‘Winter is coming’: time to replace the financial system!

By Elisa Barwick

With the turbulence simultaneously in US stock and bond markets, recent warnings from the world’s premier banks are ringing loud. The International Monetary Fund, Bank for International Settlements, Bank of England and European Central Bank have all issued financial warnings for the coming period. Though they don’t say it, the crises of which they warn are existential threats to the global financial system as we know it.

Borrowing an expression from the popular TV series “Game of Thrones”, Indonesian President Joko Widodo told a packed plenary session of the 12-14 October IMF and Wold Bank Annual Meetings in Nusa Dua, Bali that “With all the problems that the global economy currently faces, it is appropriate to say that ‘winter is coming’.” Citing weak coordination and cooperation in the face of growing economic uncertainty, he said that in order to respond appropriately to the situation, “We rely on you, the world’s fiscal and monetary policymakers, to maintain the commitment to global cooperation.”

The IMF has itself expressed grave concerns. In its October 2018 World Economic Outlook report it surveyed the effort to bring about an economic recovery since the 2008 global financial crisis (GFC). While it said those efforts forestalled an even worse outcome, “large challenges loom for the global economy”. In fact, said the report, “The extraordinary policy actions to prevent a second Great Depression have had important side effects. The extended period of ultralow interest rates in advanced economies has contributed to the build-up of financial vulnerabilities.... The large accumulation of public debt and the erosion of fiscal buffers in many economies following the crisis point to the urgency of rebuilding those defences to prepare for the next downturn. Moreover, some of the crisis management tools deployed in 2008–09 are no longer available (the Federal Reserve’s bailouts of individual institutions, for example), suggesting financial rescues in the future may not be able to follow the same playbook.”

The troika who bailed out Wall Street in 2008, former US Federal Reserve Chairman Ben Bernanke, and former Treasury Secretaries Timothy Geithner and Henry Paulson, likewise tried to claim in a 7 September column in the *New York Times* that there are fewer legal tools available today to bail out the banks in a crisis. Under the headline “What We Need to Fight the Next Financial Crisis”, the three lamented that while it was the US Congress that made the 2008 bailout possible, “in its post-crisis reforms, Congress also took away some of the most powerful tools used by the FDIC [Federal Deposit Insurance Corporation], the Fed and the Treasury. Among these changes, the FDIC can no longer issue blanket guarantees of bank debt as it did in the crisis, the Fed’s emergency lending powers have been constrained, and the Treasury would not be able to repeat its guarantee of the money market funds. These powers were critical in stopping the 2008 panic.”

At a 26 September event at the USA’s National Press Club in Washington, DC, however, to mark ten years since the collapse of Lehman Brothers, Marcus Stanley, policy director for Americans for Financial Reform, commented on this editorial, saying that the frightening reality is that “in fact, very few legal limits have been put on their ability to bailout the banks”.

Looking down the barrel of a new global blowout, financial insiders never fail to demand greater powers for central banks and regulators in order to deal with the fallout, when the pre-emptive action of reinstating a Glass-Steagall firewall, to prevent bank deposits being used to boost gambling,

The big debate: Can we prevent a new Great Depression? Photos: screenshots

would be far more effective. But it would restrict the power of banks. Law professor Arthur Wilmarth proved conclusively in the Press Club dialogue that the repeal of the *Glass-Steagall Act* was the major factor in the 2008 crash (“Glass-Steagall would have prevented the GFC”, *AAS* 3 October).

In the 16 September *Telegraph*, City of London scribe Ambrose Evans-Pritchard warned, “The world’s major economies are skating on dangerously thin ice and lack the fiscal, monetary, and emergency tools to fight the next downturn.” He cited ex-IMF chief economist Olivier Blanchard, however, who affirmed that similar interventions could still be made, albeit by tearing up the rule book. While the Fed’s balance sheet is already chock-full from quantitative easing, he said, “If we need it, we could clearly double it and nothing terrible would happen”. EU Stability Pact rules are more restrictive though, and the Fed could not assist Europe with liquidity this time around without the approval of the US Treasury Secretary. “In short, it is no longer clear that there is a lender-of-last resort standing full square behind the dollarised global financial system and able to act instantly in a crisis”, Evans-Pritchard concluded.

This is no great tragedy for those who realise the “dollarised global financial system” is not worth saving. Instead the crisis presents an opportunity for a new financial architecture including a Bretton Woods fixed currency arrangement and national Glass-Steagall standards. BRICS countries and collaborating nations are making solid moves in this direction. (“BRICS summit looks ahead ‘as old order falls apart’”, *AAS* 1 August; “China’s Glass-Steagall standard”, *AAS* 25 July.)

More warnings

IMF head Christine Lagarde has warned that global debt (both public and private) has rocketed by 60 per cent in the decade since the financial crisis, reaching US$182 trillion. The list of factors playing into a detonation of the debt bubble is long. It includes: central bank money flows being reined in; interest rate normalisation; rising oil prices; a stronger US dollar and sinking emerging market currencies; escalating trade tensions; and a growing crisis in Europe, particularly Italy. The IMF meeting’s Communiqué concluded that the “risks are increasingly skewed to the downside”, calling for action to “mitigate risks”, “rebuild buffers” for fiscal policy and “financial and structural reforms”, none of which adequately address the systemic problems.

The Bank of England’s Financial Policy Committee warned after its last meeting that “The global leveraged loan market is larger than—and growing as quickly as—the US subprime mortgage market was in 2006.” It is worried about the “rapid growth of leveraged lending” and will review the “implications for UK financial stability”. Between the USA and EU the volume of such loans is some US$1.3 trillion compared with US$50 billion in 2000.

Because leveraged loans are risky, banks package and sell them as Collateralised Loan Obligations (CLOs) to get them off their books. In the UK, CLO issues doubled over the last year. The US leveraged loan market has doubled since 2012. Eighty per cent of UK leveraged loans are "cov-lite"—covenants protecting lenders are light or nonexistent. (By comparison, in 2010 100 per cent were covered by covenants.) In the USA it is much the same.

The central bank of central banks, the BIS, warned in its latest quarterly report that the extended period of low interest rates has driven a major increase in the number of "zombie firms"—companies more than ten years old that cannot service their debt. The number is at an all time high and rising interest rates will distress the firms further, said the BIS. "We find a ratcheting dynamic" since the 1980s, the report said; "the share of zombie companies has trended up over time through upward shifts in the wake of economic downturns that are not fully reversed in subsequent recoveries."

BIS chief economist Claudio Borio warned in a conference call with reporters on 23 September that the global financial system is in danger of a "relapse", and "There is little left in the medicine chest to nurse the patient back to health". He also expressed concern about "red-hot" leveraged loans and the vehicles used to pass them on to unaware investors—CLOs—"close cousins" of the collateralised debt obligations (CDOs) that repackaged dodgy mortgages and triggered the GFC.

European Central Bank (ECB) Executive Board Member Sabine Lautenschläger warned in an understated speech on 11 October that financial stability is about "preventing the build-up of bubbles", admitting that ECB policies might have contributed to risk. "So there are some risks", she said: "There are risks that bubbles might be building up. There are risks that assets might be mispriced." Referring to new data in the ECB's Financial Stability Review, Lautenschläger warned that public and private debt may not be sustainable and if market sentiments suddenly changed, "a downturn in the real economy" could be set off. "Banks may lose their ability to finance the economy", which though she didn't say it, is their most important function.

Italy: economic warfare

The IMF's October Financial Stability report, "A decade after the global financial crisis: Are we safer?", pointed to Italy as a potential trigger for a new crash: "Recent events in Italy suggest that the sovereign-bank nexus remains an important risk transmission channel. ... Should market concerns about fiscal policy re-emerge, there is a risk of reigniting the sovereign-bank nexus given banks' holdings of Italian government bonds and their exposure to the domestic economy. In such a scenario, market tensions could spread to other government bond markets in Europe...."

The sovereign-bank nexus, i.e. between the government and private banks, is commonly referred to as the "doomloop". If banks—which in Italy hold nearly 10 per cent of government debt in the form of bonds—run into trouble, it affects the government and therefore the economy, which in turn affects the banks, and so on.

The latest instability was sparked by a letter sent to the Italian government on 5 October by EU Commissioners Pierre Moscovici and Valdis Dombrovskis saying that Italy's deficit targets are a "source of serious concern". The letter asserted a breach of fiscal discipline as Italy is increasing its public deficit target to 2.4 per cent of GDP in order to increase spending on poverty alleviation and job creation. This is 1.4 per cent greater than acceptable levels, according to EU Stability Pact rules. "We threw the gauntlet to Old Europe", declared Italian Minister for European Relations Paolo Savona, "Now we must win the war, because it will be war." (Below.)

The EU challenge set off a run on Italian bonds, spiking bond yields and driving instability in markets. If the EU holds its ground it risks spreading contagion Europe wide, driving Italy out of the EU or both. Determined to punish the "populist" government for daring to change the current financial framework, EU Commission President Jean-Claude Juncker raised the spectre of a "new Greece"; Italian Deputy Prime Minister Matteo Salvini accused him and his colleagues in "their Brussels bunker" of waging economic warfare, driving the market reaction with his actions.

The IMF downgraded growth estimates for the country and ratings agencies are expected to weigh in shortly. Former IMF Deputy Director Desmond Lachman warned, "It is hugely systemic, and could be Lehman in reverse", meaning this time a government crisis could detonate the private banking system. Meanwhile, the USA has seen its Treasury bond yields rise to a seven year peak following the Fed's last interest rate increase, further evidence of the globally systemic nature of the coming "winter".

Italian Government: Instead of austerity, emulate FDR's New Deal to stabilise economy

By Claudio Celani

13 Oct. (EIRNS)—The Italian Parliament on 11 October approved the government Document of Economy and Finance (DEF), which plans an increase of the budget deficit to 2.4 per cent of GDP, violating the EU's austerity rules which limit government spending.

Representing the government in the Chamber of Deputies was Minister for European Relations Paolo Savona, standing in for Finance Minister Giovanni Tria who was at the IMF meeting in Bali. According to protocol, Tria should have been represented by one of his undersecretaries, therefore the choice of Savona has a high political significance. It was a slap in the face of the EU leaders who earlier this year vetoed Savona's nomination as finance minister. It is also reported that Savona may become a candidate of a European-wide "sovereignist" front in the European Parliament elections in April 2019.

In his reply to criticism from the Parliamentary opposition, Savona said that he personally would have liked to authorise much more spending, but a decision was taken to proceed with "prudence" while nonetheless demonstrating that investments, not austerity, are what improve fiscal stability. He said: "I greatly insist on the fact that it is necessary to replicate, a hundred years later, what Roosevelt did with the New Deal and his reforms. He brought together the industrialised part of the northern United States with the agricultural part—which included serious flaws of racism—and he succeeded. Therefore, it is my belief that the experiment we are conducting at this moment is really a great effort of national unity, of coincidence between the interests of the advanced and the backward—economically speaking—parts of the country.