

Global Financial Systems

Chapter 24

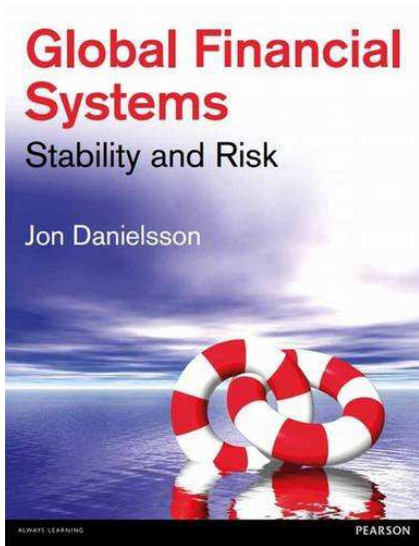
Liquidity and Debt

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To accompany
Global Financial Systems: Stability and Risk
<http://www.globalfinancialsystems.org/>
Published by Pearson 2013

Book and slides



- The tables and graphs are the same as in the book
- See the book for references to original data sources
- Updated versions of the slides can be downloaded from the book web page www.globalfinancialsystems.org

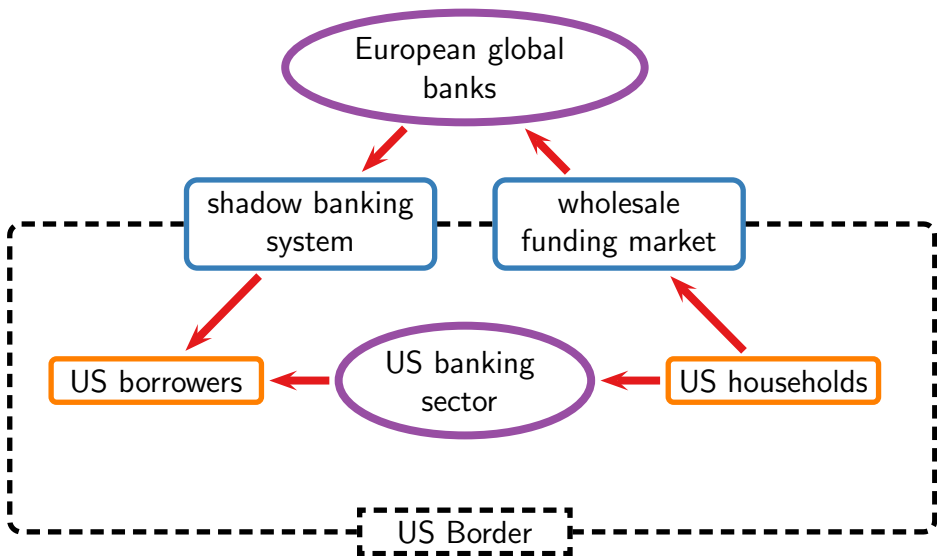
- Version 4.1, November 2016
- These slides draw on Chapter 24, “Global liquidity and debt sustainability” that is published on–line

Global liquidity

The role of liquidity

- Liquidity is at the heart of almost every financial crisis
- In upturns, virtuous cycle between money flows, investments, profits and leverage
- In downturns, things reverse even more rapidly, and the bubble bursts
- These chains of events can be referred to as *“global liquidity phases”*
- Most work on this issue has been done by the BIS

European banks in the first phase



Increasing vulnerabilities

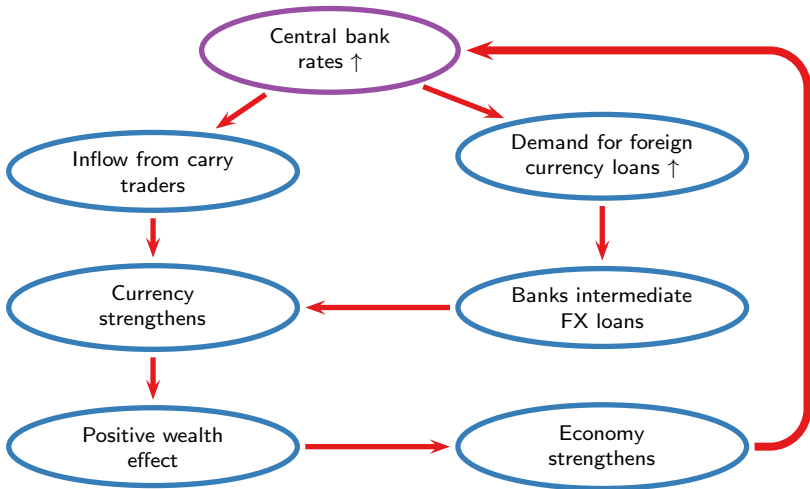
- When looking at net cross-border flows, vulnerabilities were hardly visible
- EU banks borrowed and lent to the same country
- Transactions were not captured by the net exposure

Why did EU banks expand so rapidly?

- The emergence of the euro
- European banks were subject to Basel regulations earlier than US banks
- Thus, US banks were subject to the *leverage ratio*, while EU banks were constrained by *RWA*, which is more amenable to this sort of transactions

- Widespread availability of liquidity increased banking sector inflows in many countries
- (including EU crisis countries, Korea, Turkey).
- The example of Spain:
 - In 1998, before joining the euro, total credit in Spain reached €414 billion, entirely financed from Spanish deposits
 - By 2008, total credit reached €2 trillion, with only half being financed domestically

The risk-taking channel of the currency appreciation



2007-2009: Financial crisis, response & asset manager intervention

Crisis response: lessons from the Great Depression

- Today's massive liquidity provision has its origins in the critique on the central banks' reactions following the Great Depression
- Especially liquidity

Financing from debt securities issuance

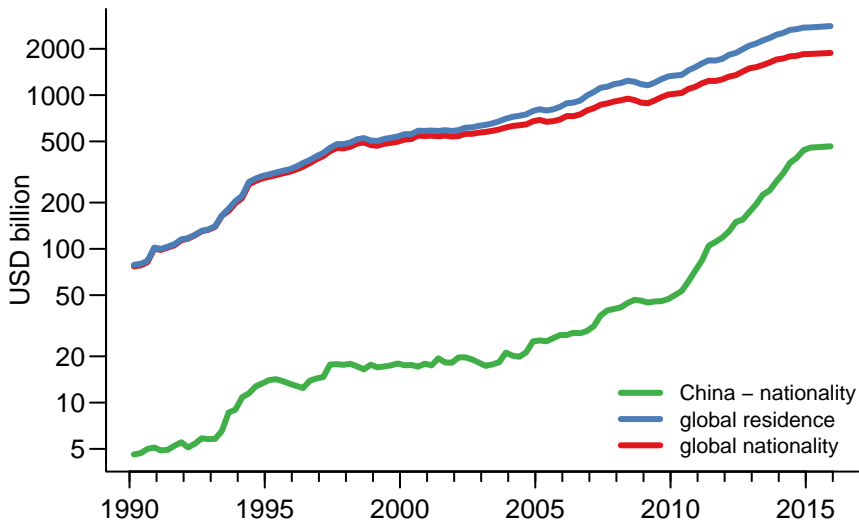
- Retrenchment of major global banks (especially from the EU) after the crisis
- Borrowers in EMEs had easier access to international capital markets
- In EMEs, particularly China and Brazil, the issuance of debt securities in offshore financial centers increased rapidly

Increase in international securities issuance by EME corporates

- Investors still want to avoid exposure to EME currencies and legal systems
- So EME corporates have issued more debt securities in offshore financial centers
 1. Lower administrative, legal and tax costs
 2. Offshore markets are also more developed for sub-investment grade bonds
 3. Preferential tax system for foreign investors

Outstanding international securities

Developing countries, all borrowers

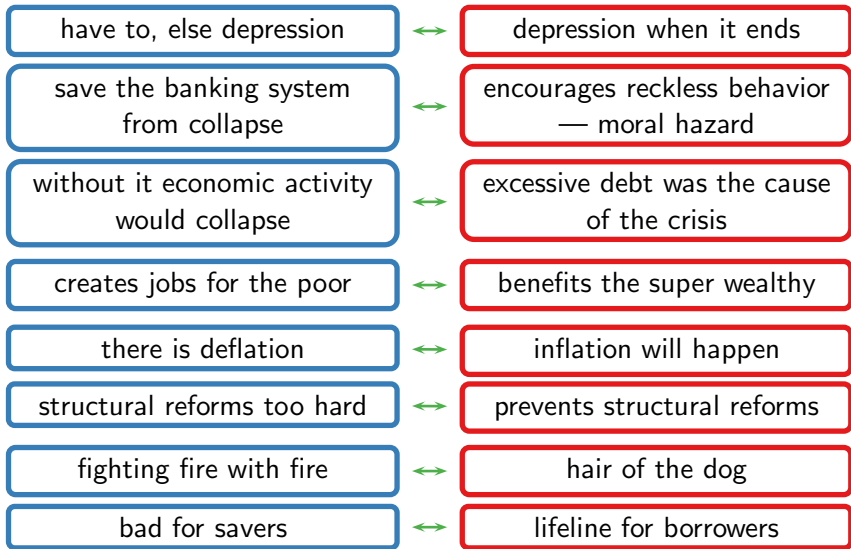


Current consequences for the world economy

Debt and liquidity sustainability

- Expansion of liquidity prevented global depression in 2008
- But
- Debt before 2007 was also unsustainably high
- But the growth environment was much more positive back then
- Today there is slow growth and uncertainty regarding world interest rates
- Liquidity creation programs have created the illusion of “infinite liquidity”

Challenges



Shift in the debate

- Initially, the argument for liquidity injection was to prevent credit crunch
- More recently it has been about supplying the economy

The only way to prevent depression and get growth

- SMEs contribute importantly to economic activity and jobs (strong political force)
- Liquidity injected so financial sector intermediate the newly created liquidity to important economic sector, especially SMEs
- Such arguments draw directly from the Great Depression arguments

Impact on financial markets

- Liquidity injection was also implemented to prevent bank failures like after the Great Depression
- Liquidity injection aimed at banks is controversial
 - Recall moral hazard in the 2008 crisis
 - Bailout probability reflected in funding costs
- On the other hand, bailout programs depend heavily on the political support
- But it is hard for political authorities to credibly commit NOT to bail out

Income and wealth distribution

- The liquidity policies post-crisis have changed the composition of winners and losers
- Biggest losers are poorer savers, retirees and pensions funds
- Liquidity creation is likely to affect income distribution through three main channels
- Next slides...

Income composition channel

- Households receive income from their work as well as from other income sources (when owning or having shares in a company)
- Accomodative monetary policy helps companies' profits directly but has a lower and only indirect effect on wages
- People who own companies are also usually wealthier

Financial segmentation channel

- The financial sector is a direct beneficiary from the support given to the financial markets
- People employed in the financial sector already receive higher incomes and are wealthier
- So increase in money supply resulting from accommodative monetary policy widens the income distribution gap

The portfolio channel

- Wealthier households are those that own assets while poorer households own less or are net debtors
- Any policy explicitly designed to support asset prices will increase the wealth gap between the rich and the poor

- Controlling inequalities is not the mere mandate of central banks
- But the FED and the BoE justified their QE program by a *trickle down* argument: eventually, everybody should benefit from liquidity creation
- The BOE found that, in the UK, the benefits of QE were heavily skewed towards the top 5% of households, who own 40% of assets

Structural reforms?

- Liquidity provision undermines the support for necessary reforms
- Short-term benefits prevent long-term support for reforms
- Liquidity programs just "kick the can down the road"
- Stronger economies may be able to delay adjustment
- But EMEs may have a harder time reacting to liquidity shocks

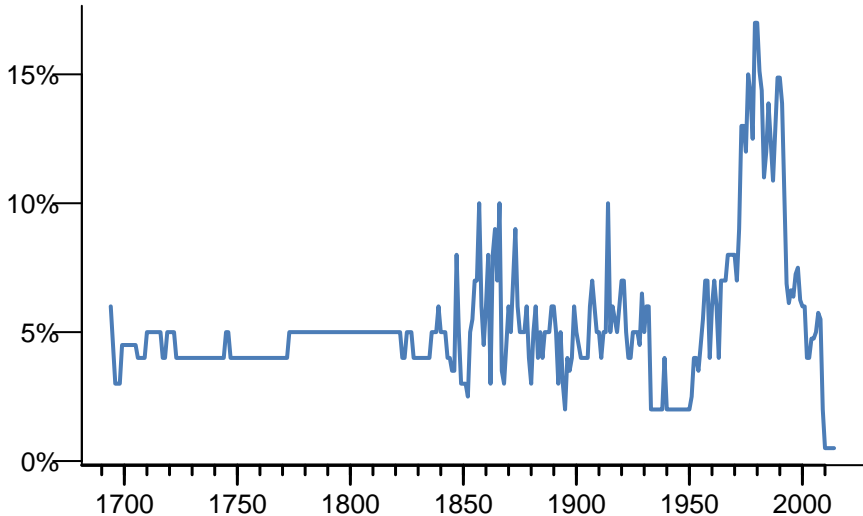
Unexpected consequences of low interest environment

- Low interest rates should increase borrowing by providing cheap money
- Instead of investment, people start saving more
 1. Lower interest rates mean lower interest on retirement savings, causing people to hoard more money for their pension
 2. Saving only takes place if people have enough confidence about the future
 3. Recent liquidity policy caused uncertainty
 4. Retrenching to riskier investments with higher yields rather than investment in SMEs

Long-term inflation

- Post crisis liquidity creation programs would have been highly inflationary if implemented before 2007
- But the recent low inflation environment shows there are still strong deflationary forces
- Empirical research on interest rates suggests they are mean reverting
- Consider the example of the BoE, with an historical average of 5.25%
- The current near zero interest rate is quite anomalous

Annual maximum bank rates, 2015 is to November



Fragilities

- Recent monetary policies have made the private and public sectors dependent on low interest rates
- So it is harder to increase rates if and when inflation increases
- Example of the FED dilemma now

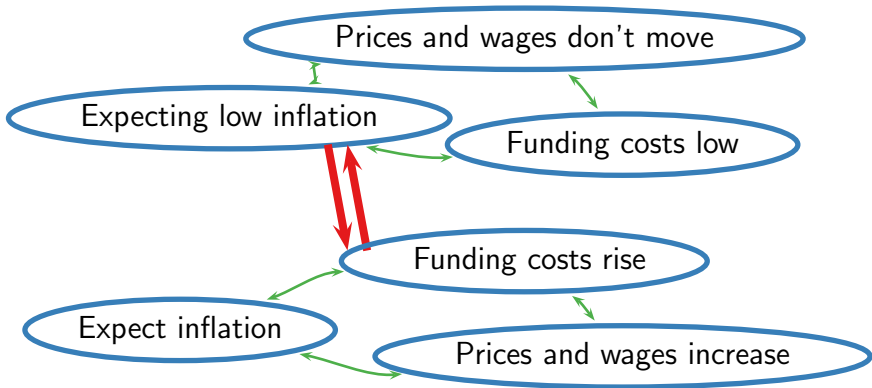
In the EU

- If the European economies start picking up growth, inflation is sure to follow
- So it is very unlikely interest rates will remain so low
- Unprofitable borrowers may get into serious difficulties when interest rates rise
- Today, banks are able to “extend and pretend” on a vast amount of poorly collateralized real estate lending

Where has inflation gone?

- Various QE programs have not lead to an increase in inflation as expected
- Most of all, banks have not been lending the freshly created money, and kept it in their central bank reserve accounts
- While poor labor market conditions have prevented salary growth

From self-reinforcing low interest rate environment to high inflation environment



Market distortions and bubbles

- Liquidity creation distorts markets
- By encouraging risk-taking that private entities do not wish to take
- Over time, divergence between Wall Street and Main Street became bigger and bigger
- Financial markets have become less likely to appropriately react to good or bad economic news affecting the value of an asset
- Negative macro-economic news in Europe in 2014 led to a market rally rather than a drop
- Deteriorating economic conditions increased the likelihood of the ECB adopting QE

US monetary policy normalization

The role of the US in global liquidity expansion

- The US dollar is the reserve currency
- Learning from history: the FED injected liquidity to avoid the recession experienced during the Great Depression
- Other countries had little choice but to follow the US monetary policy
- So the liquidity creation program was exported

The end of accommodative monetary policy

- QE program was stopped in October 2014
- US employment, inflation and growth have risen
- Fed increased policy rates in December 2015 by 0.25%
 - EMEs and investors prepared and already priced in decision
 - Different than Taper Tantrum (2013, next slide)
- But debates remain:
 - Has the US economy recovered enough?
 - What will be the impact on international markets (particularly EMEs) in case of further increase?

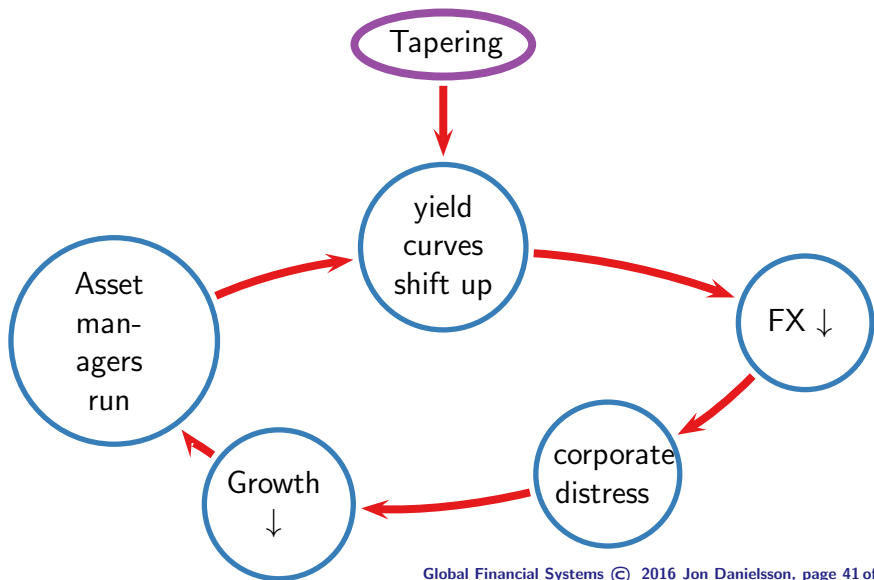
Taper Tantrum - 2013

- Bernanke announced the progressive interruption of the QE program in May 2013 and a potential hike in policy rates further ahead
- Severe impacts on EMEs:
 - Capital outflows from bond markets
 - Increase in bond yield spreads
- So rising rates could have severe impacts (short- and long-term) on markets
- But the US law only considers effects on the US, not other countries!

Three major concerns

- *First*, offshore and foreign currency-denominated securities carry with them high currency risks;
- Investors are not convinced about the strength of EMEs economic fundamentals anymore
- *Second*, FED rates hike may trigger a repatriation on US dollar assets and bring EME currencies downwards;
- EME will be pushed to raise rates too, increasing EME corporates' debt burden
- *Third*, maturity of EMEs' overseas debt has increased, which enhances duration and volatility risk for investors

Dangerous feedback loop



Global savings glut

US

- US biggest net consumer globally
- Substantial *trade imbalances*
- Imports offset exports by \$124 billion (March 2016)
- Open market economy: net differences borrowed on international capital markets
- Increased productivity
- Low political risk, reliable legal environment and economic standing attracted investors, causing capital inflows and currency appreciation
- Imports became artificially cheap

Shift in EMEs

- Shift from net borrowers to net lenders
- Hit by crises during 1990s: borrowed money was not effectively employed
- Experienced rapid capital outflows, currency depreciation and recessions
- Reaction of EME authorities: build large foreign reserves and increase current account surplus

Other reasons

- Eurozone has developed large savings surpluses, too
 - *Germany*: internal devaluations in mid 2000s
 - *Periphery countries* like Greece, Spain and Portugal: reduction in domestic investment opportunities due to deep recessions
- Pension funds
- Insurance companies
- Sovereign Wealth funds
- Low rates stimulate savings

Consequences

- Because global savings outstrip global investment: real interest rates should fall
- US will keep role as global consumer
- Continuation of its current account deficit

Criticism

Borio and Disyatat, 2011

- Global imbalances only capture net resource flows, not gross flows
- Increase in global gross capital flows happened due to flows between advanced economies rather than flows from EMEs
- Savings not equal to investment in current account deficit countries

Criticism II

Borio and Disyatat, 2011

- Global savings glut explains downward trend in natural interest rate, not market rate
- Natural interest rate: determined by global supply of savings and the demand for investment
- Market rate: determined by central bank policy rates, market expectations and investors' preferences