Bank for International Settlements points to increased financial fragility

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The increasing value of the US dollar against other currencies could provide the trigger for another major global financial crisis. That is the conclusion to emerge from the latest *Quarterly Review* of the Swiss-based Bank for International Settlements (BIS). Sometimes known as the central bankers' bank, it functions as a kind of watchdog over the global financial system.

The quarterly report focused on two key developments in financial markets during the recent period: sharp movements in August and October, pointing to underlying fragility, despite seeming buoyant conditions, and the rapid rise in dollar-denominated loans to so-called emerging markets, especially China.

The BIS pointed to the implications of the events of October 15, following an earlier experience of market volatility in August, when, for a brief period, financial markets began to resemble those of September 2008 following the collapse of the US investment bank Lehman Brothers.

"Mid-October's extreme intraday price movements underscore how sensitive markets have become to even small surprises. On 15 October, the yield on 10-year US treasury bonds fell almost 37 basis points (0.37 percentage points), more than the drop on 15 September 2008 when Lehman Brothers filed for bankruptcy."

The report noted that this movement was large relative to actual economic and policy "surprises," as the most notable piece of news that day was the release of somewhat weaker than expected US retail sales data an hour before the sharp drop.

Commenting on this incident, Claudio Borio, the head of the BIS monetary and economic department, said it was possible to draw some comfort, as did those who referred to the speed of the rebound.

According to Borio, however, the real significance of the abrupt drop was the extent to which it underlined "the fragility—dare I say growing fragility?—hidden beneath the markets' buoyancy." Central banks issued soothing statements that calmed the situation, but this only "highlighted once more the degree to which markets are relying on central banks: the markets' buoyancy hinges on central banks' every word and deed." The "highly abnormal" was becoming "normal."

The report warned: "More than a quantum of fragility underlies the current elevated mood in financial markets."

The BIS also pointed to the potential impact of a continued rise in the value of the US dollar on emerging market economies (EMEs), where firms have taken out dollar-denominated loans. In conditions where other central banks, notably the European Central Bank and the Bank of Japan, are engaged in quantitative easing while the US Fed is looking to tighten monetary policy, any consequent rise in the value of the US currency immediately increases the debt and real interest rate burden.

"The appreciation of the dollar against the backdrop of divergent monetary policies, may, if persistent, have a profound impact on the global economy. A continued depreciation of the domestic currency against the dollar could reduce the creditworthiness of many firms, potentially inducing a tightening of financial conditions," the report said.

Since the Lehman crisis, debt levels in emerging markets have jumped by 30 percentage points and now stand at an amount equivalent to 175 percent of gross domestic product.

The biggest rise has been in lending to China. It has become the largest emerging market borrower, with

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cross-border claims totalling $1.1 trillion in June this year, compared to $311 billion for Brazil and more than $200 billion each for India and Korea. The BIS reported that banks' exposure to China was almost twice as large as any emerging market economy.

This is the result of rapid changes that have taken place since 2008. At the end of that year, China accounted for 6 percent of all cross-border claims on EMEs. By mid-2014, that figure stood at 28 percent, with loans to Chinese banks and companies rising at an annual rate of 47 percent. The cross-border claims on China are now the seventh largest in the world.

Borio described the post-crisis surge in lending to China as "extraordinary," with the amount outstanding more than doubling since the end of 2012. "Contrary to prevailing wisdom," he said, "any vulnerabilities in China could have significant effects abroad… through financial channels."

The significance of movements in the dollar for international debt and financial markets was highlighted in other parts of the report. It pointed out that the world's central banks still hold more than 60 percent of their reserves in dollars, a ratio that has changed very little in the past 40 years. At the same time, the overall amounts have risen from $1 trillion in 2000 to $12 trillion today.

Cross-border lending in dollars has tripled to $9 trillion over the past decade. Significantly, some $7 trillion of this is outside the sphere of direct American regulation, as neither the borrower nor the lender is a US resident.

This means that where companies and banks ran into problems because of an increase in the value of their dollar-denominated debts, they would rely on their own national governments and central banks to help bail them out. Whether countries such as Russia and India would have sufficient dollar reserves is another question.

China is generally considered to have sufficient reserves to bail out companies that experience difficulties. In the event of a major crisis, however, it would most likely have to consider selling off some of its large holding of US treasury bonds, leading to upward pressure on US interest rates and creating turbulence in American financial markets.

Coming just one day after the release of US jobs figures that recorded an unexpectedly large increase in the number of jobs created in November—321,000 as compared to predictions of 230,000—the BIS report served to pour cold water on claims that the US was sparking a global economic recovery.

The *Financial Times* greeted the US jobs numbers with the assertion that the US was riding "to the rescue of the global economy." Following the decision of the German Bundesbank to halve its forecast for German growth next year, "US consumers could once again help drag the global economy through a soft patch."

In the first place, however, the increase in American employment is largely a result of the low-wage regime imposed across the economy. Secondly, any significant improvement in the US economy will further strengthen the dollar which, as the BIS points out, could have major adverse implications for the global financial system.

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