ECONOMY AND POLICY

The Fed Has Averted A Systemic Financial Crisis—For Now. Here are 3 Areas To Monitor.

By Reshma Kapadia April 6, 2020 7:30 am ET

Photograph by Cliff Hawkins/Getty Images

Bad news is said to come in threes, but let's hope full-blown crises don't. The Covid-19 global health crisis rapidly became a global economic crisis, but, so far, it has not touched off a financial crisis. U.S. banks, for the most part, are in good shape, and central bankers injected trillions of dollars to stabilize financial markets—and stand willing to do more. But three areas—emerging markets, corporate bonds, and, of course, the banks themselves—require close monitoring to ensure today's fragile fiscal stability doesn't turn into a big problem.

The economic crisis is clear to see—companies see revenue dry up overnight, unemployment spikes, nations fall into a recession. Though less visible, financial crises can be even more debilitating, threatening the flow of money through an economy and sparking contagion through the financial system. Financial crises usually arise when high asset prices (like stocks after a decade-long bull market) fall sharply at a time when there is too much debt in the system (such as after years of companies, and countries, using record-low interest rates to borrow heavily). Sound familiar? That's often when panic hits, sending investors to dump assets in a fire-sale, and threaten bank-runs. Sometimes a crisis can be limited to financial institutions, but it can touch off, or worsen, a broader economic crisis. And sometimes a severe economic downturn itself, can jeopardize financial stability, as rising unemployment and drop in economic production triggers a wave of defaults, hurting banks.

But policy makers have learned from 2008, and moved aggressively at the first signs of trouble. Between March 16 and April 2, for starters, the Federal Reserve purchased nearly $1.3 trillion in Treasury securities. It also moved to backstop money market funds when the market for extremely short-term debt obligations began seizing up, and created a dollar swap line with other central banks to help with countries' short-term financing needs. These measures provided much-needed liquidity for companies to make payroll and continue operating, keep economies working, and help calm markets.

But economists and investors say policy makers must stay vigilant. Economic activity has ground to a halt in large swaths of the world, and it's unclear how many companies—and countries—may have to default on their obligations. "I don't think we are out of the woods," says Adam Tooze, a Columbia University economic historian and author of Crashed: How a Decade of Financial Crises Changed the World. "This will require continued firefighting from the Fed. They have to be on tender hooks, constantly waking up trying to deal with the second- and third-order effects."

The global economy is facing the biggest downturn in 150 years, says Kenneth Rogoff , former chief economist at the International Monetary Fund and current professor at Harvard University. And whether we can avoid a financial crisis rests on how fast the world can pull itself out of this economic pause, he adds. Crisis-watchers are closely monitoring three key areas that could trigger a systemic risk to global financial stability: Emerging markets, corporate bonds, and banks themselves.

Emerging Markets Are The First To Fall

Emerging markets are often the first dominoes to fall, since many developing countries have less room to navigate in terms of monetary and fiscal policy. For years, investors trying to find yield in a low-interest rate world have flocked to emerging markets as eager lenders. Countries and companies went on a borrowing binge—and are now struggling to service their dollar-denominated debt. That comes against an already-difficult economic backdrop in countries like South Africa and Brazil, and a brutal blow from the collapse in oil prices for commodity exporters like Colombia and Lebanon.

Investors are fleeing. In the first quarter, investors pulled $62 billion out of emerging markets assets, roughly twice the size of outflows recorded at the peak of the global financial crisis, according to the Institute for International Finance. And it may not be over yet: IIF Chief Economist Robin Brooks is worried about a broader contagion as foreign investors rethink emerging markets.

Rogoff expects a wave of emerging markets will need to restructure debt, and independent research firm Capital Economics warns of a wave of emerging market sovereign defaults. Countries like Ecuador, Argentina, and Zambia have seen major stress already, with borrowing costs soaring. And there could be trouble elsewhere: South Africa, for instance, has a substantially overvalued currency; a very weak balance of payments and persistent current account deficit; and negative growth, Brooks says. Also vulnerable: Many state-owned enterprises, including Mexico's oil giant Petroleous Mexicanos, better known as Pemex, and Brazil's Petróleo Brasileiro (ticker: PBR), or Petrobras.

Already, some 85 emerging market countries have asked the International Monetary Fund, the lender of last resort, for assistance. The IMF has said it is mobilizing a $1 trillion lending capacity to help countries. But in a note to clients, Capital Economics said the IMF's ability to help may be more limited, since some of that $1 trillion is already spoken for. While the IMF should have enough resources to bail out smaller emerging markets, its finances could struggle if much larger economies—the likes of Turkey or South Africa—need assistance, according to Capital Economics.

Could the turmoil in emerging markets trigger a systemic crisis globally? Probably not. Bigger emerging markets—Brazil, India, Russia, China, Korea—have large currency reserves, less of their debt owned by foreign investors, and large domestic bond markets, all of which means they are unlikely to need bailouts, even if the situation worsens, according to Capital Economics. Two exceptions: If China's all-important property market melts down or China devalues the renminbi, though the Chinese government will likely use their considerable resources to avoid using either of those two options.

Corporate Bonds Can Cause Bigger Problems

Emerging markets may be the first to fall, but when problems arise in the U.S. corporate debt market, it's more worrisome. Extremely low interest rates have encouraged companies to borrow heavily in recent years, and problems can arise quickly when levered companies see demand for their business evaporate. In March alone, $92 billion of bonds became "fallen angels," dropping from investment-grade down to high-yield. Risks lie not just in the investment-grade bond universe, but also lower-quality collateralized loan obligations and structured finance that could be the 2020 version of subprime mortgages.

Companies are already drawing on credit lines and revolvers, and highly-rated companies have rushed to tap bond markets while they can, willing to pay one or two percentage points more than a couple weeks ago to lock in extra money now—a sign of anxiety among companies of what could lie ahead, Tooze says. Harvard's Rogoff expects massive corporate defaults if the economy stays on pause. The question for global financial stability: Whose balance sheets will suffer when those companies can't make good on their debt?

In 2008, the toxic assets were mortgages, and they sat on the balance sheets of banks that were highly-levered. This time around much of the potentially troubled assets are sitting on the balance sheets of nonbank financial institutions—like pensions and insurance companies—that can provide credit to businesses and households and manage risks. Many of the biggest owners are foreign investors, including European and Japanese insurers and pensions that gravitated toward U.S. debt in search of yield as they faced negative yields at home, says Deutsche Bank Chief Economist Torsten Slok.

The IMF has been warning about rising debt levels in non-bank financial institutions for a while, cautioning that there are fewer tools to use in a crisis to offset the fallout from a sharp economic downturn. The threat of rising risks outside of the banking sector requires increased focus on asset managers and exchange-traded funds, where investors might liquidate risky investments suddenly, according to a recent blog post by Adrian Tobias, director of the IMF's Monetary and Capital Markets Department.

The trouble? “No one has eyes on it,” says Neil Shearing, chief economist at Capital Economics of the opacity of the risk in these institutions. “The lessons from 2008 is that problems can spread from the financial plumbing in ways you can’t see.”

How bad the fallout will be depends in part on what investors do with those beaten up assets. If they sell, that could ripple through the market. But it may not be as bad as 2008, in part because most of these owners, unlike those who owned mortgages in 2008, aren’t that levered. “The risk of systemic problems in the financial system are smaller this time around and the location of the problem assets is on the buy-side, not on the sell-side,” Slok says.

Banks Can’t Get Complacent

Banks are the nerve center of the global financial system, and many economists have taken comfort in the stress-tests that improved the health of the system after the global financial crisis.

But caution is needed where complacency has arisen: “It is a mistake to say or imply all will be OK out there, whatever happens. Some jurisdictions have suspended stress-tests. That’s a mistake,” says Sir Paul Tucker, former Bank of England deputy governor and current chairman of the Systemic Risk Council, which was set up after the global financial crisis. They should still conduct tests, he tells Barron’s, but using current worst-case scenarios: “Either a second wave if they reopen the economy in the summer in one of the major countries, and it turns out to be a mistake—or for an economic lockdown that continues until there’s a vaccine. None of that is implausible.”

Authorities need to assess how the system would cope with surging credit demand and losses from inactivity in those instances, Tucker says, adding that the Council has stressed that authorities should call for a halt to bank dividends and high-end bonuses, as well.

The IMF’s Tobias expressed similar caution in a recent blog post, warning that pressure on the banking system was growing and higher debt defaults were imminent, with conditions in many countries as severe as the adverse scenario of stress tests regulators often use for the banking system. Many of the current assumptions are based on economic activity restarting later in the year. “Under more severely strained circumstances, we will have to rethink our playbook substantially. Some banking systems might have to be recapitalized or even restructured,” Tobias wrote.

It may take some unorthodox measures, but Harvard’s Rogoff sees one reason to not panic. “We’re not going to let our banking system collapse,” he says. “Worst-case scenarios is that we end up like Europe, with a banking system that is moribund—a lot of the reason why Europe has stagnated.”

At this point, a moribund banking system sounds like a glass-half-full view.

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