

Global Financial Environment and Challenges

Michael Hutchison

Distinguished Professor of Economics, UC Santa Cruz

Presentation G20 Global Financial Stability Conference 2019



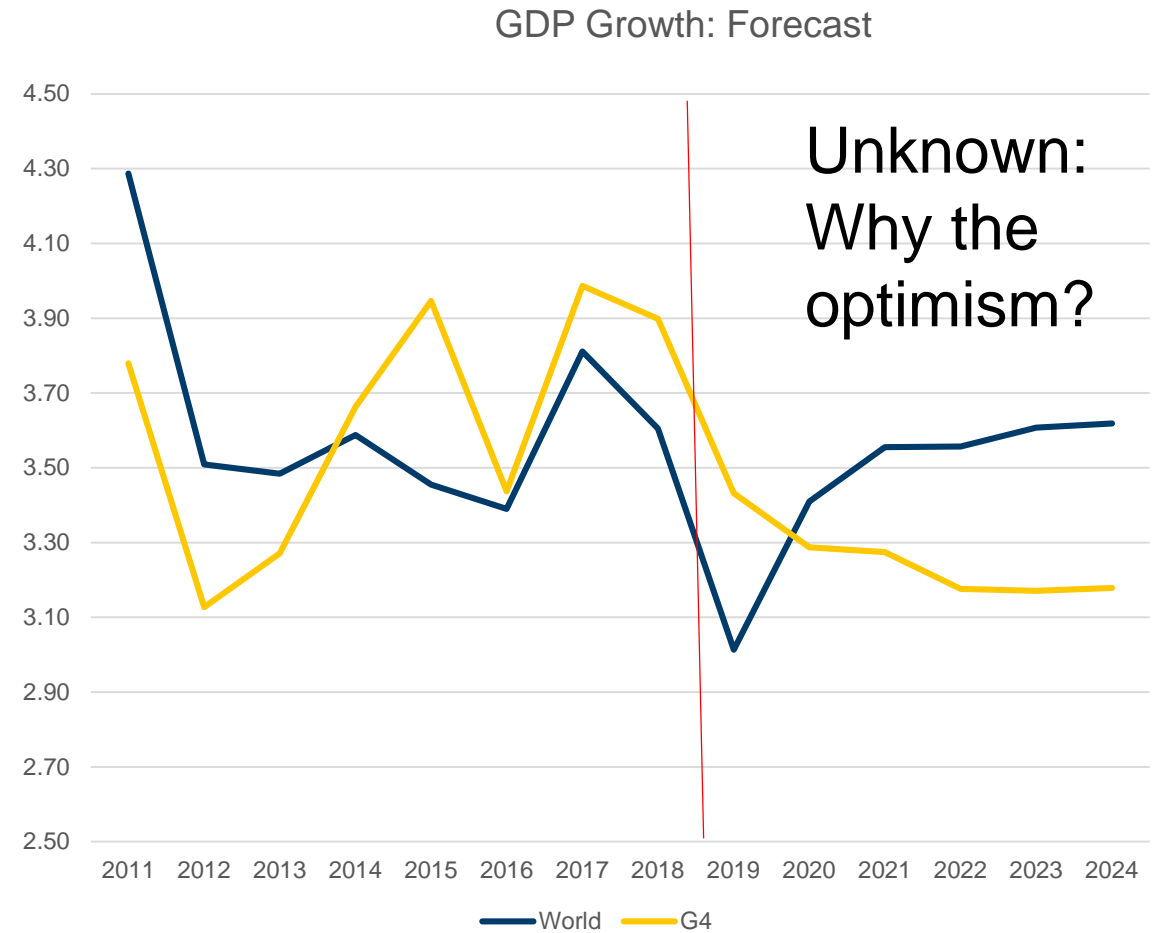
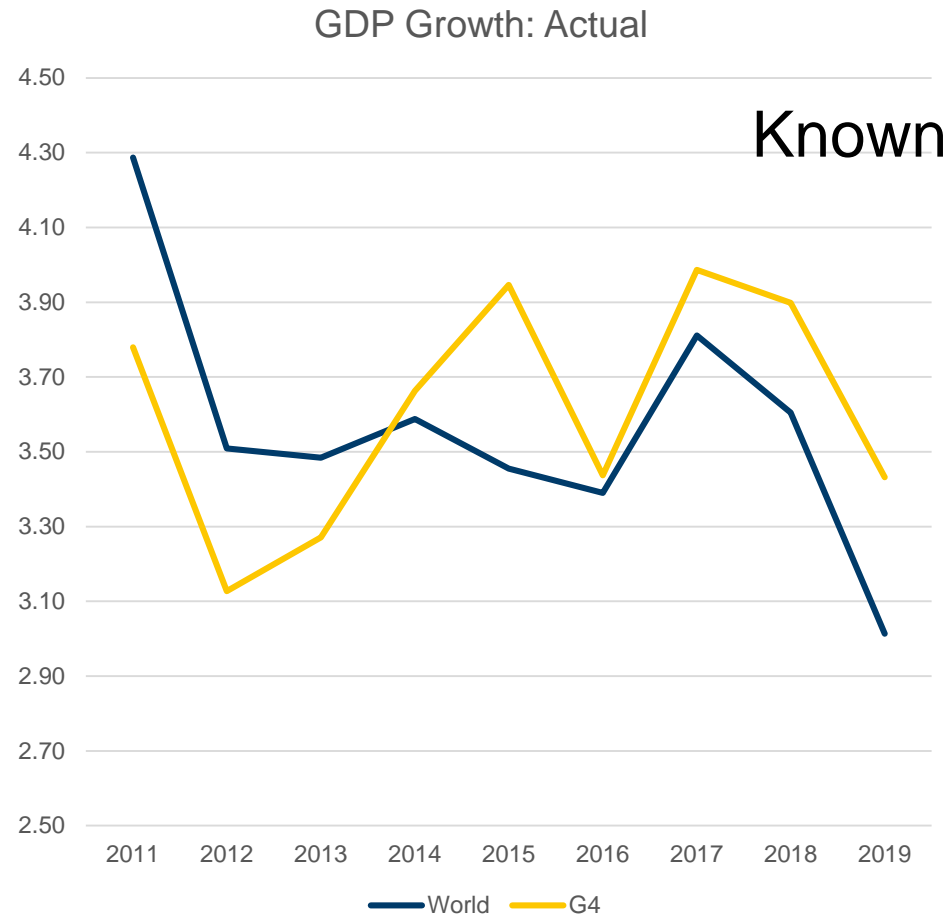
UC SANTA CRUZ

Key Topics

- Slowing Global Economies
- Warning Signs-- Usual List of Suspects
- Global Downside Risks
- Limitations of Policy Responses
- Depression Economics in Good Times...and Bad



Slowing Global Economy

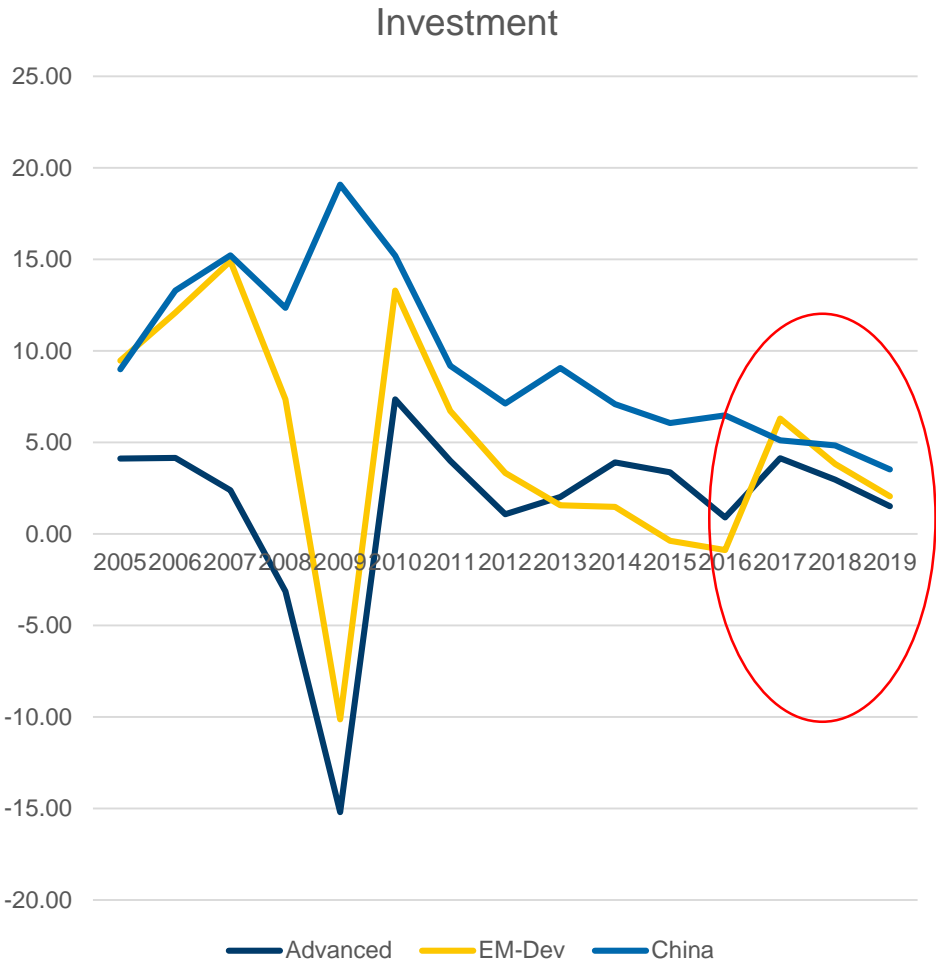
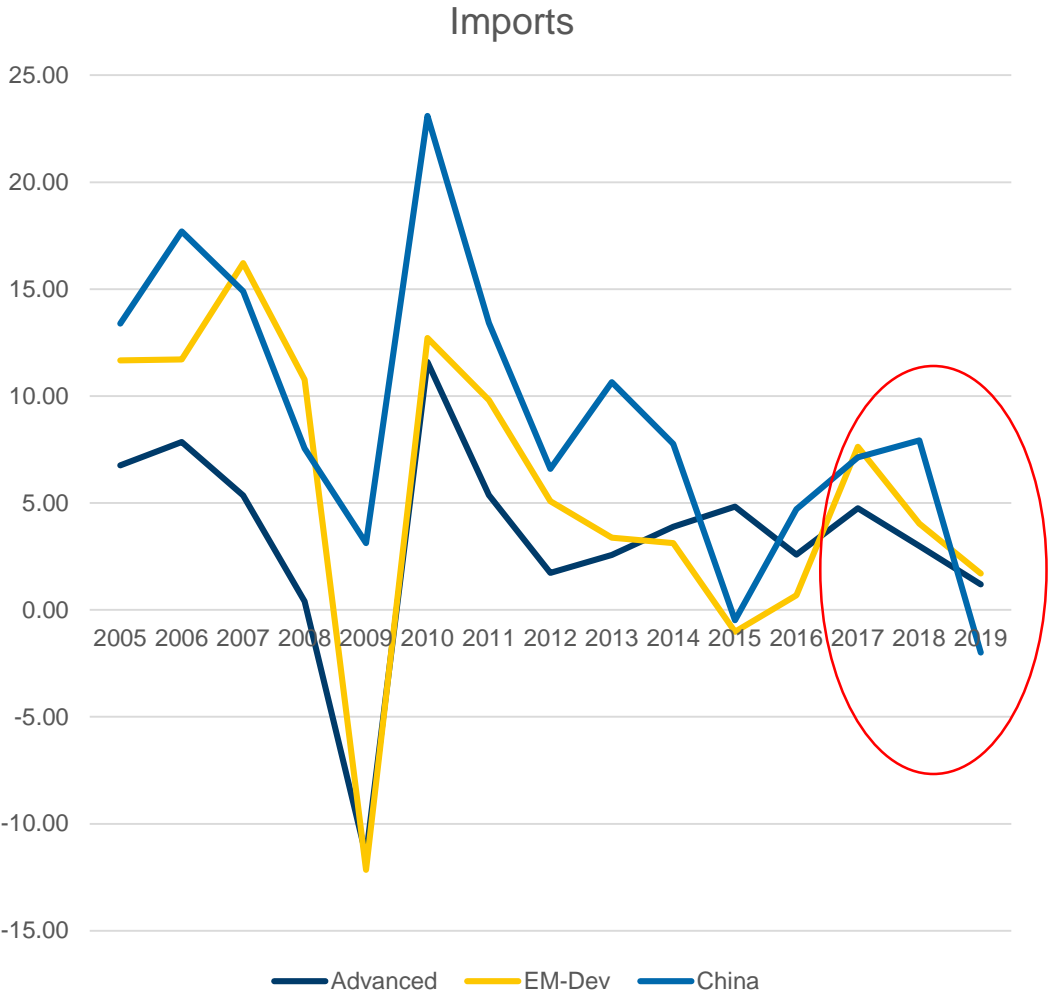


IMF October 2019 WEO Last half of 2019 is estimated and forecasted



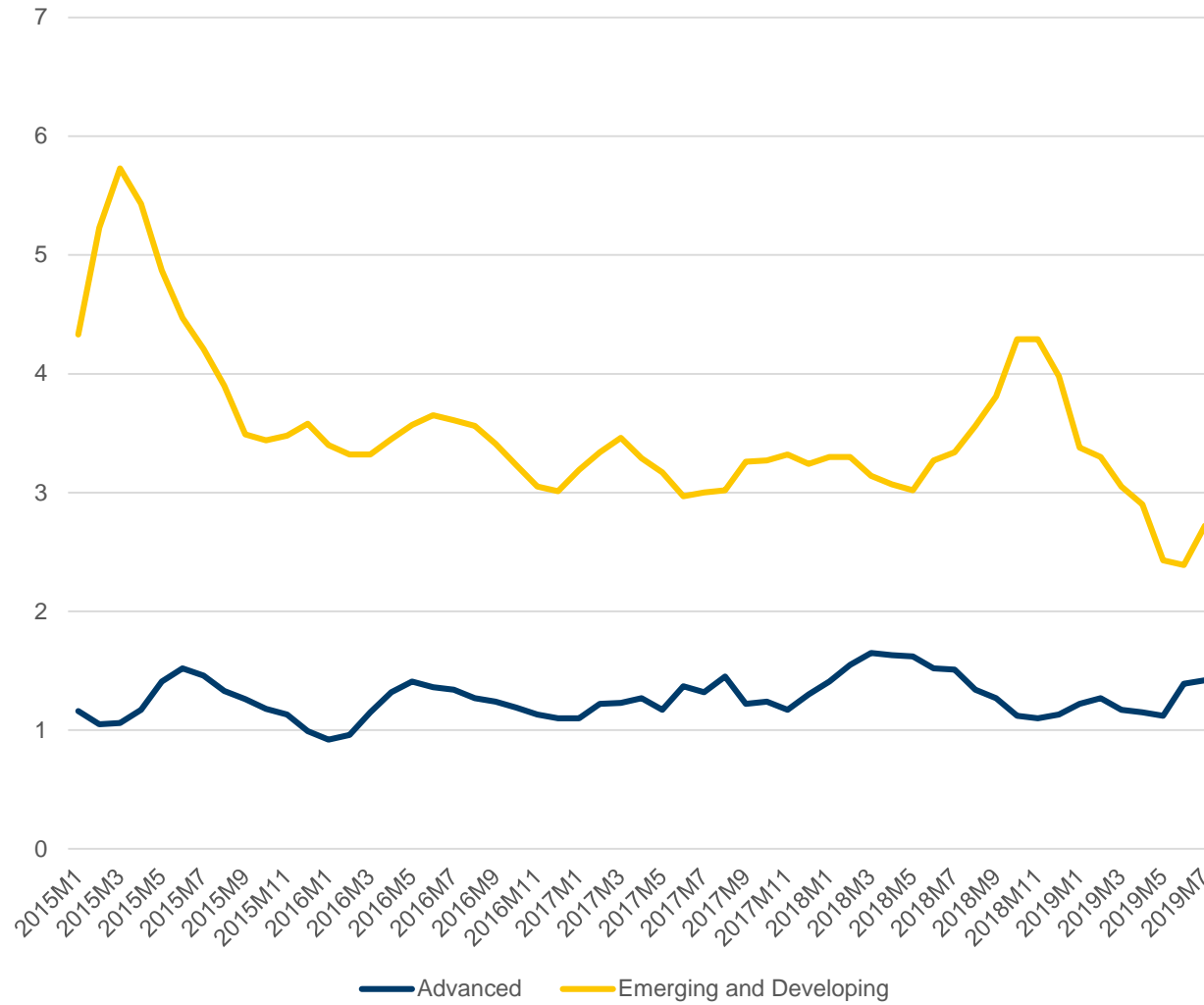
UC SANTA CRUZ

Slowing Imports, Slowing Investment



IMF October 2019 WEO

Global Inflation Remains Subdued Core CPI





Shaded areas indicate U.S. recessions

Source: Federal Reserve Bank of St. Louis

myf.red/g/pcbz

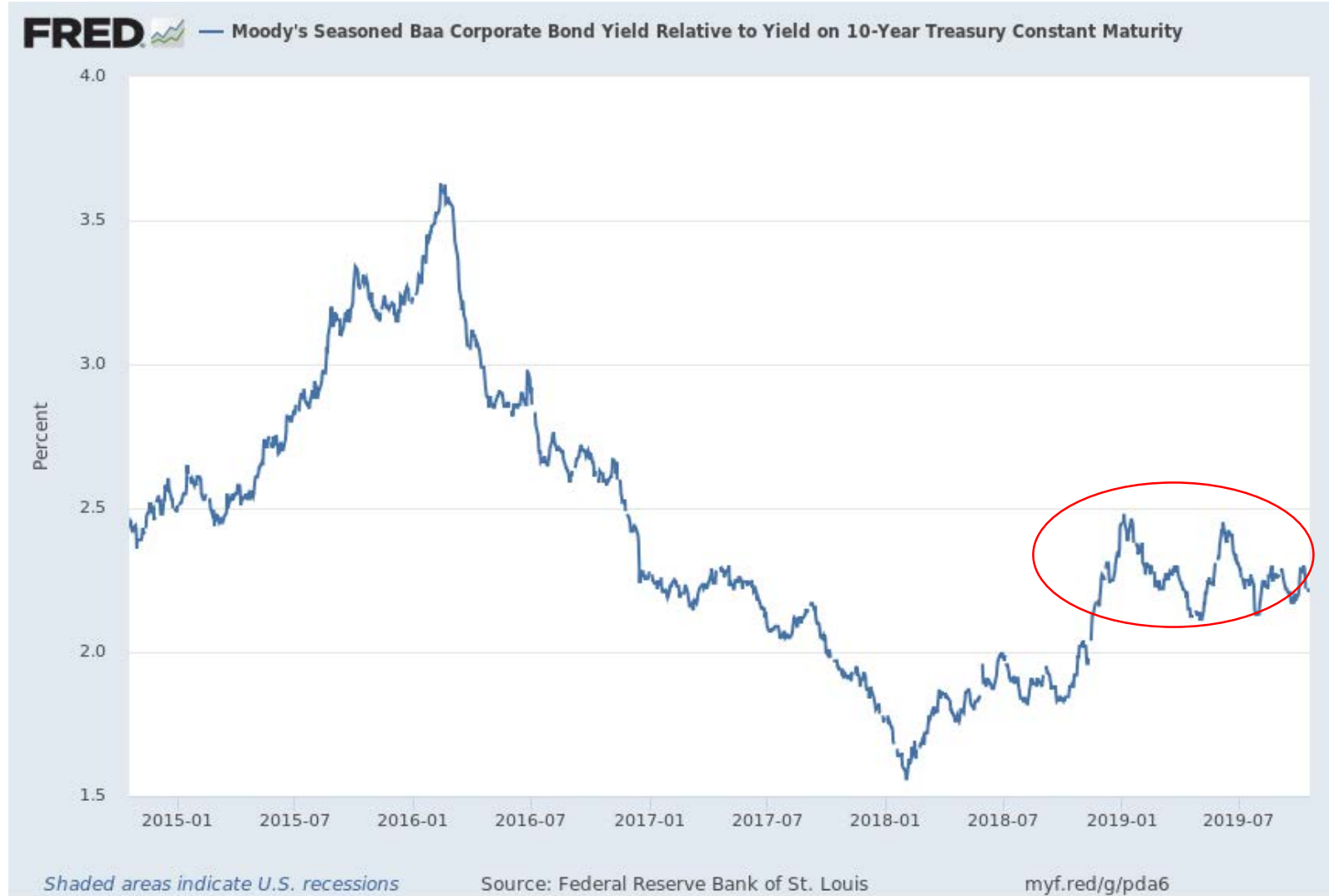
Good news

Little financial stress seen in U.S....

The STLFSI measures the degree of financial stress in the markets and is constructed from 18 weekly data series: seven interest rate series, six yield spreads and five other indicators. Each of these variables captures some aspect of financial stress. Accordingly, as the level of financial stress in the economy changes, the data series are likely to move together. How to Interpret the Index: The average value of the index, which begins in late 1993, is designed to be zero. Thus, zero is viewed as representing normal financial market conditions. Values below zero suggest below-average financial market stress, while values above zero suggest above-average financial market stress.



And Credit Spread Stable...no evidence of rising risk premiums

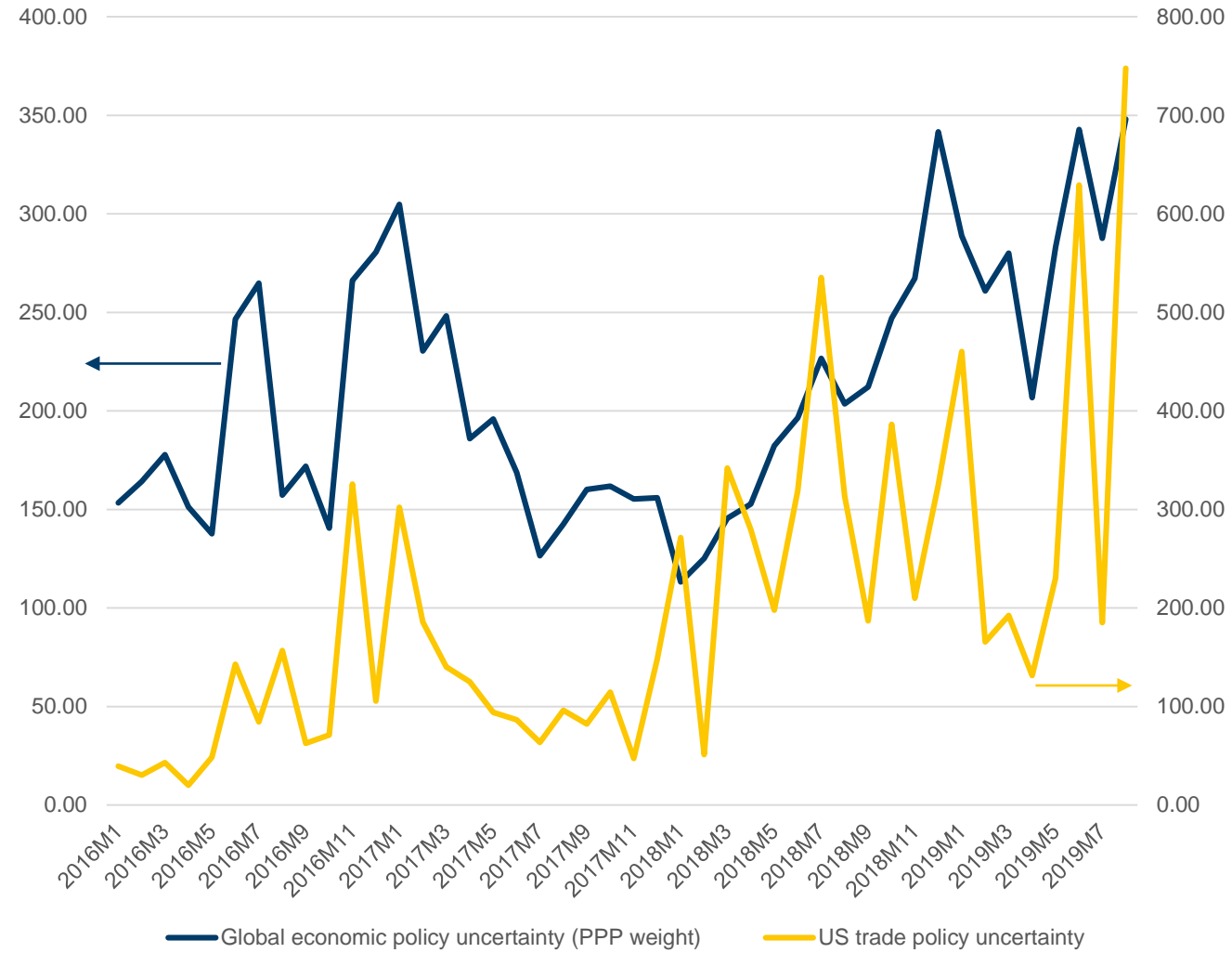


Warning Signs...usual list of suspects

- World Trade Tensions and Tariffs Slowing Trade
- Uncertainty in World Oil Supplies – The Strait of Hormuz and Attack on Saudi Arabia
- BREXIT risks
- Political disruption in U.S. (impeachment) causes hit to business and consumer confidence



Global Economic and Trade Policy Uncertainty High and Rising



Source: IMF October WEO

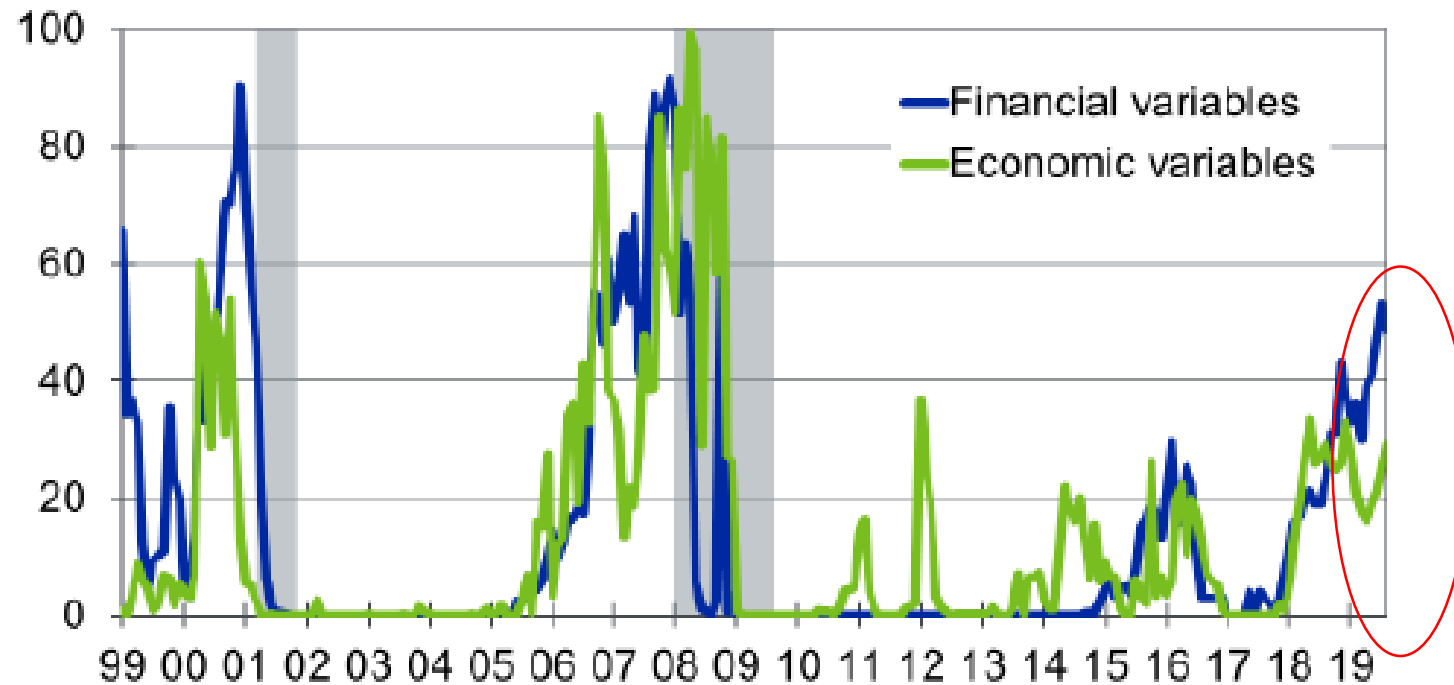


UC SANTA CRUZ

U.S. downside risks rising...

Recession Odds on the Rise

Probability of recession in 12 mo, %, using only...



Source: Moody's Analytics



Global Downside Risks

- Downturns– accelerator principle and “nothing lives forever”
- IPO in new tech ventures...rough patch transmits to equity markets and banking sector
- Consumer Credit at Historic Highs
- Rapid growth of leveraged finance and CLOs in search for yield
- U.S. Debt limit increase...political “game of chicken”



<u>Peak month</u>	<u>Trough month</u>	<u>Duration, peak to trough</u>	<u>Duration, trough to peak</u>
February 1945	October 1945	8	80
November 1948	October 1949	11	37
July 1953	May 1954	10	45
August 1957	April 1958	8	39
April 1960	February 1961	10	24
December 1969	November 1970	11	106
November 1973	March 1975	16	36
January 1980	July 1980	6	58
July 1981	November 1982	16	12
July 1990	March 1991	8	92
March 2001	November 2001	8	120
December 2007	June 2009	18	73
1945-2009 (11 cycles)		11.1	58.4
Present Cycle: June 2009 - October 2010			124.0

U.S. Expansion Peaking?

U.S. Business Expansion
Longest in Post-WW2
Period....longest since
NBER records maintained
(1850s)



Struggling IPOs

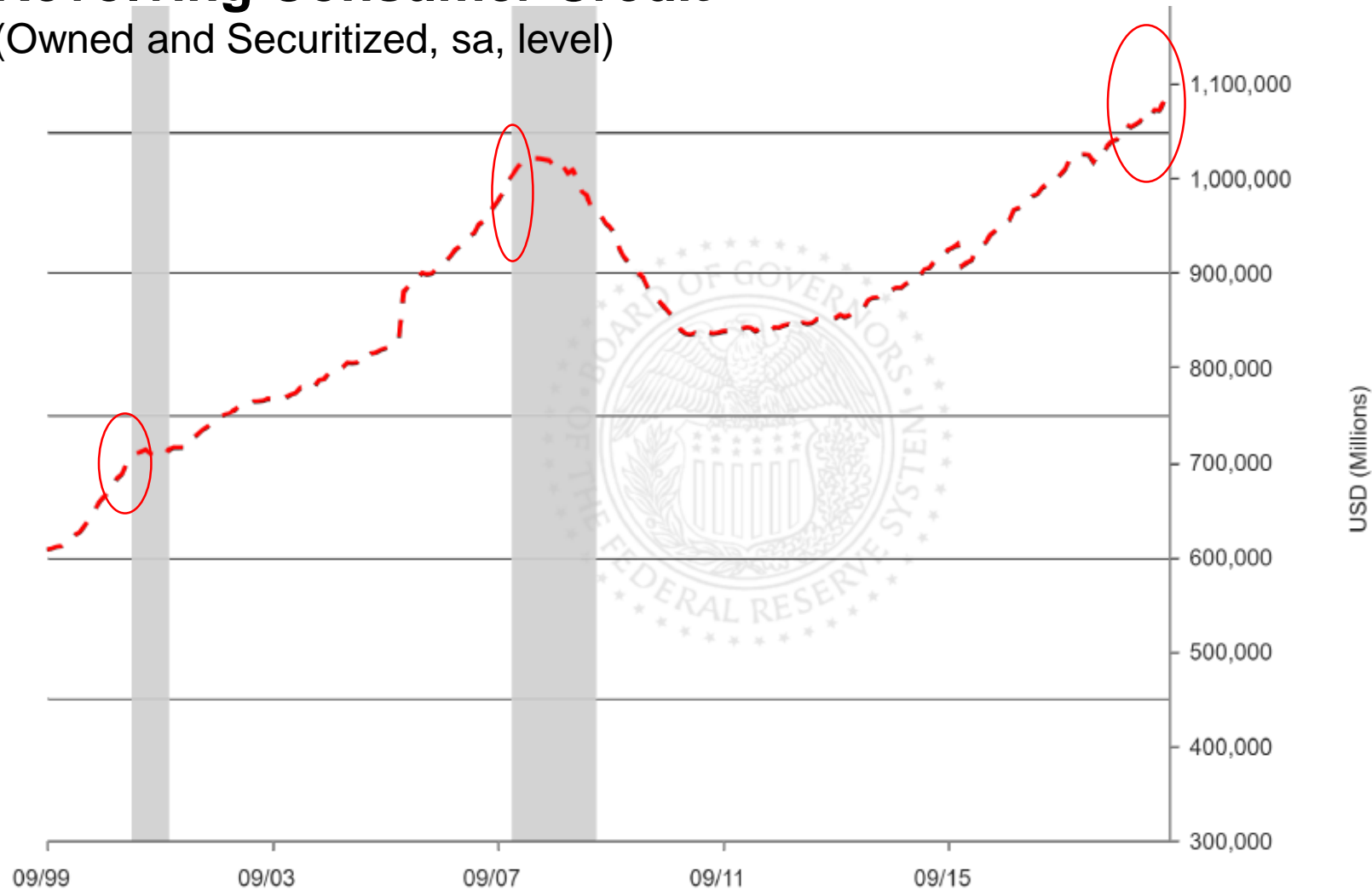
- Struggling IPOs...overvaluation in start ups, threatening financial model for firms from venture capital to public companies
- Failed IPOs
 - WeWork IPO failed, bailout from SoftBank
 - Endeavor, LeasePlan
- Problem IPOs– Uber, Lyft, Peloton
- Delayed IPOs: Airbnb, Palantir Technologies
- Investors confidence shaken in start-up business models
- ...but IPO market still very active



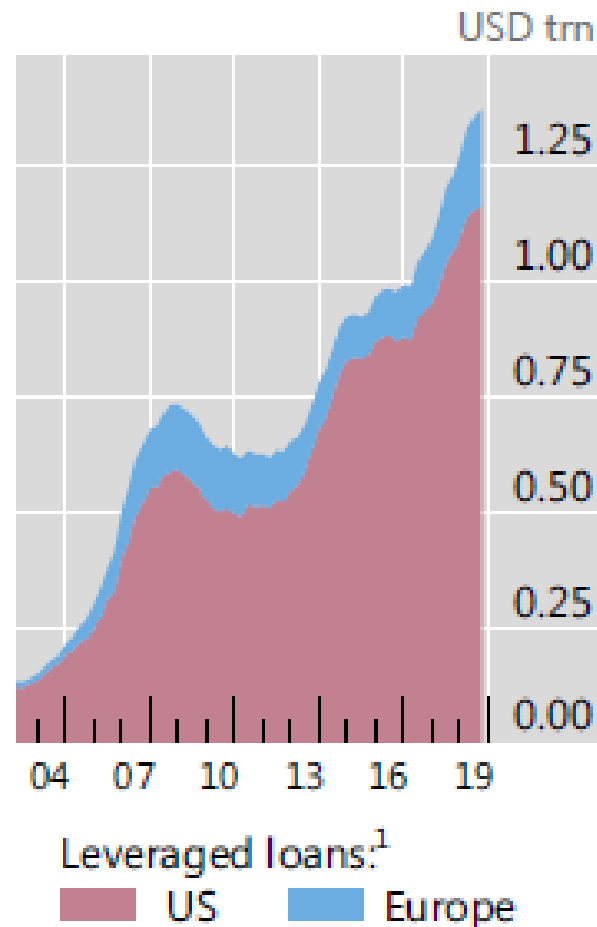
Historical High U.S. Consumer Credit

Revolving Consumer Credit

(Owned and Securitized, sa, level)



Leveraged loans grow as investors search for yield



Rise of Leveraged Loans: Risky?

- No longer sub-prime CDOs issued since GFC
- Other forms of securitization have grown substantially – especially collateralized loan obligations (CLOs).
- CLOs invest mainly in leveraged loans-- bank loans to firms that are highly indebted, have high debt service costs relative to earnings and are typically rated below investment grade.
- The leveraged loan market has surged in recent years to roughly \$1.4 trillion outstanding.
- As of June 2019, over 50% of outstanding leveraged loans in US dollars and about 60% of those in euros had been securitized through CLOs.

Source: BIS Quarterly Review, September 2019



UC SANTA CRUZ

Limitations of Monetary Stimulus

- Very Low (ZLB) or negative interest rates
- Flat or inverted yield curves
- Small impacts of further quantitative easing



Monetary Easing Near or Below ZLB Across the Globe

- Room to maneuver: The Federal Reserve cut its policy rate by 25 basis points in late July, and by another 25 basis points in mid-September (to range 1.75-2%)
- Negative: On 12 September, the ECB cut the deposit rate by 10 basis points to -0.5% and restarted its asset purchase program.
- Negative: -0.1% now. Investors expected that policy rates would drop, by the end of 2020, by roughly 15 basis points in Japan.

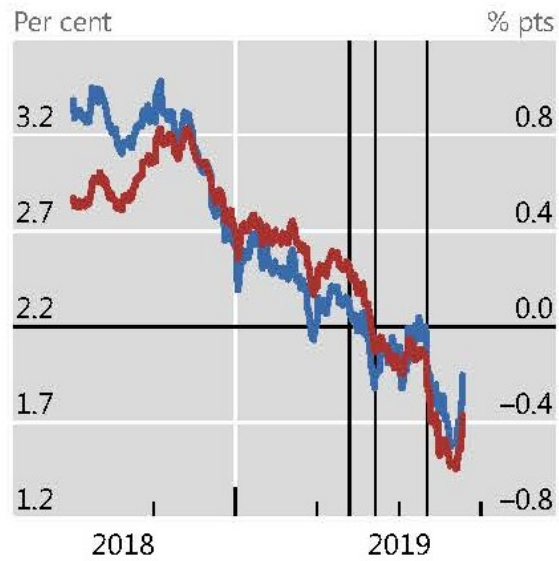


Depression Economics in Good Times

Long-term government bond yields declined across the board

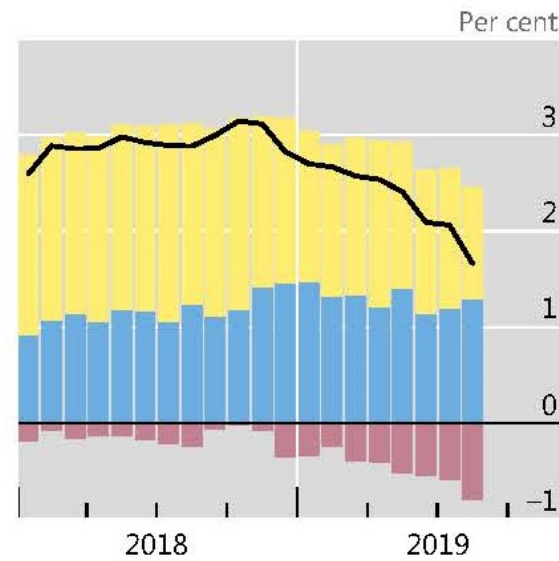
Graph 5

Ten-year Treasury yield slid and the term spread turned negative



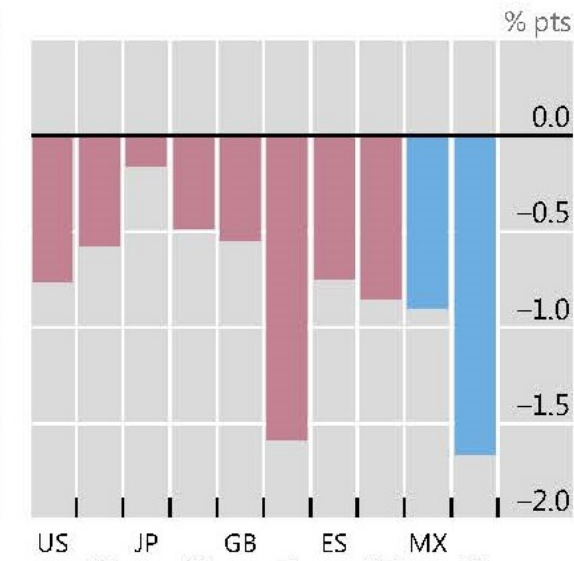
US Treasury:
 — 10-year yield (lhs)
 — 10y-3m spread (rhs)

Both expected inflation and the term premium contributed to the decline¹



— Nominal yield
 — Term premium
 — Expected inflation²
 — Expected real rate

Long-term interest rates dropped globally³



30 Apr–11 Sep 2019 change in yield:
 — AEs 10yr gov't
 — EMEs 10yr gov't

The vertical lines in the left-hand panel indicate 6 May 2019 (first business day after US announces intention to raise tariffs on \$200bn of Chinese imports), 4 June 2019 (Fed Chairman states that the Fed “will act as appropriate to sustain the expansion” in midst of trade uncertainty) and 1 August 2019 (US announces intention to impose new trade tariffs on \$300bn of Chinese imports).

Source: BIS QR
 Sept 2019



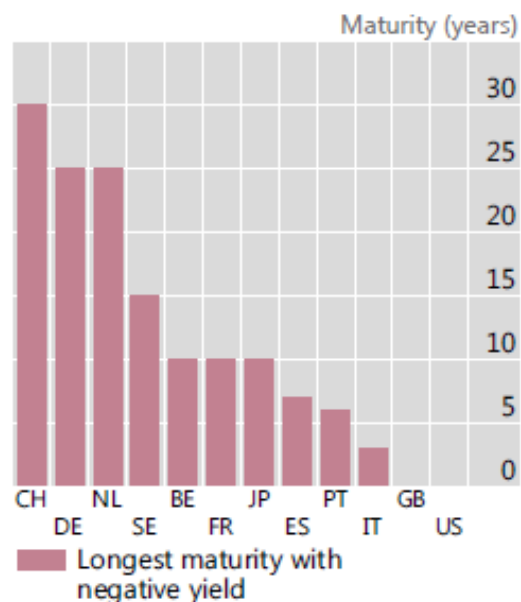
UC SANTA CRUZ

Depression Economics in Good Times

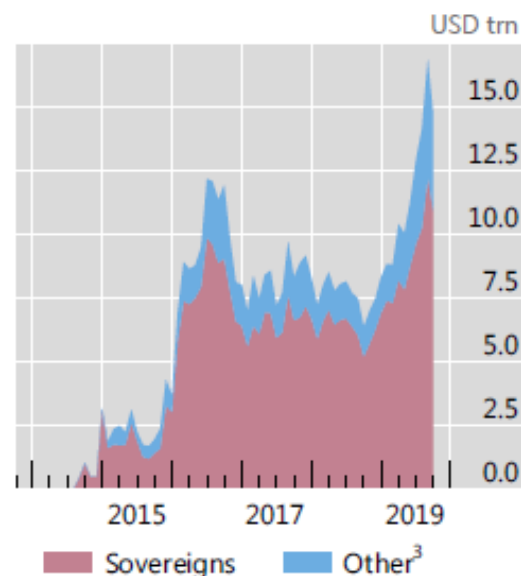
Negative-yielding debt soared

Graph 6

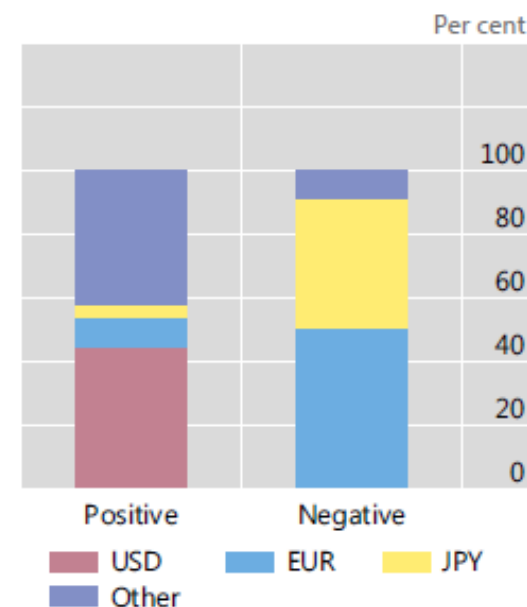
More sovereign yields became negative in more countries¹



Amount of negative-yielding bonds kept rising²



Negative debt was mainly denominated in euros and yen⁴

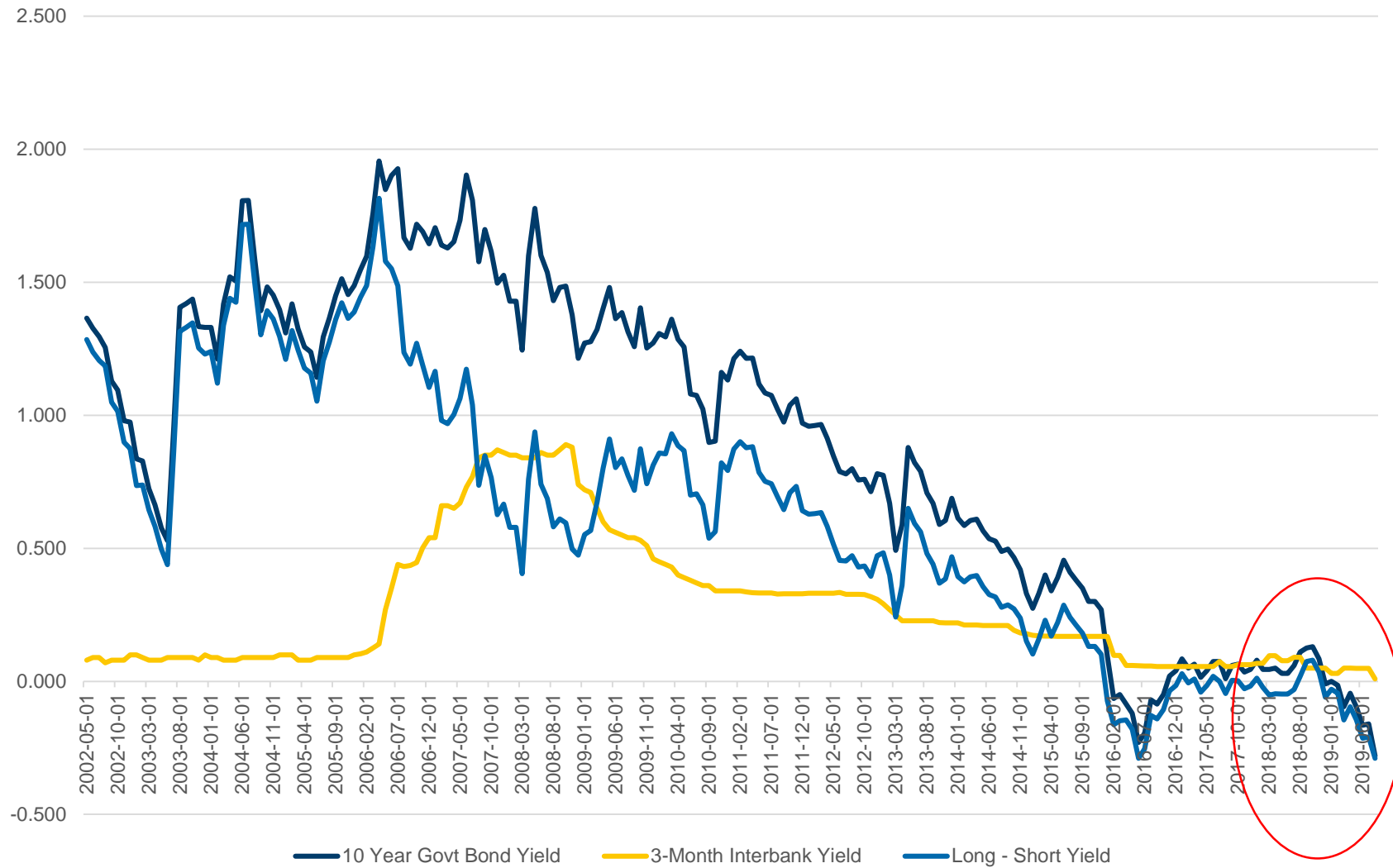


¹ As of 11 September 2019. ² Based on Bloomberg Barclays Global Aggregate Negative Yielding Debt indices; September 2019 corresponds to 11 September 2019. ³ Sum of government-related, corporates and securitised. ⁴ As of 11 September 2019; estimated on government and corporate securities tracked by Bloomberg.

Sources: Bloomberg; BIS calculations.

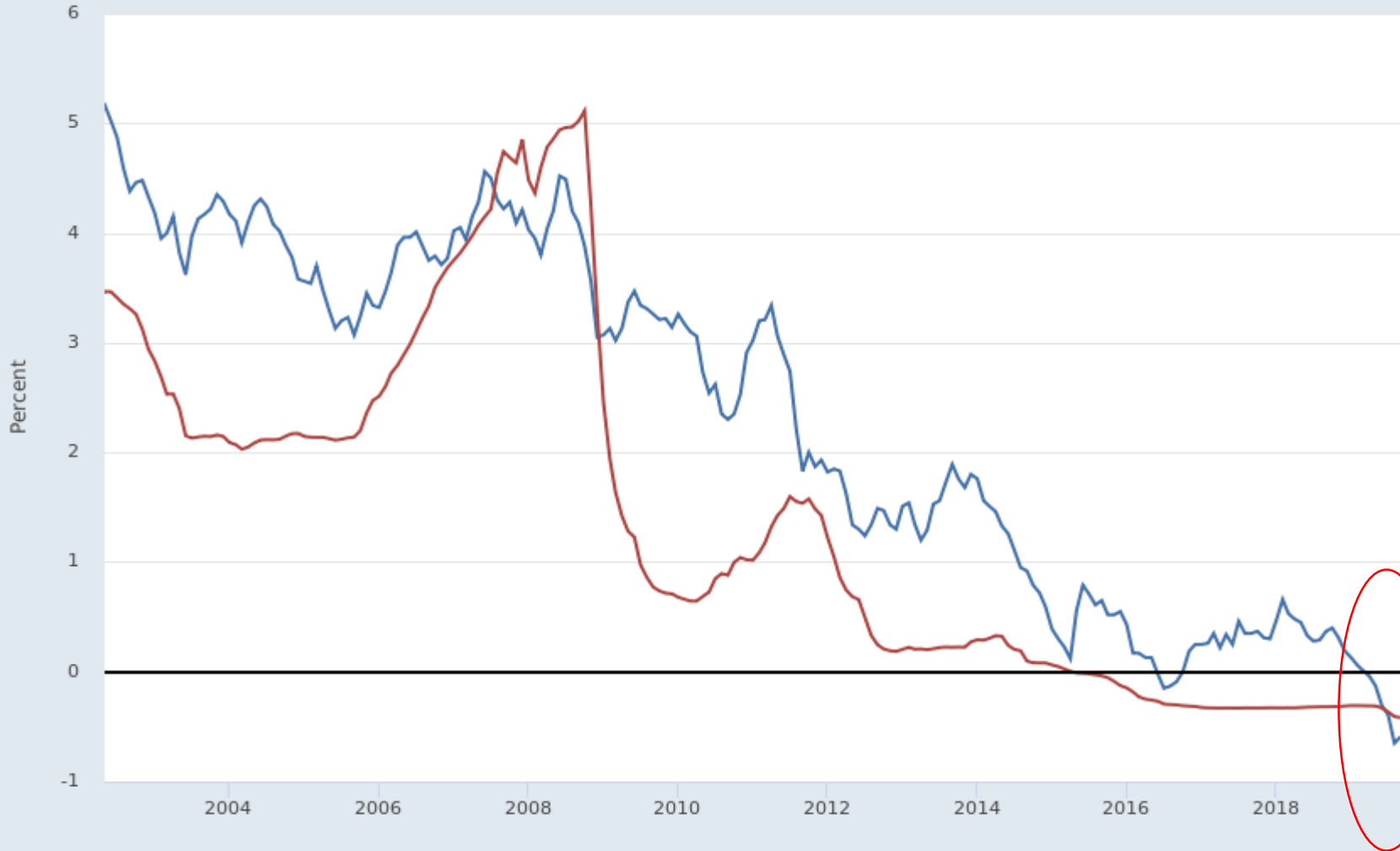


Japanese Yields Negative



FRED

— Long-Term Government Bond Yields: 10-year: Main (Including Benchmark) for Germany
— 3-Month or 90-day Rates and Yields: Interbank Rates for Germany



Source: Organization for Economic Co-operation and Development myf.red/g/pd6E

German Yields Negative



UC SANTA CRUZ

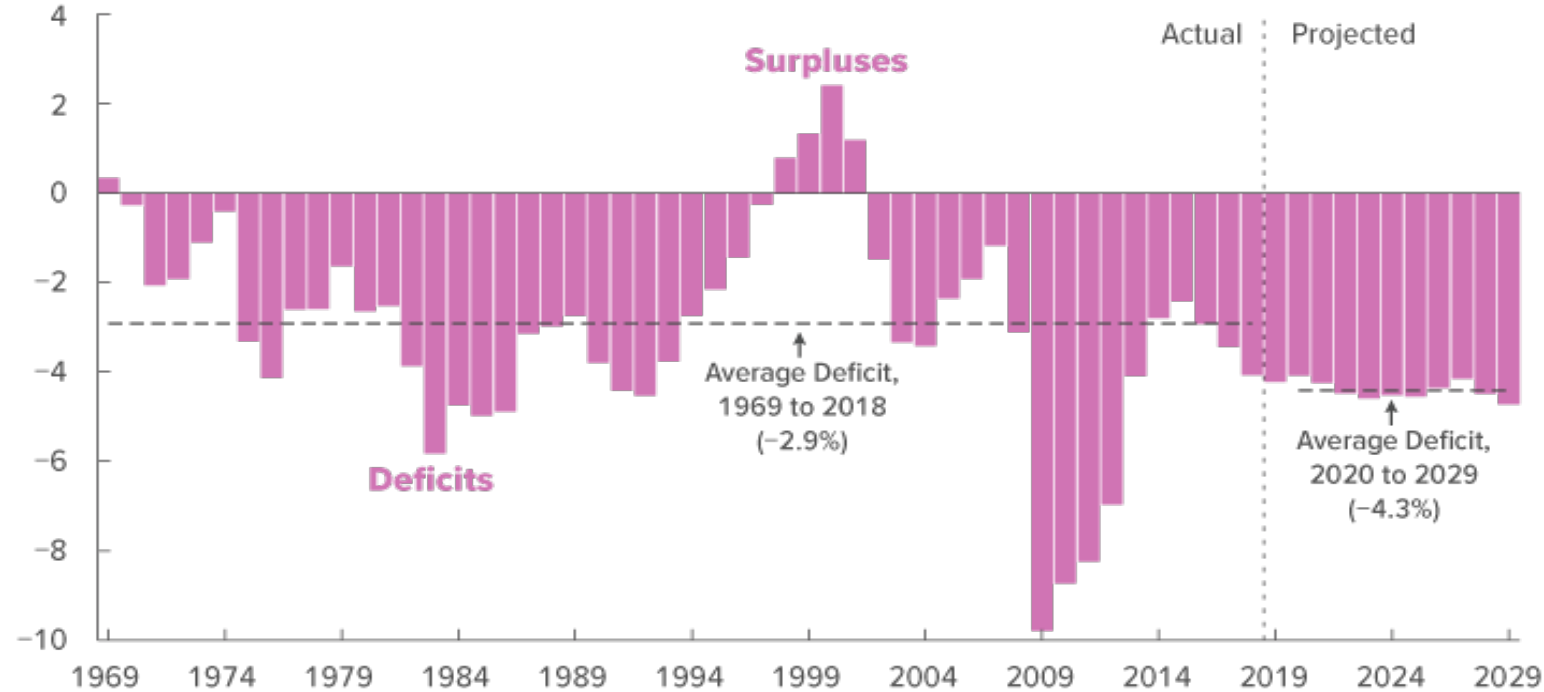
Limits to Fiscal Stimulus



Total Deficits and Surpluses

Deficits as a percentage of gross domestic product are projected to remain relatively stable over the coming decade. They exceed their 50-year average throughout the 2020–2029 period.

Percentage of GDP



CONGRESSIONAL BUDGET OFFICE

MAY 2019

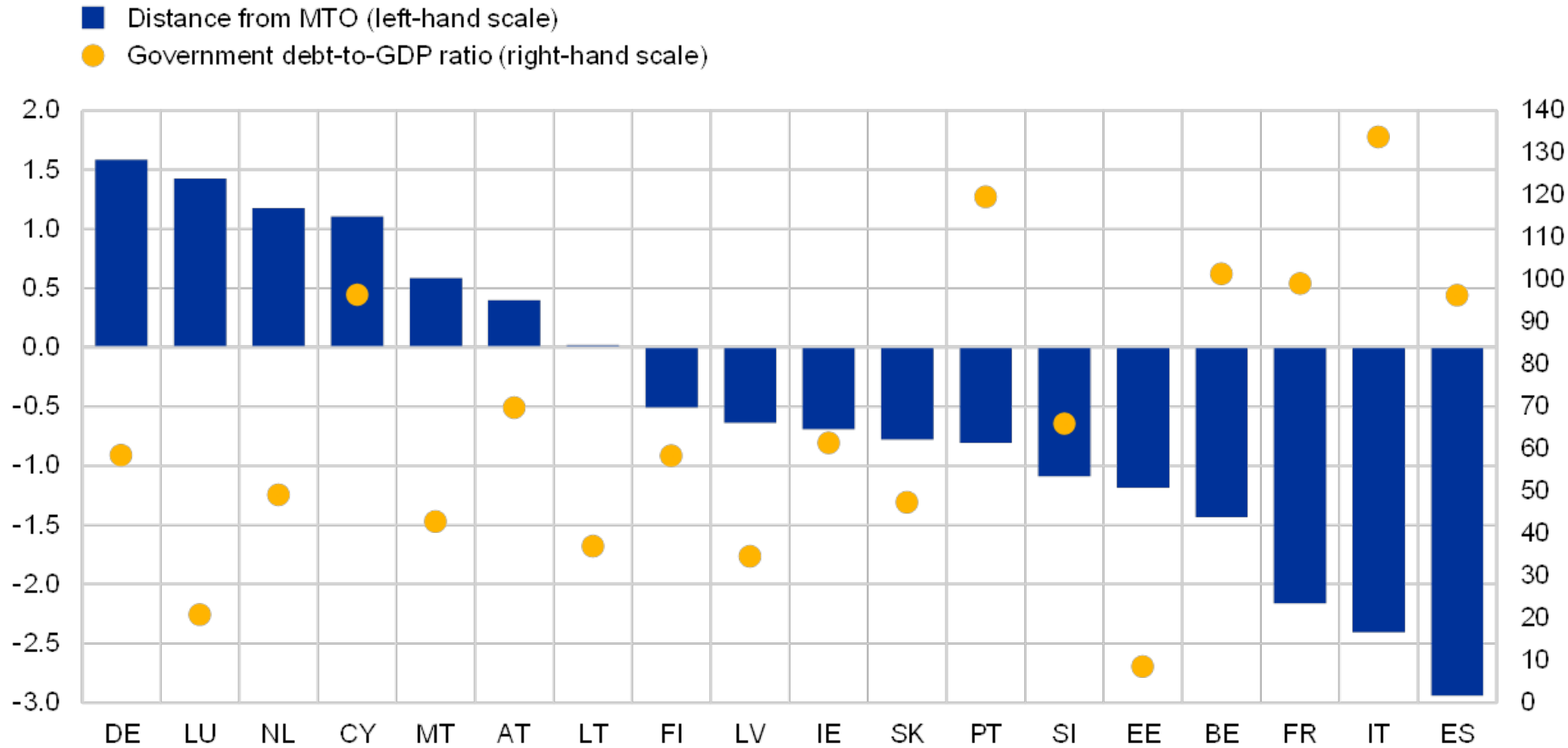
Little room for U.S. fiscal stimulus if downturn occurs

- U.S. running large deficits despite strong economy
- Pro-cyclical tax cuts
- Large run-up in government debt
- CBO projects debt held by the public to rise to \$28.5 trillion, or 92 percent of GDP, in a decade—up from 78 percent now.



UC SANTA CRUZ

Europe is bifurcated...Germany has room for fiscal stimulus, France-Italy-Spain do not



Concluding Points

- Falling investment, tumble in trade behind slowdown
- Policy uncertainty high, and global trade and oil supply tensions
- Financial conditions stable
- Troubling downside risks– usual suspects and off the radar
- Limited monetary and fiscal arsenal to provide stimulus
- Depression Economics in Good Times: Monetary and Fiscal
 - What about bad times?

