

Who will save the world from 2020 peril?

There is clear presumption in my title today. How can I – or anyone – be sure that peril will befall the world – whether its economy or financial markets, or both – by 2020? We cannot be certain but have very strong grounds to expect both the global economic expansion to falter and the progress of the global financial markets to suffer an abrupt reversal over the coming year or so.

Since we set the topic for this seminar 6 weeks ago, hardly a day has gone by without some famous person – Stan Druckenmiller, Ray Dalio, Ken Griffin – warning of troubled times ahead. Maybe it's the autumnal blues and the subliminal awareness of stockmarket crashes around this time of the year. I am reminded of a football match that took place one March between the Bank of England and the Treasury, a keen rivalry at every level. The Treasury officials were toiling long hours preparing papers for the Budget, while the Bank staff generally had an easier life, some with half-carpeted offices. The Bank won 5-1, but the Treasury claimed afterwards that, seasonally adjusted, the score was only 3-2.

This prognosis – which is increasingly shared by thought leaders inside and outside the financial sector – is an indictment of the elaborate international regulatory response to the global financial crisis of 2007-09. This response has focused too narrowly on the recapitalisation and reliquification of global banks. As Basel 3 comes fully into force next year, there is an air of self-congratulation in some quarters, a celebration of a job well done. Yet the financial stability discussion, where it exists at all, has revolved around small changes to the counter-cyclical capital buffer for internationally active banks. Indeed, in August, some members of the FOMC favoured an increase in US banks' CCyB (from zero) but chairman Powell is unimpressed by the arguments. In July, he averred: "Our financial system is much stronger than before the crisis and is in a good position to meet the credit needs of households and businesses. We feel that those financial sector vulnerabilities are at, sort of normal, moderate levels right now."

Meanwhile, there has been a migration of financial risk to capital structures (such as collateralised loan obligations), to mutual, closed-end and exchange-traded funds with glaring liquidity mismatches, to unsecured consumer finance (including auto credit and student loans), to highly leveraged venture capital funds and from over-the-counter derivatives to under-capitalised central counterparties that leaves the financial system wide open to new crises. A fifth of all US non-financial corporate and foreign bonds is held in fund structures, as against 7 per cent in 2008.

Despite some bold initiatives designed to give financial stability objectives a commensurate status to monetary policy objectives, little has changed in the past 10 years. There is a cultural objection to the restraint of balance sheet leverage in the private sector that reduces financial stability policy to traffic light, heat-map and box-ticking exercises. Monetary policy still rules the roost and, for the past decade, highly unconventional and ill-advised monetary policy has ruled the roost. The suppression of government bond yields and the compression of corporate credit spreads, aided and abetted by forward guidance, has fostered the greatest ever international search for yield, measured not in billions but trillions of US Dollars. The failure to phase out emergency policies years ago has enabled the efficient transfer of risk from robust balance sheets to flaky ones.

When supine central banking meets the unrestrained and prolific expansion of private sector leverage, the only available resolution mechanism is crisis. Monetary policy is at pains to prolong the economic expansion, judging the inflationary risks to be minor. Macro-prudential policy is too new and fearful

of a negative public reaction. The spectre of 1937 is wheeled out whenever policymakers begin to speak more confidently about clipping the wings of the over-leveraged and under-capitalised parts of the private sector. The closest that we are likely to come to a financial setback triggered by a deliberate act of policy lies in the context of the cessation/retraction of QE. Whether induced by a policy 'mistake' or merely by the weight of absurdity bearing down on unstable structures, when the next crisis arrives, the global financial system will still be effectively uninsured.

My first objective is to describe the catalysts and the contexts of this not-too-distant disruptive event. The developed world is exhibiting symptoms of economic overheating and growing inflationary pressures. There is extreme tightness in US and European supply chains (slide 3) – soon to be aggravated by punitive tariffs; there are chronic staffing and skill shortages (slide 4) and no sign that the demand for fossil fuels is abating despite the return of US\$80/barrel Brent. For all the tentative steps taken towards the tightening of monetary policy, credit conditions remain far too slack, especially in the financial sector and for large non-financial corporations. Global nominal GDP growth is hovering close to 6 per cent per annum, sustained in the second half of this year by quickening income growth in US and Japan.

Our contention, based on empirical work, is that the nominal interest rate structure – short and long – that is appropriate for global nominal growth of 6 per cent, is still some way north of what we observe today, even in the US. The sheer momentum of the global economy should ensure that interest rates move higher over the next 6-12 months. As policy becomes bolder – and elite bond markets reprice the nominal risks – the probability of refinancing maturing debt on existing terms will collapse. As we approach the private sector refinancing mountains of 2019-2023 and the spiky bill refinancing scheduled for the US public sector, debt service burdens will escalate. Without a fresh wave of central bank large-scale asset purchases, financial conditions will tighten abruptly and businesses with negative cash-flows will become severely challenged. Debt defaults will surge from today's insignificant levels and, finally, corporate credit spreads will widen. The performance of corporate bond funds will worsen and, naturally, net inflows to these vehicles will be replaced by net outflows.

The unfolding of these events over the next 12-18 months is likely to leave its mark on virtually all asset classes. Ironically, longer-dated government bonds, so-called safe assets, may be most immediately imperilled as a weakening demand for bonds coincides with a faster pace of primary and secondary supply. Less than 30 per cent of today's OECD sovereign bond issuance is rated as prime grade, down from 90 per cent in 2008. In investment-grade corporate debt, there has been an alarming gravitation to BBB, on the boundary with high-yield. Similarly, the median high yield rating has slipped to single B.

Developed market corporate bond markets are keenly-priced but relatively well-insulated, for the time being, by strong corporate earnings momentum. In a break with tradition, tight labour markets have not yet delivered a consistently rising factor share for labour incomes: this has delayed the erosion of corporate profitability and of the return on capital. S&P500 profit margins struck a new high at 11.5 per cent in 2018 Q2 and margins have expanded every year since 2015. The pain in corporate credit may arrive later, but when it does, the losses in high yield could be brutal, aggravated by low recovery rates.

Ex-China, emerging market sovereign and corporate debt, denominated in DM currencies, is already an impaired asset class. There may be some scope for remission if the US Dollar gives up its 2018 gains, but the impact of soaring debt service costs, expressed in local currency, is destined to become intolerable for some countries. Debt repudiation is a distinct possibility.

Chinese debt should be considered in isolation. For now, the only opinion of China credit that matters is China's. The government is eager for foreign investment in Chinese government and corporate debt and equity instruments, and for the assimilation of Chinese debt and equities into global portfolios and benchmarks. The authorities have the means to regulate Chinese government bond yields and it would be foolish to impute the outlook for EM corporate debt to China.

Lax credit conditions have undoubtedly helped to protect equity prices. Positive net debt issuance in US, Euro area, Japan and UK combined is matched by negative net equity issuance for the sixth successive year. On the basis that the expected further increase in interest rates over the next 12 months will not be much of an impediment to corporate earnings, quantitative tightening poses the greater threat to global equity prices. When corporate credit conditions tighten, it is unlikely that excess liquidity will provide support (slide 20). An eruption of market volatility is a likely side-effect of liquidity withdrawal.

While the near-term risks of a global economic recession are minimal, notwithstanding the flattening of the US yield curve, the seeds of the next global downturn have been sown. The uplift in interest rates across the curve, a deceleration of private sector debt and a widening of credit spreads is the deadly combination that brings the global economy to its knees by 2020.

For those who share the conviction that our collective course is perilous, we pose a deeper question: can the next crisis be resolved in such a way as to leave the economic policy frameworks, and associated institutional arrangements, intact? Or, will the resolution of the next crisis require a fundamental reappraisal of these policies and institutions? We will refer to these as path A and path B.

To be clear, path A involves a resolution of an economic and financial crisis in which: central bank inflation targets and operational independence remain intact; governments adhere to budget deficit and public debt ratio limits, the central bank views the QE-related expansion of its balance sheet as a temporary measure, to be unwound, and there is societal approval for bail-ins, as opposed to bail-outs, as a mechanism for absorbing financial losses.

Path B implies that these policy and institutional frameworks bend or break. It implies fiscal dominance, where budget discipline is eroded and deficits are accommodated by monetary policy, where the central bank becomes the guarantor of sovereign creditworthiness, where some version of people's QE is attempted, where some parts of the financial sector are drawn into public ownership and control, and some private debt holders may be disenfranchised.

Beginning with path A, we explore the capacity of various countries to relax policy in the face of a serious economic downturn and/or asset price correction. There are four headings: fiscal capacity – or fiscal space, as it is known in the trade; aggregate non-financial debt capacity; scope for reducing policy interest rates and scope for further expansion of QE (expressed in terms of domestic government bonds).

Of the larger economies, on a cyclically-adjusted budget balance basis, only Germany, Australia and Korea have significant fiscal space, with Canada as a possible addition to the list (slide 26). The US and Japan have no room for manoeuvre. Taking into account the public debt ratio, Germany would also rule itself out.

In terms of overall non-financial debt capacity, the issue is harder to judge. If we assume that even the poorest country has the capacity to reach a debt-GDP ratio of 150%, and that the cap for the richest per capita country is 300%, then we can obtain a rough-and ready gauge of maximum debt capacity appropriate to all intermediate levels of per capita income. The results of the exercise are on slide 29. By this reckoning, both Japan and China are already seriously over-indebted. Both US and Germany appear to have scope to expand private sector debt as a response to a protracted economic downturn, as would many emerging market economies. However, when scaled by economic size, US debt capacity would only allow for a 4 per cent of GDP per annum boost over 10 years. Germany has the capacity to sustain a similar boost for 25 years.

Who has the scope to lower short-term interest rates? Given that most countries have barely raised rates since 2009, the answer is predictable: very few. Hardly any large countries could implement even a 200-basis point reduction in policy rates, while remaining positive.

Finally, what is the scope for a resumption of QE, measured in relation to the size of the domestic public debt? Excluding Switzerland and Norway, where special factors apply, we judge the limit of QE to be equivalent to around 65% of the domestic government bond stock, roughly where both ECB and the Swedish central bank reside. On this basis, Japan would have an extra 15 percentage points of QE capacity, the Bank of England, 35pps and the US Federal Reserve, 40pps. On the face of it, these represent a massive amount of firepower to direct at an ailing economy. The political economy of unleashing another significant wave of QE in either US or UK is likely to prove the binding constraint.

To summarise, we can identify a few countries – principally US and Germany – as having the potential capacity to stimulate not only their own ailing economies in a global downturn, but to have a significant impact on the rest of the world, should they be willing to do so. This is an important caveat. Under present leadership, the US has retreated from multilateralism and embraced a form of economic nationalism. Germany's leaders remain terrified of a European syndication of sovereign debts, and potentially pension liabilities, let alone accept the burden of a global recovery.

If we are concerned that there may not be the resources nor the resolve to meet the challenge of the next crisis within existing policy and institutional frameworks, then it is necessary to explore the implications of path B.

Simply put, if there is a diminished prospect of a G20-style reflationary response to the next economic and financial crisis, then individual country responses may fall well short of the mark. Countries that lack monetary, fiscal or debt capacity will reach for more radical remedies that will have externalities on the world economy. Foremost among them will be an inflationary release.

At our last seminar we described the Little and Large Inflations. The Little Inflation has gathered momentum over the past six months. Global inflation regained 3 per cent in July and August, a level that it has not bettered since 2012. There are good reasons to believe that we have not seen the back

of the Little Inflation, as labour market tightness spills into wage bill acceleration, tariffs aggravate supply chain inflation and stubbornly high oil prices persist.

But the much graver threat lies in the emergence of the Large Inflation in the context of a monetary reset. What I have sought to do is to describe a credible path to the resurgence of much faster rates of inflation on a time scale that could be viewed as alarmingly close: 2021-22.

By all means, challenge this representation of the logic and timing of the global downturn; challenge the scope and willingness of the various actors to respond to a new incarnation of financial dislocation and economic recession; challenge the fragility of the safety mechanisms that defend global financial stability. But please, take seriously the possibility that we are heading towards a new, hubristic, financial crisis – probably focused on sub-prime corporate debt and debt funds – and that the price of another taxpayer-funded rescue will be a radical re-ordering of policy priorities and institutions.

Before closing, I want to thank my colleagues for all their hard work in preparing for today. And thanks to all of you for humouring my attempt to gaze into the far distance.

Thank you for your attention.