

THE COMMON THREAD IN FINANCIAL CRISES

What have we learned from the last 40 years?

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History suggests financial crises may be the norm not the exception. Each crisis is different but there is a common thread running through them all. This Insight looks at the lessons from the last 40 years, what can trigger a crisis and whether there are any indicators of where the next crisis might be.

KEY POINTS:

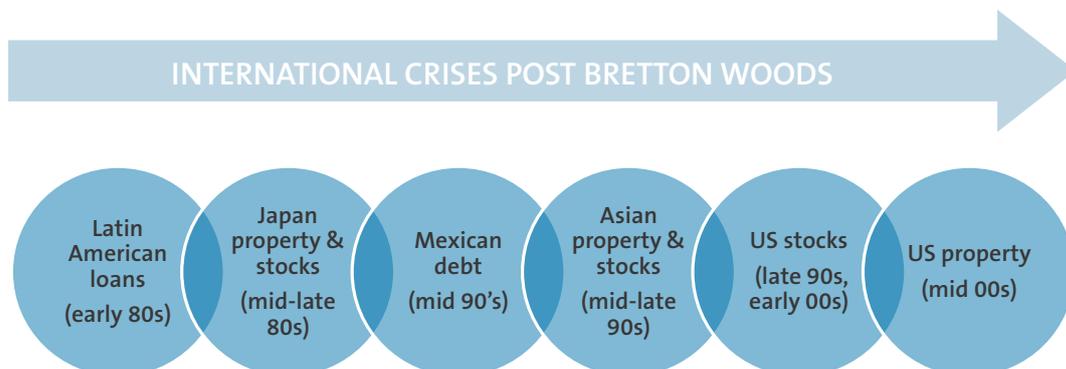
- > The breakdown of the Bretton Woods arrangement for fixed exchange rates and capital controls removed the constraints on monetary policy and international investment returns.
- > From this time, differences in inflation, interest rate and exchange rate expectations led to large movements of international capital.
- > International money flows facilitate a build-up of credit, which can lead to rising asset prices and currencies.
- > When some event triggers a reduction or reversal of capital flows, asset prices fall along with currencies which often result in bank insolvency and financial crises.
- > Tighter monetary conditions in developed markets can be a trigger for capital reversal and financial crises.

A BRIEF HISTORY OF FINANCIAL CRISES

The Bretton Woods agreement was established toward the end of World War II by the Allied nations. It essentially fixed exchange rates (via gold) to limit the flows of speculative capital and “beggar thy neighbour policies” that was judged to have contributed to the 1930s depression and WWII.

Fixed exchange rates coupled with foreign direct investment and lower trade barriers were used to encourage a freer and more balanced trade environment. The Bretton Woods system effectively ended in the early 1970s when gold convertibility was dropped by the United States. Controls on global capital flows (portfolio flows) were liberalised towards the end of the 1970s.

There were very few financial crises in the quarter century following World War II. Since the mid 1970s, however, there has been a major crisis at least every decade. Each crisis is different but there is a common thread running through them all: high credit growth often facilitated by global capital, and rising asset prices. Indeed, policies to combat the last crisis together with fleeing capital may help create the next boom and bust.¹



From the Middle East to Latin America

The two oil shocks of the 1970s created large surpluses for Middle East oil exporters. As their economies were too small to absorb this windfall, the money earned from the sale of oil, termed ‘petrodollars’, were deposited with US commercial banks. With the backing of the US government, US banks used these deposits to extend loans to Latin America which were in need of credit to fund current account deficits. US banks benefited from higher rates in Latin America compared to domestic rates, but credit flows reversed when the new US Federal Reserve governor Paul Volcker tightened monetary policy sharply from 1979 to combat inflation. The ensuing financial crisis led to sixteen Latin American countries rescheduling their debts.

...to Japan

Volker’s regime change in the early 1980s and the resultant stronger US dollar helped boost Japanese trade surpluses. To counteract upward pressure on the yen, the Bank of Japan purchased US dollars. The result was increased deposits at Japanese banks, allowing credit growth to surge during a period of heightened optimism about Japan’s economic success. This helped further fuel a massive bubble in property and share prices.



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¹This is not a new idea. See for example ‘Manias, Panics and Crashes – a history of financial crises’ by Kindleberger and Aliber.

...to Asia

The Japan property and stock bubble peaked in 1989 when the new Bank of Japan governor put limits on bank loan growth as sky high property prices were deemed to be unacceptable. As the bubble burst in the early 1990s some Japanese firms invested in Asia to take advantage of their lower labour costs and lower currencies. International capital flows followed as Asia liberalised their economies. Property and stock prices surged and spread beyond the four Asian tigers (Hong Kong, Singapore, South Korea and Taiwan).

...and Mexico

Around the same time in the early 1990s Mexico was liberalising its economy in preparation to join the North American Free Trade Agreement (NAFTA). Interest rates were hiked to reduce inflation and international capital flows followed. When a Mexican presidential candidate was assassinated in early 1994 and the US Federal Reserve (the Fed) started raising interest rates, capital flows reversed, the Peso plunged and a US-led bailout was required in 1995 as the country faced default.

Asia continued to boom until 1997 when Thai banks began to experience large loan losses. International credit flows subsequently declined, the Thai baht sank and contagion spread across Asia with property and share prices experiencing large declines.

...to the US (shares first)

With the rest of the world looking unwell, the US became the only game in town and the tech revolution just reinforced the argument for US assets in general and shares in particular. When the stock market boom turned to bust in the early 2000s there was no banking crisis because banks are less exposed to shares than property. We would have to wait another few years for a full blown banking crisis.

The Fed responded in the usual way to the stock market crash by cutting interest rates. Long term rates followed and were pushed lower by purchases from Asian central banks that wanted to build up dollar reserves to avoid funding shortages like those that occurred during the Asian crisis.

...to the US (property next)

Capital flows from Asia found a home in US homes as lower rates encouraged credit demand to meet the supply. As a consequence, property prices boomed. Other regions, particularly the UK, Ireland and Spain, also experienced a similar effect from low rates and capital inflows.

The Fed started to raise interest rates from a record low 1% in 2004 to over 5% by 2006. House prices fell by a third over the next few years. With bank assets closely tied to home prices, either through direct loans, securitised home loans, or through small businesses, banks faced insolvency as their assets fell while liabilities remained unchanged. Confronted with the worst financial crisis since the Great Depression the Government recapitalised the banks, while the Fed cut interest rates and introduced a massive asset purchase programme.

WHAT HAVE WE LEARNED FROM THE LAST 40 YEARS?

The breakdown of the Bretton Woods arrangement for fixed exchange rates and capital controls removed the constraints on monetary policy and international investment returns. From this time, differences in inflation, interest rate and exchange rate expectations led to large movements of international capital.

International money flows facilitate a build-up of credit, which can lead to rising asset prices and currencies. When some event triggers a reduction or reversal of capital flows, asset prices fall along with currencies which can result in bank insolvency and financial crisis.

Tighter monetary conditions in developed markets can be a trigger for capital reversal and financial crises. Emerging markets are often a destination for global capital flows and associated asset bubbles. But as we have seen, the US is also a destination for global capital, given its record of technological innovation and reserve currency status. The US is often the 'borrower of last resort' and has experienced its fair share of asset bubbles over the last few decades.

WHERE IS THE NEXT CRISIS GOING TO BE?

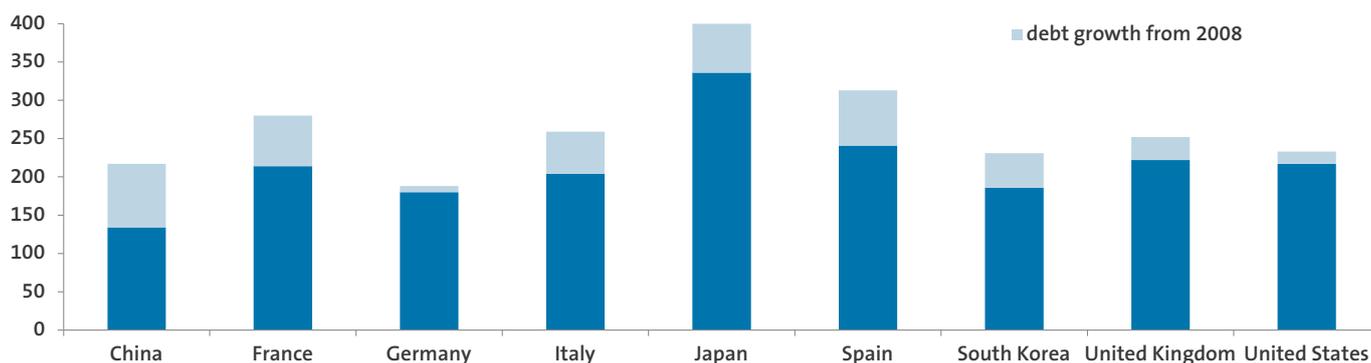
Cash rates in the United States have been zero for over six years and the last interest rate hike was in 2006. With the Fed expected to lift interest rates this year, could this be a catalyst for the next crisis?

Good indicators of potential crises include:

- > a rising currency along with rising capital inflows or current account deficits
- > excessive domestic credit growth along with rising property or share prices.

There are some concerns that the next global crisis will be in China given high domestic credit and debt growth since the global financial crisis.

Total debt to GDP*



Source: IMF, BIS, McKinsey, AMP Capital

* Total government, household and corporate debt, ie excludes financial sector to avoid double counting.

Credit growth has been strong in China but that is partly because saving rates are very high (50% of GDP) and this saving has to be lent internally to domestic borrowers given capital account controls. China property prices are currently falling not rising. Property prices did appreciate briskly in 2013, but this followed price declines in 2012. Share prices remain well below 2007 highs.

China's currency is managed by a floating peg against the US dollar and has appreciated around 10% over the last few years, which is not extreme. As noted above, China's capital flows are controlled and the current account is in surplus not deficit.

Together with relatively low government debt ratios and high international reserves, these factors suggest the next financial crisis is not necessarily going to be a China centric one.

WHAT ABOUT THE US?

Could the next crises occur in the United States? The US dollar is experiencing very strong gains and international flows into US bonds and equities have been rising. Long term bond yield are near all-time lows and equity prices are well above long term averages relative to historic earnings and book values. However, credit growth is relatively subdued and the current account deficit has improved materially since the financial crisis. Moreover, property prices are growing modestly and are well below historical extremes.

CONCLUSION

There is no smoking gun pointing where the next crisis is going to be but the lessons from history suggest financial crises may be the norm not the exception. Crisis locations vary and they come in differing magnitudes, and in that context the 2008 crisis was a massive one.

In terms of investment strategy, with the Fed on course to raise interest rates this year, this is not a time to be taking extreme overweight positions in either bonds or equities. However, holding some cash in the portfolios appears prudent, even if it is costly in terms of returns in the shorter term.

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