

Did This Straw Break the Finance Sector's Back?

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The world's financial markets are hurtling towards a new phase of crises ranging from currency, to balance of payments, to sovereign debt, to banking crises. The monetary tightening policies of the United States Federal Reserve and the European Central Bank will only precipitate crises in emerging markets as well as peripheral eurozone economies, which will have global repercussions.

I will define the straw and start with quoting from my July 2017 HT Parekh Finance Column titled "Debts That Cannot Be Paid Will Not Be" (Öncü 2017).

With my June 2015 HT Parekh Finance Column article titled "When Will the Next Financial Crisis Start?" [Öncü 2015a] I initiated an investigation of the possibility of a new phase in the ongoing global financial crisis (GFC) that started in the summer of 2007.

[This article was retitled on the *Policy Research in Macroeconomics* website as "What Straw Will Break the Finance Sector's Back?" when it was republished three days later (Öncü 2015b).]

Then followed two more articles, "Has the Crash of the Global Financial Markets Begun?" and "It's the Private Debt, Stupid!" (Öncü 2016a, 2016b) and my July 2017 article was the fourth in the series. In this fourth article I said:

Time will tell whether this article will be the last in the series or not as financial markets have a way to put even the best forecasters to shame. (Öncü 2017)

Now is the time for a fifth article in the series, and who knows when the sixth article will come?

Bubbles Everywhere

I have written about the quantitative easing programmes (QEs) extensively in the *EPW* (see, for example, Öncü 2016a) so I will not go into details here. To put it briefly, the QEs were essentially about purchases of government bonds through which the involved central banks increased not only the base (central bank) money, but also an equal amount of broad money (that can buy things in the real economy) to avoid a major deflation.

As Roach (2017) noted,

[f]rom 2008 to 2017, the combined asset holdings of central banks in the major advanced economies (the United States [us], the eurozone, and Japan) expanded by \$8.3 trillion, according to the Bank for International Settlements. With nominal GDP [gross domestic product] in these same economies increasing

by just \$2.1 trillion over the same period, the remaining \$6.2 trillion of excess liquidity has distorted asset prices around the world.

This happened because the broad money created through the QEs (and increased some more by the banks by extending credit) ended up mostly in the hands of speculators in search of high yields, who spent that money to blow bubbles around the world to cause asset price inflation in such assets as real estate, equities, bonds, and other types of securities. Another major result of the QEs was the emerging and developing countries bubble that is bursting as I write.

We entered the year 2018 with almost all these bubbles at their peaks.

Wisdom or Complacency?

Another notable event at the start of 2018 was an upbeat synchronised global growth story the world started to hear from major forecasters, ranging from the International Monetary Fund (IMF) to Citibank, Morgan Stanley, and the like. Many others joined the choir from around the world and a consensus was formed. According to this consensus, after the start of the global growth in the latter half of 2016, the global financial crisis that started in the summer of 2007 officially ended in 2017, and starting from 2018 there would be synchronised global growth that would last for a few years. To the credit of the members of this choir, many of the global economic indicators, including fixed investments, appeared quite robust.

Of course, not everyone joined the choir and some of us remained sceptical. In his article cited earlier, Roach (2017), one of the sceptics, said the following:

While I have great respect for the forecasting community and the collective wisdom of financial markets, I suspect that today's consensus of complacency will be seriously tested in 2018. The test might come from a shock—especially in view of the rising risk of a hot war (with North Korea) or a trade war (between the us and China) or a collapsing asset bubble (think Bitcoin). But I have a hunch it will turn out to be something far more systemic.

The world is set up for the unwinding of three mega-trends: unconventional monetary policy, the real economy's dependence on assets, and a potentially destabilizing global saving arbitrage. At risk are the very fundamentals that underpin current optimism.

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One or more of these pillars of complacency will, I suspect, crumble in 2018.

When the first one crumbled, none other than the Reserve Bank of India Governor Urjit Patel sent the following warning to the us Federal Reserve (Fed) in his recent *Financial Times* article:

Dollar funding of emerging market economies has been in turmoil for months now. Unlike previous turbulence, this episode cannot be attributed to the us Federal Reserve's moves on interest rates, which have been rising steadily since December 2016 in a calibrated manner.

The upheaval stems from the coincidence of two significant events: the Fed's long-awaited moves to trim its balance sheet and a substantial increase in issuing us Treasuries to pay for tax cuts. Given the rapid rise in the size of the us deficit, *the Fed must respond by slowing plans to shrink its balance sheet.* (Patel 2018; emphasis mine)

The Last Straw

Whether one agrees with Patel's argument or not, his timely warning came at a moment when there were signs of international capital flowing out of some emerging economies, including Turkey, Argentina, Brazil, South Africa, Indonesia and, these days, even India. And, Patel was not alone. As Khor (2018) mentions, increasingly there have been warnings of an imminent new financial crisis, not only from the billionaire investor George Soros, but also from two eminent economists associated with the Bank for International Settlements (BIS), the bank of all central banks.

These two economists are Peter Dittus, former secretary general of the BIS, and Hervé Hannoun, the former deputy general manager of the BIS. In a launch of their recent book *Revolution Required: The Ticking Time Bombs of the G7 Model* (2017), organised by the South Centre (Khor 2018), they claimed that the G7 central banks have to choose between two highly risky scenarios: policy normalisation or government debt monetisation.

In his article discussing their presentation, Khor (2018) mentioned that the G7 central banks' policy normalisation was the only option consistent with their mandate. He, then, claimed that when the G7 central banks eventually exited from their unconventional policies, they would contribute to the bursting of the

asset price bubbles engendered by their monetary experiment.

Although some (if not all) of the G7 central banks may convert—with its own associated problems—to government debt monetisation in the future, the current tendency appears to be towards policy normalisation, and the Fed started its policy normalisation when it stopped rolling over the coupon and principal payments up to certain limits to the bonds on its balance sheet in October 2017. Since then, the emerging markets have been in turmoil with the Argentine peso falling about 30% and the Turkish lira falling about 20% from the end of 2017. Further, although Argentina called for help from the IMF in May 2018, this has not calmed the markets for long and the peso started falling again in the second week of June 2018.

There is no question that these two countries are in currency crises and the future does not look bright for Brazil and South Africa, with Indonesia, India, Poland and Hungary among the next in the sequence. The crisis is spreading and may even turn into balance of payments as well as banking crises in some of these countries. Contagion will continue unless there are radical changes in the behaviour of the major central banks, which looks unlikely.

As for the last straw, it came in the form of the last meetings of the Fed and the European Central Bank (ECB) that took place on 12–13 June 2018 and 14 June 2018, respectively.

Meeting the market expectations, the Fed raised its policy rate by 25 basis points. This was the seventh rate increase since late 2015 when the Fed first began raising interest rates from near zero. Not only did the Fed signal two more rate hikes this year for a total of four, but also made clear that it will continue with its quantitative tightening according to its original plans to shrink its balance sheet. This was the first bit of bad news for the emerging markets and the first half of the last straw.

A worse news for the emerging markets and the remaining half of the last straw came from the ECB the next day. Although the ECB kept its policy rate unchanged, it decided to halve the pace of its QE programme after September

2018 to just €15 billion per month, and then to stop buying new bonds altogether by December 2018.

Meanwhile, in the Eurozone ...

The ECB's signalling of the end of its QE programme has major consequences for the eurozone in general and for the peripheral eurozone countries such as Italy, Spain, and Portugal in particular also, but their detailed discussion would take another article of equal length, so I will not go into details. As Joseph Stiglitz (2018) said in his 13 June article titled "Can the Euro Be Saved?": "the euro may be approaching another crisis." And, I add that even the second phase of the "European Sovereign Debt Crisis" followed by a "European Banking Crisis" may start soon unless Germany and the ECB change their stance.

Let me now conclude by quoting from my February 2016 H T Parekh Finance Column (Öncü 2016a: 11):

On 29 January 2016, the *Guardian* asked a number of economists whether the gyrating financial markets are facing a global meltdown. One of the economists was the former Greek Finance Minister Yanis Varoufakis. He concluded his response as follows: "Should we be afraid? Yes. Is it inevitable that a new 2008 is coming? In political economics, nothing is inevitable. I respectfully disagree."

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