Brexit financial fallout widens

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Problems in the global financial system are mounting following the June 23 British referendum vote to quit the European Union. One of the clearest manifestations is the spike in the volume of government bonds trading at negative yields.

Over the past month, the total has surged by $1.3 trillion to $11.7 trillion, reflecting a massive "flight to safety" by investors and institutions that have lost all confidence in the prospect of normal growth in the world economy. Last week, German ten-year bonds traded in negative territory, while in Japan all government bonds of less than 15 years duration have yields below zero.

A negative yield means the price of the bond is so high and the consequent yield so low (prices and yields move in inverse relationship to one another) that investors would lose money if they held a bond to its maturity date.

The shift in the bond market indicates that the outlook for the global economy is worsening following the Brexit vote, prompting central banks around the world to prepare to pour still more money into the financial markets.

Longer-term British rates remained marginally positive after the British ten-year bond dropped to a record low of 0.78 percent last week. But yields on a two-year bond went negative for the first time ever amid predictions by economists of a UK recession in the coming months and a downbeat assessment by Bank of England Governor Mark Carney.

He said the decision to quit the EU marked a "major regime shift." He added that "uncertainty over the pace, breadth and scale of these changes could weigh on our economic prospects for some time," while he foreshadowed "some monetary policy easing" over the next few months.

Besides uncertainty over Brexit, there were longer-term shifts at work, Carney indicated. "These challenges have been compounded by deeper forces that have radically altered the balance of saving and investment in the global economy," he said. "Whether called 'secular stagnation' or a 'global liquidity trap,' the drag on jobs, wages and growth is real."

"Secular stagnation" or "liquidity trap" refers to the situation, first identified in the 1930s, where investment prospects are so low that cuts in interest rates provide no boost to economic activity in the real economy, and economic stagnation becomes a permanent condition.

Carney pointed to a number of interrelated factors leading to a worsening economic outlook both in the short and longer term. Globalisation and automation had reorientated the location of jobs, and the growth of bigger, more global markets had been accompanied by "winner-takes-all" patterns of compensation.

In the short term, indices of policy uncertainty in the US and Japan were about one-and-a-quarter times their averages before the financial crisis, and three times greater in China. In the UK, "progress since the financial crisis has been more than totally unwound this year with the measure having risen to five times the pre-crisis average by the start of the referendum campaign."

Households, businesses and financial markets were suffering a form of "economic post-traumatic stress disorder." There was an inchoate sense of economic insecurity for many people.

On the business side, there were "serial disappointments" in corporate earnings. "The failure of past relationships, especially rates of productivity growth, has embedded a sense of uncertainty in markets about the fundamentals upon which future prosperity will be built."

Carney said uncertainty over global growth was holding back spending by corporations in the advanced economies. Global investment remained "weak" and investment in the UK was "tracking below past cycles."

On the stability of the British financial system, Carney offered the reassurance that, as a result of "reforms," the capital requirements of major banks were now ten times larger than before the crisis. But as *Financial Times* economics commentator Martin Wolf noted, ten times near-zero was still close to zero, and the way capital measurements were carried out was "dicey."

Another round of European economic and political turmoil is looming, with indications that the Italian government of Prime Minister Matteo Renzi could defy an EU ruling and pump billions of euros into the debt-ridden Italian banking system. After the Brexit vote, the share values of Italian banks, which have around €360 billion of non-performing loans, dropped by 30 percent.

The *Financial Times* has reported that Renzi is determined to intervene with public funds if necessary, despite opposition from Berlin and Brussels to such bailouts. According to the report, the threat of direct government intervention has "raised alarm" among EU regulators that it would "devastate the credibility of the union's newly implemented banking rule book during its first real test."

Last week German Chancellor Angela Merkel gave the thumbs down on Italy's request for a suspension of rules on state aid to recapitalise the country's banks, and senior European Central Bank official Benoit Coeure said any suspension would spell the end of the banking union "as we know it."

Renzi has responded to suggestions of rule-breaking by saying he will not be "lectured by the school teacher."

Renzi has staked his political future on a constitutional referendum in October designed to lessen the powers of the upper house of parliament and promote government stability. But he faces opposition from the populist and nationalist Five Star Movement and the Lega Nord, which say the proposed amendment concentrates too much power in the hands of the government. The financial group Citi has described the referendum as "probably the single biggest risk on the European landscape this year outside the UK."

While share markets have been boosted by the prospect of still more cheap money, like a heroin addict getting another shot, there is a growing sense among the financial elites that the measures taken since 2008 are leading to disaster.

Speaking in a panel discussion of central bankers convened by the Bank for International Settlements at the end of last month, the retiring governor of the Bank of India, Raghuram Rajan, warned that it was wrong to assume that central banks always had a "big bazooka" up their sleeves. The major industrial nations insisted that emerging markets had to be "orthodox" in their policies, but they had themselves "thrown the orthodoxy out of the window."

Rajan, who as chief economist at the International Monetary Fund was one of the few to warn prior to 2008 of the problems being created by cheap-money policies, said trust in the financial elites and financial institutions had collapsed, there was no common economic paradigm, and the crisis had brought the major economies "back to the conditions we experienced in emerging markets."

In a Bloomberg article published July 2, Mohamed El-Erian, a senior economic adviser to the Allianz finance group, pointed to the structural uncertainties created by the Brexit vote as well as worsening underlying economic conditions reflected in low productivity growth and investment. "This state of affairs has made it enormously difficult for central banks (and others) to come up with a vision that commands sufficient conviction and foundation, leaving their policy approach without a solid secular foundation," he wrote.

Repeatedly, he wrote, central banks had gone deeper into unchartered territory. That journey has led to a situation where the balance sheets of the world's central banks have tripled in size since 2008. In contrast to the situation in 2008, when central banks stood on the sidelines of the financial markets, they are now major players. This means that when what global bond trader Bill Gross calls the bond market "supernova" explodes, the central banks will be massively compromised and sucked into the maelstrom.