Financial Market CSI

By

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Analysts have different explanations for the current financial market volatility. It is weaknesses in the banking system especially specific European firms, the problems in bank capital issues such as contingent capital (“co-cos”) securities, weak commodity prices and rising credit margins. It is slowing Chinese growth or weaknesses in developed markets. It is merely a necessary ‘correction’.

But the volatility increasingly reflects loss of faith in policy makers. Celebrity central bankers are learning that they must constantly produce new miracles for their followers.

Since 2009, improvements in the real economy and financial markets have been driven by policy measures. Budget deficits, low, zero and (now) negative interest rates and quantitative easing were meant to restore growth and inflation, necessary to bring high debt levels under control. The results have fallen well short of expectations.

First, the measures created an artificial stability and an asset price boom in many markets. Growth, as evidenced by repeated downgrades, has not recovered to pre-crisis levels. Inflation remains low. Both indicators measure change so there will be a predictable upturn in the near future. But the absolute rate of GDP expansion and level of price changes is inadequate to solve global debt problems.

Second, new initiatives seem the risky response of clever but desperate men who have run out of ammunition and ideas. The actions of central bankers reflect George Santayana’s observation that “f*anaticism consists in doubling your efforts when you have forgotten your aim*”.

Central to this debate is negative interest rate policy (“NIRP”), now in place in Europe and Japan and under consideration in many other countries. Markets do not believe that NIRP will create borrowing driven consumption and investment which generates stronger growth. Existing high debt levels, poor employment prospects, low rates of wage growth and over-capacity have lowered potential growth rates, sometimes substantially.

NIRP is unlikely to create inflation, despite central banker’s stubborn belief that increasing money supply can and will ultimately always create large changes in price level.

There are concerns about toxic by-products. Bank profitability is likely to be adversely affected. Potential erosion of deposits may reduce banks’ ability to lend and also reduce the stability of funding, something which central banks perversely want improved.

Bank weakness has significant contagion risks. Profitability and solvency issues will affect investors in hybrid capital issues (such as the now controversial co-cos) and bail-in bonds which can be converted into equity or written down under certain circumstances. Designed to strengthen banks, these securities, merely shift the risk to investors, such as pension funds, insurance companies and individual savers.

The capacity of NIRP to devalue currencies to secure export competitiveness is questionable. Euro, Yen and Swiss France have not weakened to date despite additional monetary accommodation. One reason is that these countries have large current account surpluses: Euro-zone (3.0% of GDP), Japan (2.9% of GDP) and Switzerland (12.5% of GDP). The increasing ineffectiveness of NIRP in managing currency values merely reflects the fact that the underlying problem of global imbalances remains unresolved.

Third, the panic amongst policy makers is undermining belief in their magical powers.

The US Federal Reserve's attempt to normalise interest rates has contributed to instability. Speculation, prompted by comments of various current and ex-Governors, of a reversal, a new QE program or negative interest rates has compounded confusion. Homespun wisdom ("growth does not die of old age") has not proved reassuring.

The European Central Bank ("ECB") looks increasingly impotent. Incantations of "*whatever it takes*" sound desperate, no longer having the desired effect. The ECB has failed to date to deal with weak banks and €1.2 trillion plus non-performing loans. Instead it recently called for European Union banking laws to be changed to permit discretionary payments to investors of dividends, bonuses or coupons on CoCos, where it would not be eligible to do so, for example if a bank posts losses. This is odd given that these securities were specifically designed to enhance bank capital in case of difficulties.

The Bank of Japan's decision to switch to NIRP was in direct contradiction of an earlier statement made less than a month ago. With the economy on the verge of a new recession despite ongoing massive QE, Japanese officials have appealed to world's major economies to save Abenomics by stimulating their domestic economies.

Chinese policy makers, until recently applauded as exemplary economic managers, have struggled to bring its stock market slide under control despite numerous expensive attempts. The Chinese central bank has also struggled to prevent capital outflows or avoid pressure to devalue the Yuan. The People's Bank of China has resorted to aggressive market intervention and erratic fixing of the currency, designed to surprise and inflict losses on external "speculators".

Facing slowing growth and unwilling to reform quickly, China is reverting to the strategy of increasing spending and bank lending. Credit growth is approaching the levels of 2009, ignoring the already high debt levels and financial stresses evident.

The new policies also seem half hearted. Japan's NIRP proposals only affect a small part of the financial system, apparently to avoid destabilising banks.

Fourth, despite the IMF urging bold, broad measures, the G20 showed little appetite for new initiatives. International co-operation is being replaced by conflict. Each nation is increasingly targeting fiscal and monetary policy on domestic objectives, whilst paying lip service to not seeking currency devaluation or beggar-thy-neighbour policies.

Fifth, there is recognition that available options have diminished. In recent weeks, 'embedded' pundits have called for more co-ordinated monetary easing, more fiscal easing and more structural reforms to support growth. The prescriptions are familiar and unlikely to be more successful on the umpteenth go-around. Policy makers would do well to heed Winston Churchill's advice: "*However beautiful the strategy, you should occasionally look at the results*".

For the moment, the volatility is confined to financial markets and the effect on the real economy is limited. The ever present risk is of a doom loop where financial market problems lead to banking system weakness which, in turn, feeds a credit crunch and a contraction in economic activity.

That familiar movie does not have a happy ending.