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BREAKINGVIEWS

Stormier weather

Guest view:
Financial storm conditions will worsen

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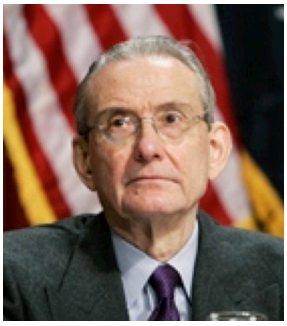

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Unpredictable and disorderly flows of capital across national borders and in and out of currencies, equities, bonds and other financial assets are proving to be highly disruptive. Storms are swirling across the world's financial markets - and conditions will get worse, hitting the markets, global trade and economic growth.

The costs and consequences of the near-indiscriminate search for yield by investors after the financial crisis are being counted as holders of vast amounts of mostly dollar-denominated assets face repayments and start to unwind their positions. We are seeing exceptional foreign-exchange and stock-market volatility and conditions may deteriorate further.

The pace of asset liquidations is likely to increase, especially by investors and corporations, including state-owned enterprises in emerging markets. The introduction of negative interest rates is just the latest development to continue the momentum of swift and vast international capital flows that are adding to uncertainties in financial markets.

Three fundamental factors are triggering the disruptive surge in international capital flows: the slowdown in China's growth, which has damaged all countries heavily reliant on commodity exports; the collapse of oil prices due partly to China's slowing, the determination of Saudi Arabia and Russia to keep pumping high volumes of oil and the increase in U.S. domestic oil and gas output; and U.S. interest rates – both the anticipation of the boost that the Federal Reserve provided in December, as well the continuing possibility the central bank may raise rates further later this year.

The decline in China's economic growth rate, coupled with mounting concerns related to financial stability, is driving an extraordinary volume of capital outflows. The authorities have yet to develop an effective policy to curb the borrowing appetite of state-owned enterprises, provinces and municipalities, which are currently adding to their substantial debt levels, or reduce the likely volume of non-performing loans held by the financial sector, including the shadow-banking area.

Over the last year, China's foreign-exchange reserves have declined by close to $700 billion and the pace is accelerating with outflows of $200 billion in just the last two months. The amounts might have been greater had it not been for the imposition of informal capital controls by the authorities. Nevertheless, further large capital outflows from China are likely.

Then there is the oil-price impact. This takes several forms, but two of particular note relate to the dollar-denominated indebtedness of state-owned firms, including national oil companies such as Brazil's Petrobras. Too many borrowers and lenders alike anticipated that the oil price would remain above $100 per barrel. Governments, overly dependent for their budgets on oil revenue, are now pressing their sovereign wealth funds and national oil companies for cash, forcing liquidations of U.S. assets.

The Bank for International Settlements recently noted: "A substantial portion of the increased borrowing was by state-owned oil companies from emerging-market economies. From 2006 to 2014, the stock of total borrowing (syndicated loans and debt securities) of Russian companies grew at an annual rate of 13 percent, with that of Brazilian companies 25 percent and that of Chinese companies 31 percent. Borrowings of companies from other emerging markets increased by 17 percent per annum."

Alongside the problems in China and the financial impact of plunging oil prices and other commodities is the unprecedented volume of liquidity created by the world's most important central banks in response to the Great Recession. Today's turmoil is largely an unintended consequence of these monetary policies.

Since 2008, the holdings of U.S. dollar debt by non-financial institutions across the world are close to $10 trillion – most significantly, such holdings in emerging markets have almost doubled to around $3.3 trillion. Possibly one-third of this total volume has been borrowed to finance international trade transactions in U.S. dollars. A further portion has been used for long-term productive investment, but the majority has almost certainly been held in relatively short-term debt instruments.

As the dollar has gained in strength, and dollar assets have moved toward maturity, so foreign holders have felt increasingly squeezed. The need to liquidate positions has been increased by many highly indebted non-financial corporations in emerging markets whose profitability has been declining.

These factors have influenced an unprecedented reversal in net capital outflows to emerging markets in 2015, amounting to an estimated $735 billion, according to the Institute of International Finance. Further, the BIS reported a decline of $300 billion to a total of $3.3 trillion for the first time since 2009 in the total stock of dollar-denominated credit in bonds and bank loans to emerging markets (excluding banks) – the first decline since 2009. These trends will accelerate.

The unwinding of internationally owned U.S. assets now and in coming months will add to volatility in almost all financial markets. Currencies perceived as weak will face further downward pressures, especially against the dollar. Then, the financial squeezes within publicly and privately owned companies in emerging markets – from China and Brazil, to Russia, Turkey and South Africa - will soften investment activity, slow world trade yet again, and raise further fears of a global recession.