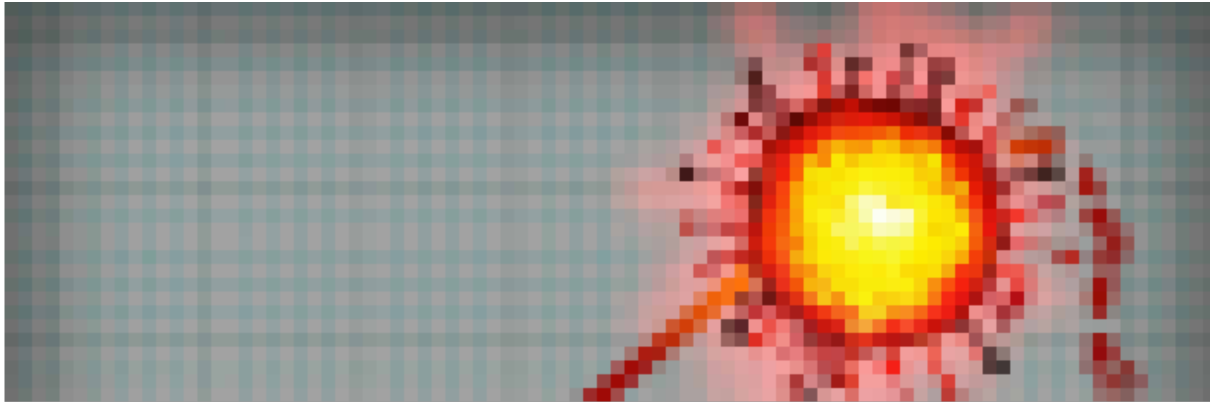
Opinion **Capital markets**

Coronavirus crisis lays bare the risks of financial leverage, again

This time it is capital markets, rather than banks, that have to reform

MARTIN WOLF



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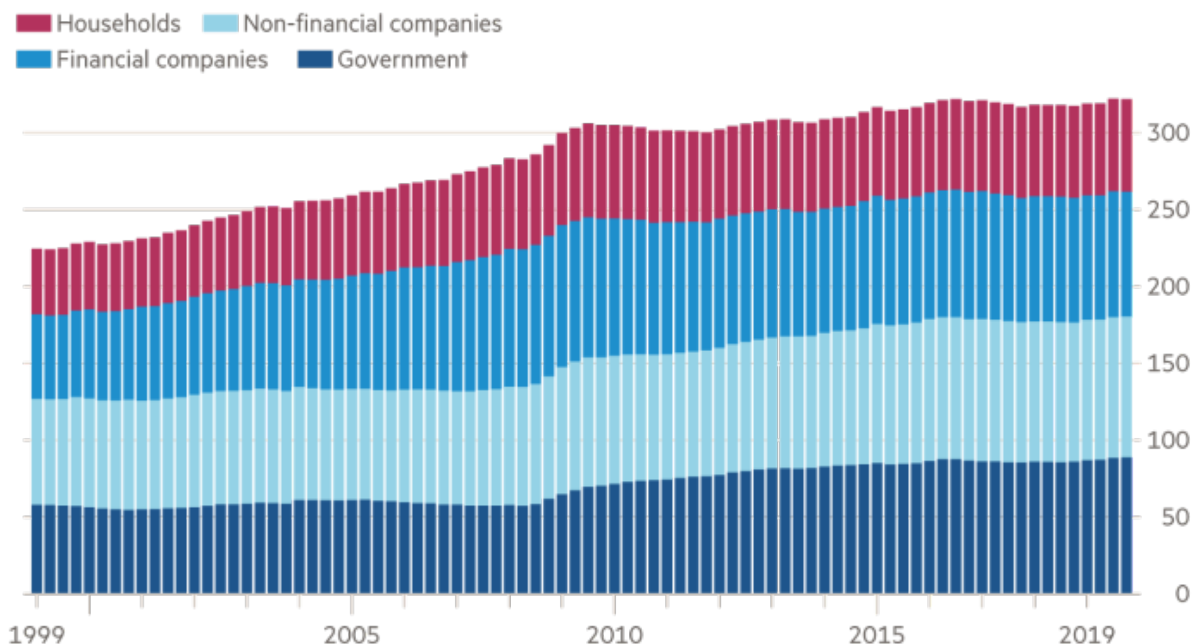
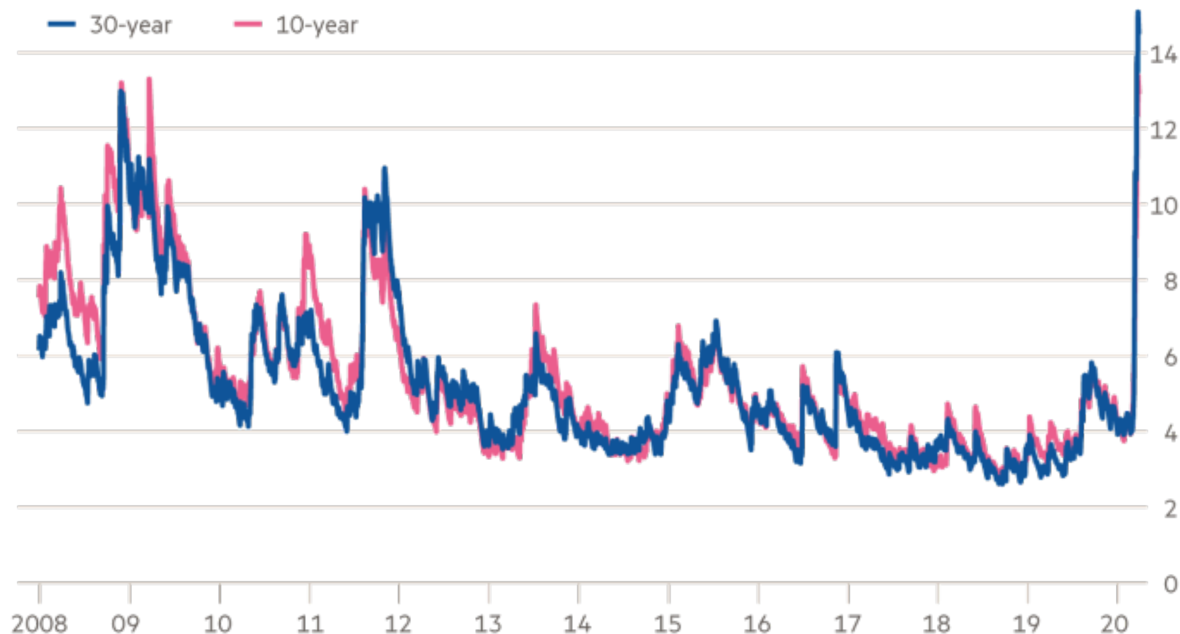
Martin Wolf YESTERDAY

Crises reveal fragility. This one is no exception. Among other things, coronavirus has revealed fragilities in the financial system. This is unsurprising. As before, reliance on high leverage as a magical route to elevated profits has led to private profits and public bailouts. The state, in the form of central banks and governments, has come to the rescue of finance on a gigantic scale. It had to do so. But we must learn from this event. Last time, it was the banks. This time we must look at capital markets, too.

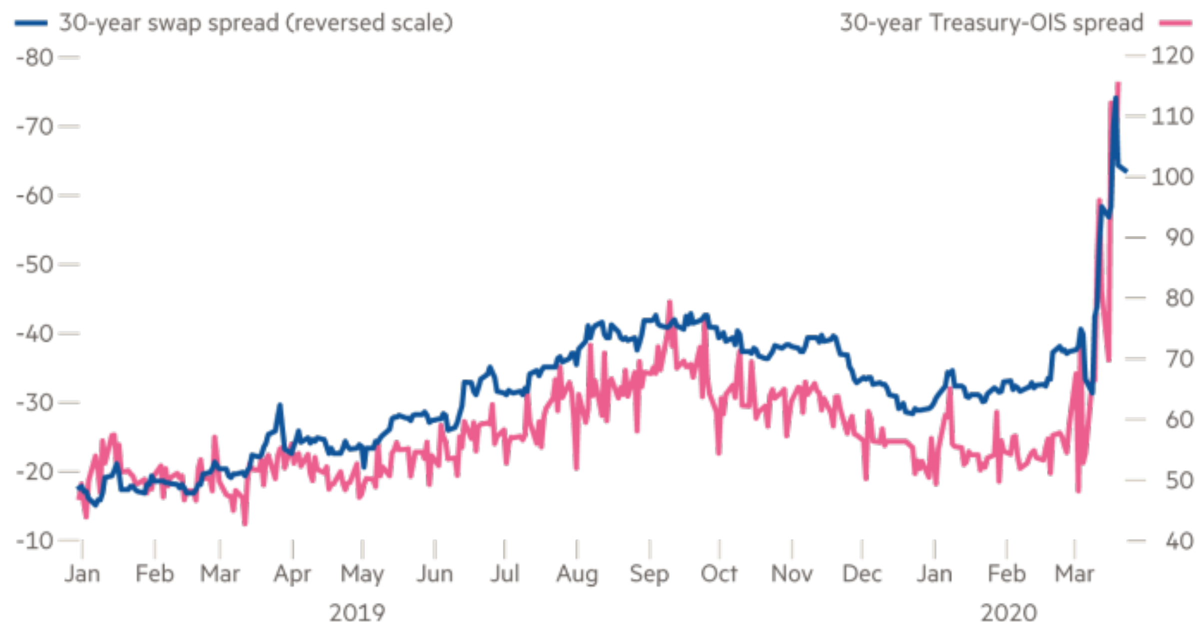
The IMF's latest Global Financial Stability Report details the shocks: falling equity prices, soaring risk spreads on loans and plummeting oil prices. As usual, there was a flight to quality. But liquidity dried up even in traditionally deep markets. Highly-leveraged investors came under severe stress. The pressures on the financing of emerging economies have been particularly fierce.



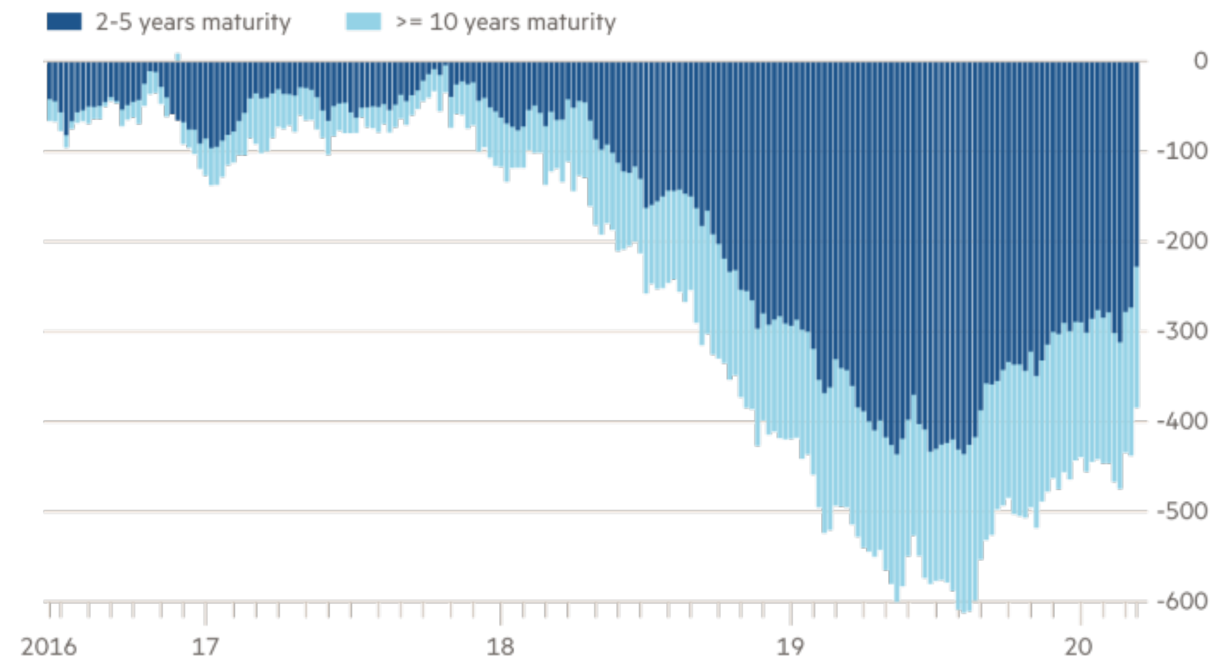
The scale of the financial disarray reflects in part the size of the economic shock. It is also a reminder of what the late Hyman Minsky taught us: debt causes fragility. Since the global financial crisis, indebtedness has continued to rise. In particular, the indebtedness of non-financial companies rose by 13 percentage points between September 2008 and December 2019, relative to global output. The indebtedness of governments, which assumed much of the post-financial crisis burden, rose by 30 percentage points. This shift on to the shoulders of governments will now happen again, on a huge scale.



The IMF report gives a clear overview of the fragilities. Significant risks arise from asset managers as forced sellers of assets, leveraged parts of the non-financial corporate sector, some emerging countries, and even some banks. While the latter are not the centre of this story, reasons for concern remain, despite past strengthening. This shock, the report states, is likely to be even more severe than envisaged in the IMF's stress tests. Banks remain highly-leveraged institutions, especially if we use market valuations of assets. As the report notes: "Median market-adjusted capitalisation is now higher than in 2008 only in the US." The chances that banks will need more capital is not small.

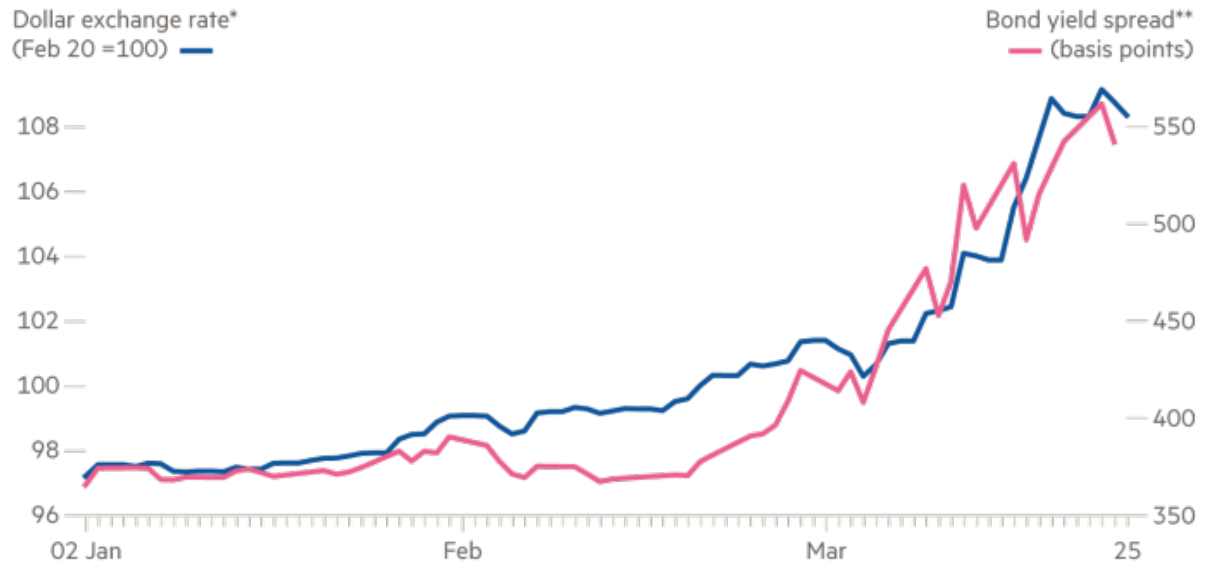


Yet it is capital markets that lie at the heart of this saga. Specific stories are revealing. The Bank for International Settlements has studied one weird episode in mid-March when markets for benchmark government bonds experienced extraordinary turbulence. This happened because of the forced selling of Treasury securities by investors seeking “to exploit small yield differences through the use of leverage”. This is the type of “long-short strategy” made infamous by the failure of Long Term Capital Management in 1998. It is also a strategy vulnerable to rising volatility and declining market liquidity. These cause mark-to-market losses. Then, as margin is called in, investors are forced to sell assets to redeem loans.



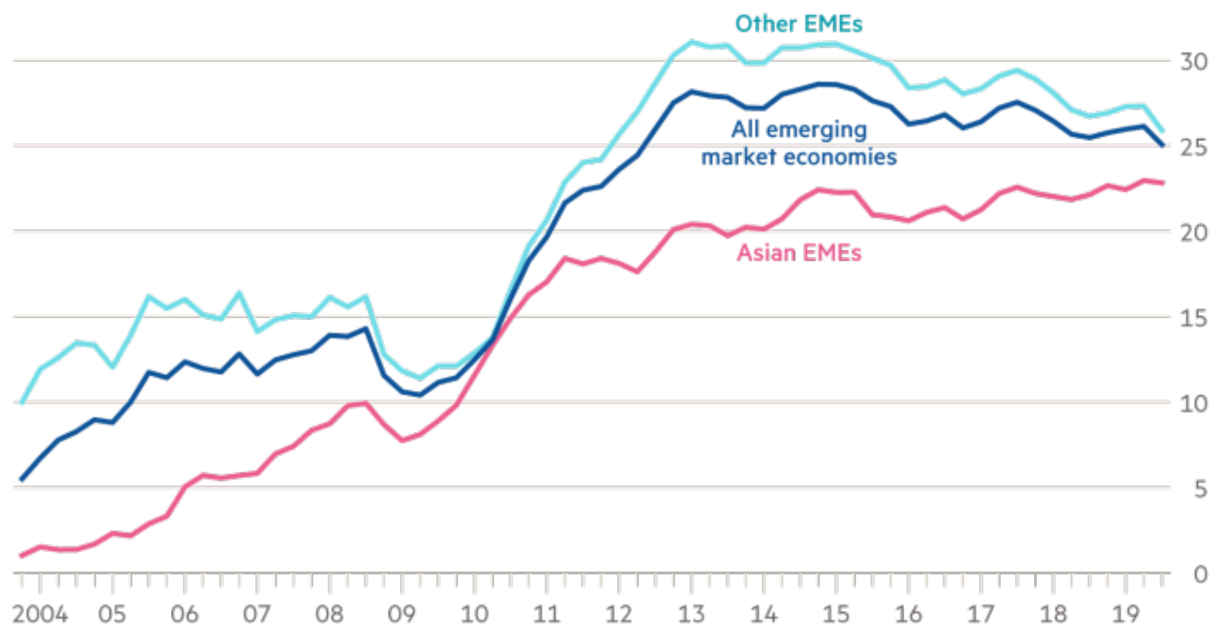
Another story elucidated by the BIS tells of emerging economies. An important recent development has been the rising use of local currency bonds to finance government spending. But when the prices of these bonds fell in the crisis, so did exchange rates, increasing the losses borne by foreign investors. These exchange-rate collapses worsen the solvency of domestic borrowers (notably businesses) with debts denominated in foreign currency. The inability to borrow in domestic currency used to be called "original sin". This has not gone, argue the BIS's Augustin Carstens and Hyun Song Shin. It has just "shifted from borrowers to lenders".

Yet another significant capital-market issue is the role of private equity and other high-leverage strategies in increasing expected returns, but also the risks, in corporate finance. Such approaches are almost perfectly designed to reduce resilience in periods of economic and financial stress. Governments and central banks have now been forced to bail them out, just as they were forced to bail out banks in the financial crisis. This will reinforce "heads, I win; tails, you lose" strategies. So vast is the size of central bank and government rescues that moral hazard must be pervasive.



The crisis has revealed much fragility. It has also demonstrated yet again the uncomfortably symbiotic relationship between the financial sector and the state. In the short run, we must try to get through this crisis with as little damage as possible. But we must also learn from it for the future.

A systematic evaluation of the frailties of capital markets, comparable to what was done with banks after the financial crisis, is now essential. One issue is how emerging economies reduce the impact of the new version of “original sin”. Another is what to do about private sector leverage and the way in which risk ends up on governments’ balance sheets. I think of this as trying to run capitalism with the least possible risk-bearing capital. It makes little sense. This creates a microeconomic task — eliminating incentives for the private sector to fund itself so heavily via debt; and a macroeconomic one — reducing reliance on debt to generate aggregate demand.



The big question now is whether the essential systems that keep our societies running are adequately resilient. The answer is no. This is the sort of question the OECD's New Approaches to Economic Challenges Unit has dared to address. Inevitably, it has created much controversy. Yet it is admirable that an international organisation is daring to do so at all. The crisis has shown us why.

We cannot afford complacency. We need to reassess the resilience of our economic, social and health arrangements. A focus on finance must be an important part of this effort.

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