and the expansion of less-regulated shadow banking are among them.

For the fifth time running, the IMF downgraded its forecast for global economic growth. Estimating growth was slowing in 90 per cent of the world, the IMF warned in a blog accompanying its report that “with a synchronised slowdown and uncertain recovery” the global outlook “remains precarious”, adding that there “is no room for policy mistakes”. The blog discussed a host of economic weaknesses, which have led to “a sharp deterioration in manufacturing activity and global trade”. These range from trade disruptions, to Brexit, to new emissions standards in Europe.

The IMF report admitted that easier financial conditions have “encouraged more financial risk-taking and a further buildup of financial vulnerabilities, putting medium-term growth at risk”. This has created major vulnerabilities in the corporate and nonbank sectors, and has driven insurance companies, pension funds and other institutional investors into riskier and less liquid investments. These investments are inflating the existing bubble (“overstretching” asset prices) and have fuelled the expansion of leveraged corporate debt and its securitisation, in a repeat of the 2007-08 mortgage-backed securities phenomenon. This heightened risk raises the “possibility of sharp, sudden adjustments in financial conditions”, concluded the report.

Up to 40 per cent of corporate debt—worth US$19 trillion—is at risk of default in a global economic downturn “half as severe as the global financial crisis”, the report declared. Despite very low interest costs, the outlook for corporations has worsened in systemically important countries— including China, France, Germany, Italy, Japan, Spain, the United Kingdom and the United States—and global credit is increasingly flowing to risky borrowers. Nonbank vulnerabilities are elevated in 80 per cent of economies with systemically important financial sectors, similar to rates at the height of the 2008 global crisis.

The impact of bonds with negative yields, now worth some US$15 trillion, is also addressed in the IMF report. One-sixth of bond funds would face a “liquidity shortfall” if they met with high rates of monthly redemptions similar to those faced in the early 2000s. If they are forced to dump assets to raise cash, the IMF said, it would “increase the risk for the financial system”.

The report also raised the dangers associated with global US dollar funding markets, the vulnerabilities of which can “amplify adverse shocks” globally. As Ambrose Evans-Pritchard wrote in the *Telegraph* on 16 October, the rising tide of dollar denominated debt, now at US$12.4 trillion “makes borrowers acutely sensitive to a complex interplay of derivatives, Fed policy, and the US exchange rate”. Low rates have encouraged an outflow of investment into emerging markets, where debt risk is growing. This time around, the weaknesses in the USA and Europe are shared by countries across Asia, South America, Africa and the Middle East.

As for solutions … the IMF comes up with the same ol’ same ol’, including: macroprudential regulation; a plea that “Monetary policy cannot be the only game in town. It should be coupled with fiscal support…”, echoing numerous other statements from officialdom; and, invoking the desperation to complete the global “bail in” regime to save the banks, a demand that “Global policy coordination remains critical. … Policymakers should also complete and fully implement the global regulatory reform agenda, ensuring that there is no rollback of regulatory standards.”

Warnings reverberate

Numerous leaders and bankers at the annual IMF and World Bank meetings on 10-11 October, and at other events, reflected the same concerns. At the Washington, DC summit the UN Secretary-General António Guterres warned that the world economy faced severe headwinds, saying that fiscal policies are required to make an impact, including tailored tax policy, long-term investment and reduction of debt.

Former Bank of England Governor Mervyn King was perhaps the most dramatic voice at the IMF meeting, demanding that we throw out orthodoxy. King, who was in charge during the GFC, warned that “Another economic and financial crisis would be devastating to the legitimacy of a democratic market system. By sticking to the new orthodoxy of monetary policy and pretending that we have made the banking system safe, we are sleepwalking towards that crisis.”

Right diagnosis, but wrong prescription: King then called for legislators to restore the Fed’s capability for monetary intervention to stave off the new crisis, which had been blunted by new regulations after the previous crisis: “Congress would be confronted with a choice between financial Armageddon and a suspension of some of the rules that were introduced after the last crisis to limit the ability of the Fed to lend.” In other words, King is saying the Fed should be allowed to do another mega-bailout, when the real issue is reforming the banks starting with Glass-Steagall, as King himself once advocated.

Former Treasury Secretary under President Bill Clinton, Larry Summers, warned on 14 October that the USA was one recession away from entering the realm of zero to negative interest rates and with it a new period of potential instability, with a “black hole, zero-interest-rate world” operating very differently than what financial institutions are used to.

Echoing concerns in the IMF report, Sir John Cunliffe, deputy governor for financial stability at the Bank of England, warned the Society of Professional Economists on 14 October that long-term low interest rates make for a “less resilient and riskier financial system” and an economy “more vulnerable to macroeconomic shocks”. He elaborated on the danger of investment funds being forced to liquidate assets due to demands for client withdrawals or having to block withdrawals for months at a time. The hunt for yield to ensure client returns in a low rate environment has driven them into riskier investments, including leveraged loans or long-term investments that are harder to unwind, creating a “liquidity mismatch” which can lead to “more frequent fire-sales of assets if funds are required to meet large investor redemptions”, said Cunliffe.

Australian Alert Service, 23 October 2019
