IMF report points to sources of increasing financial turbulence

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The global financial system has become increasingly exposed to volatility and the risk of a meltdown emanating from what were once considered stable institutions, and national-based monetary authorities exercise a decreasing degree of control over the system.

This conclusion emerges from two analytical chapters of the *Global Financial Stability* report issued by the International Monetary Fund (IMF) on Monday in the lead-up to its spring meeting later this month.

One chapter deals with the impact of "spillover" effects of turbulence in so-called emerging markets resulting from their closer integration into the global financial system over the past two decades. The other examines the heightened risks posed by insurance companies as they confront increasing problems flowing from the global low-interest rate regime.

The IMF notes that "spillovers of emerging market shocks to equity prices and exchange rates in advanced and emerging market economies have risen substantially and now explain over a third of variation in asset returns in these countries."

A spillover is defined as the impact of changes in domestic asset prices in one country on those in another. The impacts emanating from emerging markets have become "significantly stronger since the 2007–2009 global financial crisis."

Underlying these effects is the growing significance of emerging markets in the global economy. As the IMF notes, they have contributed more than half of global growth over the past 15 years. Another indicator of increasing global integration, flowing from the establishment of global supply chains by major transnational corporations, is the 20-fold rise in trade between emerging market economies since the early 1990s.

The IMF pays particular attention to China, pointing out that the suspension of trading on Chinese markets on January 6 this year "reverberated across major asset markets globally." When Chinese equities fell sharply on August 24, 2015, following a change in the exchange rate regime for the renminbi, the "subsequent plunge in Asian markets was significant." US and European markets were also "adversely affected."

While the IMF does not make this point, the analysis contained in the report is an exposure of the claim that the turn to the "free market" is the road to stability for the global financial system. In the case of China, the exact opposite is the case.

According to the IMF, the "impact of shocks to China's fundamentals on global financial markets is expected to grow stronger and wider over time." In addition to the growth of its economy, the size of Chinese financial market spillovers "is also likely to grow because of the transition to a more market-based financial system."

"In both equity and bond markets, the inclusion of Chinese securities and global benchmarking indices will likely have a large global impact. As banking and market linkages rise, the use of the renminbi as a funding currency as well as a reserve currency will grow, which will also increase spillovers through foreign exchange markets."

This analysis underscores one of the central features of the historic crisis of the capitalist economy—the ever-deepening contradiction between the global character of economic and financial activity and the nation-state system. Rather than exercising control, national-based central banks and monetary authorities—even the largest, such as the US Federal Reserve—increasingly have to react to, rather than direct, financial flows.

This lack of control has worsened since the 2008 global financial crisis, with various funds, rather than banks, playing a growing role in the intermediation of global capital flows. The result is that "close to two-thirds of dollar funding originates outside the United States," increasingly dominated by investment funds.

The second chapter deals with the global life insurance industry and the "trends and systemic risk implications" of developments since the 2008 crisis.

It notes that "across the advanced economies the contribution of life insurers to systemic risk has increased in recent years," while it still remained below that of banks. Systemic risk refers to a situation where the financial problems encountered by an individual company sweep through the money markets as a whole.

What the IMF disingenuously refers to as the "near collapse" of the American insurance giant AIG during the 2008 crisis "prompted a rethinking of the sector's systemic risk contribution." In fact, the firm went bankrupt and was only saved by a US government bailout.

By every measure, the insurance companies' contribution to that systemic risk is rising. They hold some $24 trillion, or 12 percent of global financial assets.

As the IMF explains, this is a result of "common exposures to aggregate risks." That is, insurance companies are affected by the same turbulence as other parts of the financial system. Furthermore, they are sensitive to interest rates. "Thus, in the event of an adverse shock, insurers are unlikely to fulfil their role as financial intermediaries precisely when other parts of the financial system are failing to do so as well."

A particular problem for life insurance companies is the low-interest rate regime established by the world's major central banks in the wake of the 2008 crisis. Their entire business model faces "challenges" because the promised rates of return on long-term contracts now exceed the returns that are available on "safe" assets such as government bonds and high-grade corporate bonds. This leads to a situation where the life insurers could undertake a search for higher yields in riskier assets and possibly "gamble for resurrection."

This situation is set to worsen because there is little prospect of any major change in the current low-interest rate environment.

The IMF warns that smaller and weaker firms are more likely to take on excessive rises and the "solvency problems of [these] smaller entities may result in cascading effects that become systemic."

As with the chapter on spillover effects, the IMF's analysis of the insurance industry points to the increasing impotence of national-based regulatory institutions. It says authorities should take a more macro-prudential approach to the sector—that is, closer regulation of individual firms and tighter national standards. Such an approach, it says, would be complemented by "international adoption of capital and transparency standards for the sector," indicating that in this global industry none exists at present.

One is reminded of the observation by Marx in the *Communist Manifesto* that modern bourgeois society, with its relations of production, of exchange and of property, "is like the sorcerer, who is no longer able to control the powers of the nether world whom he has called up by his spells."