Global financial system faces growing risks

By Nick Beams
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The International Monetary Fund's semi-annual assessment of the state of global financial markets is a rather contradictory document. It opens by asserting that the "resilience of the global financial system has further improved in the last six months" because of "continued improvement" in the corporate, financial and household sectors in many countries. However, it then devotes considerable space to outlining the growing dangers posed by the increasing complexity of the entire structure.

According to the Global Financial Stability report issued last week, benign conditions, including low interest rates and low credit risks, have helped strengthen the financial system over the past six months. But they have also led to the growth of complacency, always a source of danger. At present "risk premiums for inflation and credit risks leave little or no margin for error in terms of financial asset valuations". A combination of "low risk premiums, complacency and untested elements of risk management systems with complex financial instruments could ultimately become hazardous to the financial markets."

Among the risks it identifies are a continued widening of the US current account deficit—now running at $665.9 billion per year, or 5.7 percent of gross domestic product (GDP)—continued rises in oil and other commodity prices, feeding through to the general inflation rate and "negative surprises" for corporate earnings and credit quality.

There is no visible sign of a sustained decline in capital inflows into the US. But the report warns that "undue delays" in addressing the present global imbalances or "serious doubts" about the willingness of central banks to continue to accumulate dollars and thereby fund the US deficit "could spark strong incentives for investors, private and possibly even public, to reduce future dollar purchases or even reduce their existing dollar holdings." This could trigger a further significant decline in the dollar, sparking an increase in interest rates, which would dampen economic demand in the US.

While it does not mention it by name, the report's authors clearly had General Motors in mind when they noted that another area of concern was "the downgrading of a major global company to subinvestment grade for reasons that may not be linked to negative events in the global economy." Credit rating agencies have threatened to reduce GM debt to "junk bond" status—a move that could lead to financial turbulence as investment funds are forced to sell off GM bonds and shares.

Over the past decade and a half, the global financial market has seen the rapid growth of complex financial instruments aimed at spreading risk and increasing stability. But, in a period of market fluctuations, this process could itself become a source of greater instability. These instruments, the report notes, rely on quantitative mathematical models for value, assessments and pricing. "Therefore, there is a risk that models that are overly similar in their construction could cause investors to rush to exit at the same time, leading to market liquidity shortages."

This warning recalls the crisis surrounding the hedge fund Long Term Capital Management (LTCM) in September 1998 that led to a $3 billion bailout being organised through the New York Federal Reserve. The threat to global financial stability was not because LTCM was a "rogue trader" but the reverse. Its investments, based on complex mathematical models, were very close to those of other funds. Consequently, had LTCM gone down, others would have followed.

The report notes that while risk management has been strengthened and become more sophisticated in recent years, the process still depends on financial institutions having ready access to liquidity in times of "market stresses". Most risk management models dealing with the new complex instruments such as derivatives "have not yet been put to a live test". So there is still doubt over whether "the anticipated counterparties will stand ready to absorb the additional market and credit risks from those who would like to shed it."

In other words, no matter how complex or sophisticated the model, the age-old problem of the capitalist market remains. There is no guarantee that, in times of trouble, sellers will be able to find a buyer. Therefore there is the possibility that a relatively small problem can rapidly escalate into a crisis. In the words of the report: “The question of a liquidity shortage as a potential amplifier for market price shocks is still one of the major ‘blind spots’ in our financial landscape.”

One danger area is the willingness of banks and other financial institutions to take on increasing risk in the search for profits in the face of declining opportunities. There are signs this is taking place. According to a report in the *Financial Times* of April 6, the Bank of Japan (BOJ) has warned that the country’s banks are “increasing their investments in high-risk instruments such as hedge funds and derivatives in an attempt to boost profitability, even though they do not always understand the risks involved.”

The move to high-risk areas reflects the difficulties confronting lenders in an environment of falling demand for loans, low interest rates and surplus deposits. According to the report, the BOJ found that while the banks’ investments in high-risk assets were small compared with their total assets, “the structured nature of the products means losses can eliminate a proportionately large amount of capital.”

At the macro level, the biggest potential source of instability is the weakness of the US dollar and the mounting US payments deficit. But, as an editorial in the *Financial Times* of April 3 noted, the world’s two other major currencies—the euro and the yen—are not in much better shape. The euro had nothing to recommend it “other than not being the dollar” and the euro economy remained sluggish. As for the yen, the editorial pointed out that “investors are still waiting for the Japanese economy to develop a self-sustaining economy” and that late last year “Japan again flirted with recession.”

The dangers to the stability of the global capitalist economy contained in the ever-growing indebtedness of the United States have been highlighted in an article by former US Federal Reserve Board chairman Paul Volcker published in the *Washington Post* at the weekend.

Volcker began by noting that under the apparent placid surface of the world economy “there are disturbing trends: huge imbalances, disequilibria risks—call them what you will. Altogether the circumstances seem to me as dangerous and intractable as any as I can remember, and I can remember quite a lot. What really concerns me is that there seems to be so little willingness or capacity to do much about it.”

The US economy was being held together by a massive inflow of capital—running to more than $2 billion every working day—while the central banks have been willing to increase their dollar holdings. “The difficulty is that this seemingly comfortable pattern can’t go on indefinitely. I don’t know of any country that has managed to consume and invest 6 percent more than it produces. The United States is absorbing about 80 percent of the net flow of international capital. And at some point, both central banks and private institutions will have their fill of dollars.”

Volcker claimed that it was not difficult intellectually to set out the scenario for a “soft landing” and economic growth. China and the other East Asian economies had to encourage an exchange rate appreciation against the US dollar; Japan and Europe had to aggressively pursue pro-growth policies; and the United States had to increase its rate of savings. But there was little possibility of any of these policies, much a less a combination of them, being implemented. “So I think we are skating on increasingly thin ice.”

On the present trajectory, the deficits and imbalances will increase and at a certain point the sense of confidence in capital markets that benignly supports the flow of fund to the US could fade. Then a combination of events could disturb markets leading to “damaging volatility in both exchange markets and interest rates.”

Volcker did not know whether the present situation would end with a bang or a whimper but as things stand it is “more likely than not that it will be financial crises rather than policy foresight that will force the change.” There was a taste of what could develop in the stagflation of the 1970s—a volatile and depressed dollar, inflationary pressures, a sudden increase in interest rates and a couple of big recessions.