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Don't *Downsize* the Fire Brigade!

By Desmond Lachman

The world's toxic combination of massive debt, mispricing of that debt, and other serious fault lines makes the International Monetary Fund more needed than ever.

President Trump's recent nomination of a number of senior Treasury officials including David Malpass and Adam Lerrick, who are known for their antipathy towards the International Monetary Fund, suggests that he might wish to clip the wings of that organization. Before he yields to any such temptation, he might want to reflect on the fact that there is a high probability that during his administration he will be confronted with a global economic and financial market crisis that will require a large and proactive IMF for its early resolution.

Heightening the chances of a full-blown global economic and financial crisis within the next three years is an unusual confluence of adverse factors. These include the fact that the world economy is now drowning in debt, which is being grossly mispriced by the markets in the sense that investors are not nearly being adequately rewarded for default risk. At the same time, there appears to be no shortage of fault lines in the global economy, with several of these fault lines concentrated in countries of systemic importance. If the past is prologue to the present, the Trump administration would ignore the present confluence of these risks to the global financial system at its peril.

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ANOTHER MINSKY MOMENT?

Barely nine years after the 2008–2009 global economic and financial crisis, market participants appear to have forgotten economist Hyman Minsky's basic message. This is all the more surprising considering their near-death experience during that crisis. Minsky taught that when markets become overly complacent about future economic growth prospects, they take on too much risk. When they do so, they set up the very conditions for the next economic and financial market meltdown.

Had Minsky been alive today, he would no doubt have noticed the extraordinarily easy global monetary conditions of the past several years. Indeed, he could not have failed to be struck by the massive balance sheet expansions of the Federal Reserve, the European Central Bank, the Bank of England, and the Bank of Japan. Since 2009, the combined balance sheets of these banks increased by more than US$10 trillion as they engaged in highly unorthodox monetary policies to prop up their faltering economies.

Minsky would also almost certainly have noted that years of extraordinarily low policy interest rates had pushed investors to stretch for yield around the globe. They did so as interest rates on long-dated government bonds were reduced to historically low levels and even to negative interest rates in some important government bond markets.

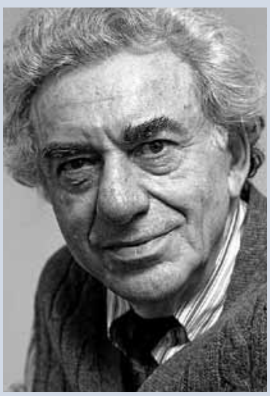
One thing that would certainly have disturbed Minsky deeply about today's global economy is that it once again appears to be drowning in debt. Recent IMF estimates show that the global debt-to-GDP ratio today is higher than it was in 2008 on the eve of the last global financial crisis. Particularly troubling is China's massive credit bubble and the large run-up in emerging market corporate debt from US$10 trillion in 2008 to around US$25 trillion today.

MARKET MISPRICING

More troubling to Minsky than the increase in global leverage would likely have been the fact that global financial asset prices today again seem to be grossly mispriced. It is not simply the fact that global equity prices are at lofty levels and that global equity markets seem to be unfazed by any bad news. Rather, it is that credit spreads across global debt markets now seem to be not offering investors with nearly sufficiently high returns to compensate them for the likely risk of debt default.

One important example of credit spreads being too tight is in the U.S. high-yield debt market, where interest rate spreads today are at the very tight sort of levels that characterized this market on the eve of the 2008–2009 economic crisis. Other examples can be found in the emerging market debt market as well as in the European sovereign debt market. Particularly noteworthy in that regard is the fact that a government as highly indebted as that of Italy can still borrow long-term at barely a 2 percent interest rate, or at practically the same rate as the United States Treasury. It is also hardly a comforting sign when the proportion of covenant-light loans today in both Europe and the United States far exceeds its pre-2008 crisis peak level.

Trump might want to reflect on the fact that there is a high probability that he will be confronted with a global economic and financial market crisis.



Hyman Minsky

He Would Be Deeply Troubled

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—D. Lachman

NO SHORTAGE OF FAULT LINES

Sadly, there are no shortage of potential triggers that could focus the market's attention on today's gross mispricing of debt, which in turn could reveal fragilities in the world financial system. One potential set of such triggers could be the unwinding of years of ultra-easy monetary policy by the world's major central banks. Another might be a setback in any of the numerous systemically important economies where major fault lines are all too apparent.

Among the more troubling fault lines in today's global economy is that of Italy, the eurozone's third-largest economy. That country ticks almost all of the boxes that are normally reliable indicators of the onset of an early economic crisis. After Greece, Italy has the eurozone's highest public debt-to-GDP ratio and the most troubled banking sector. Compounding Italy's problems is the fact that its highly sclerotic economy has literally not grown over the past twenty years and its politics have become highly dysfunctional. With Italian elections scheduled to take place at the latest by May 2018, there is the real prospect that we could have a full-scale eurozone crisis within the next year as the prospect of an Italian exit from the euro looms large.

It also has to be of major concern that over the next year or two there could be a significant economic slowdown in China, the world's second-largest economy. Such a slowdown would almost certainly have unwelcome repercussions for the economies of China's Asian neighbors

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as well as for major emerging market economies such as Brazil, Russia, and South Africa that heavily rely on commodity export earnings.

The principal reason for fearing a meaningful Chinese economic slowdown soon is that since 2008 that country has experienced a credit bubble of epic proportions. Indeed, China's recent ballooning in credit to its non-government sector has been much more rapid than that experienced either by the United States in the run-

Particularly troubling is China's massive credit bubble and the large run-up in emerging market corporate debt.

up to its housing bust in 2007 or by Japan in the run-up to its lost decade in the 1990s. Earlier experience with how bubbles on such a scale normally end has not been a happy one.

Right in the United States' own backyard, there is also the prospect of major economic trouble for Brazil, by far South America's largest economy. At a time when its public finances are on the most unsustainable of paths, Brazil now seems to be succumbing to yet another long drawn-out impeachment process, this time of Michel Temer, its embattled president. A prolonged period of political uncertainty would almost certainly put on hold the adoption of desperately needed economic reforms to straighten out the country's troubled public finances. That in turn could very well trigger a major loss of investor confidence in that country as it approaches its next presidential election in October 2018.

NO TIME TO DOWNSIZE THE FIRE BRIGADE

The toxic combination of too much debt, the gross mispricing of that debt, and serious fault lines in the global economy are all too reminiscent of the state of the world economy on the eve of the 2008–2009 Great Economic Recession. For that reason, one must suppose that it would seem to be a singularly bad idea for the Trump administration to entertain the idea of reining in the IMF at a time when there is the real prospect of a global economic crisis during his term of office. Hopefully, even President Trump must know that it is not a good idea to think about downsizing the fire brigade on the eve of a major conflagration. ◆