Global Economy Endangered by "Quantitative Easing": Towards a New Financial Derivatives Bubble?

Continental developments for a multipolar world

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Theme: Global Economy

Notwithstanding so many expert studies and international conferences devoted to the reform of global finance and of banks considered "too big to fail", we are still faced with continuing irresponsible and unacceptable economic and financial behaviour, and this is what bears the primary responsibility for the financial crisis.

To make things more complicated and dangerous, since 2008 public bailout operations have significantly increased indebtedness in the G20 economies. Overall, G20 countries have seen their total indebtedness increase by more than 30%, both domestic and international debt, public and private. This increase in total debt reflects a large increase in public indebtedness, particularly in advanced economies, that has not been offset by any decrease in aggregate private indebtedness.

Despite all efforts to decrease fiscal deficits, gross public debt of the G20 has risen by an average of 22% of GDP in the period between 2007 and 2013. The situation is more favourable in emerging economies, notably among larger economies in Latin America, where both fiscal deficits and public debt have declined on average. Among these economies, public debt to GDP is in most cases close to or below the 40% ratio.

To deal with such a major financial earthquake, central banks in major economies have lowered policy rates to near zero and have massively expanded their balance sheets. As a result, the central banks hold assets that have risen from about $4 trillion just before the crisis to $10 trillion today.

The policy of "quantitative easing"

In fact, since 2007 the US Federal Reserve System has been working with "non traditional policy tools", that is with non conventional monetary weapons, which are based on enlargement and management of its "balance sheet".

After a series of immediate operations to support the financial system in default, the Fed moved to buy directly titles of public debt and also toxic titles owned, for example, by Fannie Mae and Freddie Mac, the two giants of the subprime mortgage sector. Since November 2008, as Fed Governor Ben Bernanke reported in his speech at the 2012 Jackson Hole conference, the Fed bought titles for about $3.500 billion.

These operations are also known as “quantitative easing”. Therefore already in September 2012 the Fed had $850 billion mortgage backed securities (mbs) on its balance sheet. The Fed de facto has become a giant bad bank, something that private banking was not able and willing to do. And such an operation has been conducted with public money.

The asset-backed-securities (abs) are derivatives issued on the base of other titles of debt. They are then well packaged and sold on the markets with the guarantee of the solidity of the underlying titles. They are de facto credit multipliers and they were one of the main causes of the financial collapse. In the period of 2006-2007 about 90% of all mbs had AAA rating. Later they were suddenly downgraded to the junk level. It is also a case of conflict of interest which involved the three main rating agencies that were paid by the banks to certify their financial products, like mbs, cdo and similar.

In the US in 2008 about $1,500 billion worth of abs were created and $440 billion in Europe. After a drastic reduction in 2009, in the first half of 2013 they were again more than $332 billion. In comparison, for the same period Europe had about $36 billion, or ten times less than in the US.

In September 2012, the Fed initiated the third “quantitative easing” by announcing its decision to inject $85 billion per months into the system to buy $40 billion in Treasury bonds and $45 billion in mbs.

The Fed exercised maximum pressure on the European Central Bank to do the same. While by law it is not allowed to buy public debt titles, the ECB in 2012 made available about 2,000 billion euro to the European banking system at the very low interest rate of 0,5%. It was the “quantitative easing” European style that made available large sums of fresh money which banks used for internal repair operations, not for financing investments and the real economy. Even governor Mario Draghi not long ago had to admit that “some banks have become very dependent on the ECB liquidity emissions, they became addicted to the funds obtained”.

More recently the Fed was pushing the entire world to follow its path, promoting the idea–which was a bluff– that more cheap liquidity would trigger economic recovery. While the ECB, for the moment, would not follow the request mainly for internal political and analytical differences, the Bank of England and the Japanese government have decided to proceed with their “quantitative easing”. The Tokyo Central Bank decided to raise their inflation rate from 1% to 2% through the purchase of State bonds and other new titles. For 2013 “quantitative easing” equivalent to about $1.200 billion is planned. It should be kept in mind that the Japanese public debt, which is mostly in Japanese hands, is over 240% of GDP.

The fact that the risk of systemic crises is again on the table is the clear evidence that the “quantitative easing” policy has not worked.

Since the second half of 2012 central banks have lowered their policy rates again. As a result, not only are real short term interest rates near zero on average, and substantially negative in the advanced economies, but they are also about zero in the emerging market economies.

The major central banks of advanced countries, the Fed, the ECB, the Bank of Japan, and those of many smaller countries, are in liquidity traps today, with policy rates at minimum feasible levels. An economy enters a liquidity trap when a shortfall of demand for output calls for a low real interest rate, one so low that, at moderate inflation rates, it becomes negative. In the United States today, with a policy rate of about 10 basis points and an inflation rate around 180 basis points, the short real interest rate is minus 170 basis points.

"Quantitative easing" risks

In addition, the policy of monetary accommodation presents a number of risks. Even the Bank of International Settlements of Basel recognizes this.

Slow balance sheet repair in the countries most affected by the crisis has delayed a strong self-sustaining recovery. Monetary easing can give the impression of facilitating balance sheet adjustment at the beginning but, as time passes without significant changes, the desired benefits disappear. It may have hampered balance sheet adjustments, by reducing the perceived need to deal with impaired assets, by reducing the opportunity cost of carrying non-performing loans on the balance sheet, by distorting asset prices, leading banks to overestimate repayment capacity at more normal interest rates and by keeping alive non-viable and non-productive businesses.

Monetary accommodations have led to a deterioration of lending standards and to signs of excessive risk-taking by investors. Lower credit quality issuers have been able to borrow at historically low rates and the share of this issuance in total bonds has been unusually large. In some countries it is already much higher than before the crisis. Leverage has also risen. A number of low income countries with very low credit ratings were able to access bond markets with strong excess demand.

Extended periods of monetary accommodations may generate booms in credit and asset prices, followed by a slowdown in credit, falling prices and marked changes in flows. This is particularly risky for several emerging economies, where better economic tendencies may favour the inflow of capital. But complex situations may arise when financial imbalances combine with other disruptions, such as more volatile external financial conditions, declines in commodity prices and lower global growth.

The exit from monetary accommodation may complicate the management of the risks mentioned above. Monetary easing has pushed the bond premium in negative territory on the presumption it would support economic recovery. This has created and is still creating big problems and tension among the bond holders and also among the normal family savers that could dramatically change their traditional saving behaviour with significant financial effects in many countries. A global steepening of yield curves is hitting the balance sheet of financial institutions holding their government's debt and worsening their debt sustainability. A sudden change in premium policy could be the source of strong market volatility. In emerging markets a sharp and quick tightening of financing conditions could trigger sell-offs of assets, reversals of capital flows and other disorderly market adjustments.

A new financial derivatives bubble

Although the US Congress recently passed the Dodd-Frank Act, a document of more than 2,300 pages allegedly for a general financial reform in the US, it does not deal in a competent way with speculative bubbles, beginning with the OTC derivatives. It recognizes that "a considerable part of public money was used to cover the counterparts payments because banks because banks lacked the required capital". Indeed the big insurance company AIG alone received about $180 billion in bailout money. It recognized also the disruptive role played by leverage which, starting from a small base, moved very large amounts of capital, drastically increasing the risks.

One example to understand the leverage-risk relation: in 2008 JP Morgan Chase Bank NA, the largest American bank, had $170 billion capital, activities worth $1,670 billion and OTC derivatives amounting to $79,000 billion. Its capital was equivalent to 10.2% of total activities and to 0.21% of its OTC derivatives operations. Goldman Sachs, with capital of $64 billion, operated OTC worth $42,000 billion, with a ratio of just 0.15%

According to this document, OTC derivatives increased from the level of 98 trillion in 1998 to 592 trillion dollars at the end of 2008. Indeed, on June 2008 just before the crisis, the OTC peak reached about 673 trillion dollars. After decreasing to $550 billion in 2009, at the end of June 2011 it broke all records with $708 trillion, corresponding to a fantastic increase of about 18%, that is 107 trillion, in just 6 months!

The fact that overall OTC notional value is presently still around $640 trillion proves that no significant reform has been implemented thus far, and that the entire banking and financial system, with immediate negative repercussions for economically productive sectors, is exposed to very high risks, both old and new.

OTC derivatives on commodities also underwent a similar development. As was often indicated, OTC derivatives on commodities have a devastating effect impact on the prices of metals and food with destabilizing social and political effects. Commodities OTC increased three times from June 1998 to June 2003. They increased 19 times in the following 5 years. In June 2008 they already amounted to 13 trillion dollars. In 1998 they represented 1.5% of world GDP. The ratio was 21.6% 10 years later.

Banks “too big too fail” become bigger

After the financial crisis the five biggest American banks, JP Morgan Chase, Bank of America, Citigroup, Wells Fargo and Goldman Sachs, dramatically expanded their balance sheets and their business. In 2007 they had assets equivalent to 43% of American GDP and at the end of 2011 their assets were already 56% of GDP for a total value of $8.5 trillion.

In the past years, they accelerated the process of concentration and control of financial power. Indeed, if in 2009 the five biggest American banks controlled about 80% of all the derivates issued in the US, only four of them, JP Morgan Chase, City Group, Bank of America and Goldman Sachs, today control 94% of the total.

From a European point of analysis one has to report that, if until recently JP Morgan Chase was the number one bank in OTC derivatives with a notional value of about $70 trillion, since the end of 1012 the leading position has been in the hands of the German Deutsche Bank with over $72 trillion! Such a development underlines the international global responsibility of banks in speculation and also gives a very negative mark to the banking situation in Europe as well.

It is very shocking then to learn that, while economic recovery in the US and Europe may look good on paper but not in reality, the big American banks are swimming in gold. In the second quarter of 2013, JP Morgan Chase posted $ 6.1 billion with the perspective to reach $25 billion during the year. Wells Fargo made $5.3 billion, 20% more than the previous year. Goldman Sachs doubled its profit with $2 billion. Citi Group made $4.2 billion, that is, 42%

higher than in the second quarter of 2013. The same is true for Bank of America. We should not forget that both these last banks were almost in bankruptcy at the beginning of the financial crisis and were bailed out with $90 billion in government money. It is a big surprise to learn that in a few months their shares increased respectively 95% and 78%.

According to certain analysts the 5-6 biggest American banks intend to reach $100 billion in profit in 2013! No wonder then that, as a consequence, the bonuses for managers increased by millions of dollars. One should ask if the return to 2007 levels of profit means the end of the big crisis, or the creation of new and even bigger financial bubbles ready to explode at the first opportunity.

With such tremendously easy liquidity the big banks are devastating the local and regional banking system of America, by increasing banking concentration and the related systemic risks. These banks are also ready to pay all the numerous fines to the Federal Authorities for their illegal and speculative operations: They are also in a position to fulfil the Basel III capital requirements even before the deadline, creating big trouble for the rest of the international banking system, above all in Europe.

Clearly, while Detroit declares bankruptcy and other cities like Chicago and New York are in very bad budget situations, it is legitimate to ask if such profits come from productive investments or from speculation.

Devastating effects in the emerging economies

With all this new liquidity in American, European and Japanese economies, and in particular after one year of injections of $85 billion per month by the Fed, the results for the US economy have been very poor. Members of the Federal Reserve System, like the San Francisco Fed President , raised doubts publicly about the Quantitative Easing contribution to recovery.

But there were also many destabilizing effects in the emerging countries. The liquidity flow from the developed economies stimulated risk appetite with new real estate bubbles, easy credit and commodity speculation.

When in May Bernanke indicated the possibility of QE exit the markets went into shock. It is what happens when, after increasing a drug addict's dose, his dope supply is cut. This is why Bernanke avoided appearing at Jackson Hole, Wyoming last summer, because he was afraid he would have answer many questions about the future of Fed monetary policy.

In the emerging economies, the possibility of a Fed policy change is provoking capital outflows. This is strong in countries like India, Brazil, South Africa, Turkey and Indonesia. From the beginning of 2013 their currencies went through impressive devaluations from 8% for the Indonesian rupiah, to 15% for the Indian rupiah, to 20% for the Brazilian real. Countermeasures are being studied in the emerging countries. For example, the Brazilian central banker had to cancel his trip to the Jackson Hole conference to prepare a $60 billion emergency program in defence of the national currency.

From May the reserves of the emerging countries' central banks decreased by about $81 billion. Their stock exchange markets lost about $1 trillion. Even Christine Legarde referring to the situation of the emerging economies at Jackson Hole, had to say that "we are in a new dangerous phase which could derail the fragile recovery" and that financial markets reverberations could return to where they had their origin, that is in the US.

Continental developments as the base for a multi-polar world and a basket of currencies

All this relatively detailed data provided above serves to state the following points.

First, quantitative easing and new liquidity creation are not producing a new start up of the engines of the real economy but are setting global finance up for other major crises.

Second, after 5 years of unsuccessful international discussions and meetings at the G20 level, with the involvement of all the related international institutions like the IMF or the GFS, one cannot count any longer on their ability to find an international agreement, like a new Bretton Woods, to construct a global monetary, financial, economic, trade architecture with new rules and controls to promote coordinated peaceful social and economic development worldwide, that is, a new, more just and more democratically managed economic system.

The recent Saint Petersburg G20 summit, too, underlined such political paralysis. For the first time, as reported in the final resolution mainly due to the pressure of the BRICS countries and of few enlightened Western State development banks, the very relevant program of long term investments in infrastructure was correctly agreed upon as a priority in defining future economic developments and settings worldwide (See note 1). But unfortunately the winds of war over the Syrian crisis obfuscated its strategic potential.

At the same time, the urgent need to reinstall a modern Glass-Steagall Act to separate commercial from investment banking, to prevent deposits and capital being played on speculative markets, is being neglected and negated, despite the many international interventions on its behalf. Then the recent Cyprus banking crisis delivered a contrary signal by imposing bail-in measures, that is, the confiscation even of deposits above a certain guaranteed level, to save the banks in default.

Therefore we are left with a few proven current realities of development at the continental level as the main leverage for the creation of a new international economic architecture and agreement.

In South America a very large movement has been building up around the strength of Brazil, resisting international pressures from the United States and other areas of the world, to create a vast infrastructure-integrated Latin American continent for sovereign and independent development.

One of the best examples of such a mobilization and program is contained in the book “American del Sur: Integration e Infraestructura” (South America: Integration and Infrastructure) elaborated by a group of experts under the direction of Eng. Darc Costa, president of the Federation of the South American Chambers of Commerce and Industry. In this project, for example, it is emphasized that South America is one of the richest regions of the world in term of resources and raw materials. It lacks neither food nor the means to produce energy nor resources to promote a process of industrial development. In the past, it was the lack of adequate mobilization of these resources, instead of any demographic pressure, that condemned the majority of the South American population to poverty. Development is energy. An increase of energy production will mean an increase in industrial density and a higher density in agricultural activities to a level similar to that of development in Europe.

A network of modern infrastructures would unite all the different regions, transforming them into a continental development pole. South American will cease to be the traditional exporter of raw materials to become an independent motor of agro-industrial development. Such a process goes hand in hand with the process of political construction of South America (UNASUR) inspired by the experience of European integration.

Another area of infrastructure development and integration is what is called the Eurasian Development Belt, which includes the European Union, Russia and other countries of Asia to the interconnection with China and India. Many people are working on these very large projects. There is one initiative we recently created called “Razvitie” (Development) which studies how to integrate large infrastructure projects (transportation, energy, water, etc.) with the development and use of new advanced technologies, and their social and demographic impact. Indeed, one of the main challenges on the Eurasian land mass is the increase and settlement of population in areas which are presently without any population. In this large context, the Eurasian Union (Russia, Belorussia, Kazakhstan) would also play a very important role.

It is also for these geo-economic and geopolitical reasons that the European Union has to be maintained and further improved despite all the shortcomings and objective difficulties in its construction and in a situation of financial and economic crisis.

The other important development effort involves the African continent which for decades has been working to find a political, economic and monetary union. In this context the decision taken by the BRICS countries in April 2013 in Durban is extremely relevant. The BRICS summit established as its priority the development and unification of Africa through a network of modern infrastructure (roads and train transportation, water systems, energy, health and education systems).

China and India are de facto equivalent to two continents which are engaged in a policy of modernization and industrial development. The challenge they face is particularly related to the huge population living in both countries. In recent years in fact we have seen their economies going more and more in the direction of internal economic development, of new R&D and new technology related sectors, and away from the policy of cheap exports (which has, however, still predominated).

All these developments will promote the creation of new regional currencies, like the Euro, which will become the foundation of a new multi polar economic agreement based as well on the realization of a monetary system centred on a basket of currencies. These continental developments will become the driving force for the required new global architecture of the monetary, trade, economic and political systems.

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Note 1

Quotes from the G20 LEADERS’ DECLARATION

Saint Petersburg Summit 5-6 September 2013

Financing for Investment

35. We recognize the key role of long-term investment for sustainable growth and job creation, as well as the importance of putting in place conditions that could promote long-term financing for investment, including in infrastructure and small and medium-sized enterprises (SMEs), taking into consideration country-specific circumstances. In particular, we recognize the paramount importance of the investment climate in attracting long-term financing and will take a comprehensive approach to identifying and addressing impediments to the mobilization of private capital and improving underlying investment conditions and the efficiency of public investment.

36. To lift growth and create jobs by boosting investment, we commit to identify and start to implement by the Brisbane Summit a set of collective and country-specific actions that tangibly improve our domestic investment environments such that they are more favorable to long-term investment financing and can lead to an effective increase of implemented projects, particularly in infrastructure and for SMEs. These actions will be part of our country-growth strategies.

37. We endorse the Work plan prepared by the G20 Study Group on Financing for Investment (Annex). We call on our Finance Ministers and Central Bank Governors with input from relevant international organizations and in cooperation with other relevant G20 working groups to extend the analysis of the challenges associated with the availability of financing for long-term investment to drive well-founded, evidence-based policy initiatives. We look forward to the recommendations by our Finance Ministers at our next Summit informed by the reports of the relevant international organizations.

38. We agree in particular on the need for governments to promote policies that facilitate and encourage institutional investors to finance long-term investment consistent with their mandates and prudent risk-taking. We endorse the G20/OECD High-Level Principles of Long-Term Investment Financing by Institutional Investors (Annex) and ask our Finance Ministers and Central Bank Governors to identify approaches to their implementation working with the OECD and other interested participants by the next Summit. We look forward to the FSB's ongoing monitoring of the impact of financial regulatory reforms on the supply of long-term investment financing.

39. We call on our Finance Ministers to identify measures by the next Summit to facilitate domestic capital market development and improve the intermediation of global savings for productive long-term investments, including in infrastructure, and to improve access to financing for SMEs. We ask Finance Ministers and Central Bank Governors to explore the ways in which private financing and capital markets can be better mobilized. We also look forward to building on the ongoing work of the Multilateral Development Banks to develop new approaches in order to optimize the use of existing resources, including through leveraging private capital, and to strengthen their lending capacity. We take note of the work underway by the World Bank Group and Regional Development Banks to mobilize and catalyze additional financing for infrastructure investment, particularly in emerging markets and developing countries.

40. We recognize the importance of improving processes and transparency in the prioritization, planning, and funding of investment projects, especially in infrastructure, and in making better use of project preparation funds. Particular attention will also be given to ways to improve the design of and conditions for productive public-private partnership (PPP) arrangements.

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