

As recession looms

# IMF warns of global financial disorder

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The International Monetary Fund (IMF) released a new *Global Financial Stability Report* last Tuesday that warns that “a series of cascading shocks” endanger global financial stability. The IMF notes that since its last issuing of this report, in April of this year, the situation for the global financial system had “materially worsened.”

Deepening worldwide economic problems risk turning a more localized financial insolvency into a threat to global financial markets. The agency pointed to a list of problems: the aggressive hiking of interest rates, significant sell-offs in stock and bond markets, extreme volatility in financial markets, the appreciation of the dollar, soaring borrowing costs for emerging markets, and the general tightening of financial conditions globally.

It added to these present-day problems, a series of future threats that could further exacerbate things: Inflation could remain high (even with a recession), China’s housing market problems could endanger the country’s banking system, investors could flee emerging markets, turmoil in the EU could divide the Southern vs. the Northern economies, and a decline in housing markets that could hurt homeowners, especially in developing countries.

Tobias Adrian, director of capital markets for the IMF, told the *Financial Times*, “We’ve seen differentiation across the risk spectrum today... What I worry about is that there could be a broader base—a risk-off event—where it’s not just the riskier spectrum that sees wider spreads or wider risk premia, but also the safer issuers.”

In simpler terms, the IMF expects problems to emerge in more vulnerable parts of the financial system, like developing markets, but is worried that safer lenders—the major Western banks and financial services—could also descend into crisis.

The IMF’s report is only the latest in a series of warnings that the global economic system risks not only recession, but financial meltdown. Nearly every central

bank in the world is raising interest rates to stop inflation and a growing push for higher wages.

Last week, the American billionaire and hedge fund manager Ray Dalio said the United States economy faced a “perfect storm” and JP Morgan CEO Jamie Dimon said a recession was imminent.

In particular, the IMF report notes the fragility of developing economies amidst this coming storm. By their calculations, about a third of all banks in developing countries risk insolvency in their stress-test scenario.

They also highlight so-called “open-end investments,” and the potential risk they pose for markets. Open-ended investment funds are a growing form of mutual fund in which investors can redeem their investment at any time. The IMF states that “those offering daily redemptions while holding illiquid assets can amplify the effects of adverse shocks by raising the likelihood of investor runs and fire sales.”

Clearly, the IMF understands that the present policies of world governments threaten a financial crisis, likely beginning in developing countries. They write that “the tightening of financial conditions needs to be calibrated carefully, to aim at avoiding disorderly market conditions that could put financial stability unduly at risk.”

However, the IMF maintains that central banks must continue their tightening measures at all costs, in order to bring inflation back to its target and “avoid a de-anchoring of inflation expectations.” Put plainly, the IMF is calling on world governments to “hold the line” as they collectively work to suppress the growing movement of workers for higher wages.

The IMF, in this sense, has no real policy suggestion, except to “be careful,” as governments plunge the world economy into recession. This is a testament to the exhaustion of alternatives.

Despite all this gloom, in the forward to the report, Tobias Adrian seeks to reassure investors that nothing cataclysmic is around the corner. “A bright light,” Adrian

writes, “comes from our global banking stress tests which show relative resilience for advanced economy banks.” In other words, the resiliency of the main Western banks, ostensibly improved since 2008, will keep the system together.

The IMF, it could be said, however, is like a general fighting the last war instead of the present one. The immediate risk to the global financial system is not the major banks whose difficulties were at the heart of the 2008 financial crisis. In contrast, it is the nonbank financial sector which stands to be the seat of the next crisis.

The so-called “non-banking financial sector” is composed of a variety of financial institutions that effectively play the role of banks but do not actually have banking licenses and do not hold traditional deposits. Sometimes called “shadow banking,” the category refers to a slew of companies—whether it be Quicken Loans or Fidelity Investments—who are not actual banks, but provide services like mortgages, loans, and investments. Hedge funds, mutual funds, commodity traders, investment advisors, insurance companies, credit card companies—all of these have increasingly moved into the banking sector.

This dispersal of the role of banks masks the growth of debt and financial risk in the global economy today.

In Europe, such institutions have grown from being a minority of total assets (20 out of 50 trillion Euros in 2009) to being the majority (50 out of 80 trillion Euros). Globally, they have gone from 42 percent of assets in 2008 to 50 percent at the end of 2019. In the United States, more than two-thirds of all mortgages now originate from them.

While most conventional banks may pass the IMF’s stress test, these companies, webbed in debt and long lines of financial obligations, are not put to that test.



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