Industrialised countries today face serious risks – for their financial sectors, for their public finances and for their growth prospects. **Peter Boone** and **Simon Johnson** explain how this has happened and why there are more and worse crises to come.

The doomsday cycle turns: WHO'S NEXT?

There is a common problem underlying the economic troubles of Europe, Japan and the United States: the symbiotic relationship between politicians who heed narrow interests and the growth of a financial sector that has become increasingly opaque. Bailouts have encouraged reckless behaviour in the financial sector, which builds up further risks – and will lead to another round of shocks, collapses and bailouts.

As we described in a previous issue of *CentrePiece*, this is the 'doomsday cycle' (Boone and Johnson, 2009/10). The cycle turned in 2007-08 and was most dramatically manifest in the weeks and months that followed the fall of Lehman Brothers, the collapse of Iceland's banks and the botched 'rescue' of the big three Irish financial institutions.

The consequences have included sovereign debt restructuring by Greece, as well as continuing problems – and lending programmes by the International Monetary Fund (IMF) and the European Union – for Greece, Ireland and Portugal. Italy, Spain and other parts of the euro area remain under intense pressure.

Yet in some circles, there is a sense that the countries of the euro area have put the worst of their problems behind them. Following a string of summits, it is argued, Europe is now more decisively on the path to a unified financial system backed by what will become the substance of a fiscal union.

The doomsday cycle is indeed turning – and problems are undoubtedly heading towards Japan and the United States: the current level of complacency among policy-makers in those countries is alarming. But the next turn of the global cycle looks likely to hit Europe again and probably harder than before.

The continental European financial system is in big trouble: budgets are unsustainable and growth is nowhere on the horizon. The costs of bailouts are rising – and the coming scale of the problem is likely to undermine political support for the euro area itself.

The structure of the doomsday cycle

In the 1980s and 1990s, deep economic crises occurred primarily in middle- and low-income countries. These crises would grab the world's attention from time to time, but all proved to have little lasting effect beyond the countries most directly affected. In some cases, the experience of a crisis was actually cathartic and helped clear the way for stronger growth.

Politicians and the financial sector are in a symbiotic relationship that encourages irresponsible growth

In contrast, the crises we should now fear are in relatively rich countries with the world's 'most developed' financial infrastructure. These crises have the potential to reduce growth profoundly around the world.

The problem is that the modern financial infrastructure makes it possible to borrow a great deal relative to the size of an economy – and far more than is sustainable relative to growth prospects. The expectation of bailouts has become built into the system, in terms of government and central bank support. But this expectation is also faulty because, at times, the claims on the system are more than can ultimately be paid.

For politicians, this is a great opportunity, enabling them to buy favour and win re-election. The problems will become apparent, they calculate, on someone else's watch. So repeated bailouts have become the expectation not the exception.

For bankers and financiers of all kinds, this is easy money and great fortune – literally. The complexity and scale of modern finance make it easy to hide what is going on. The regulated financial sector has little interest in speaking truth to authority: that would just undercut their business.

Banks that are 'too big to fail' benefit from giant, hidden and very dangerous government subsidies. Yet despite repeated failures, many top officials pretend that 'the market' or 'smart regulators' can take care of this problem.

For the broader public, none of this is

clear – until it is too late. The issues are abstract and lack the personal drama that grabs headlines. The policy community does not understand the issues or becomes complicit in the schemes of politicians and big banks. The true costs of bailouts are disguised and not broadly understood. Millions of jobs are lost, lives ruined, fiscal balance sheets damaged – and for what exactly?

Over the past four centuries, financial development has strongly supported economic development. The market-based creation of new institutions and products encouraged savings by a broad cross-section of society, allowing capital to flow into more productive uses. But in recent decades, parts of our financial development have gone badly off-track – becoming much more a 'rent-seeking' mechanism that draws support from politicians because it facilitates irresponsible public policy.

The question is: who will be hurt by this structure and in what order? There are three prominent candidates: Japan, the United States and the euro area.

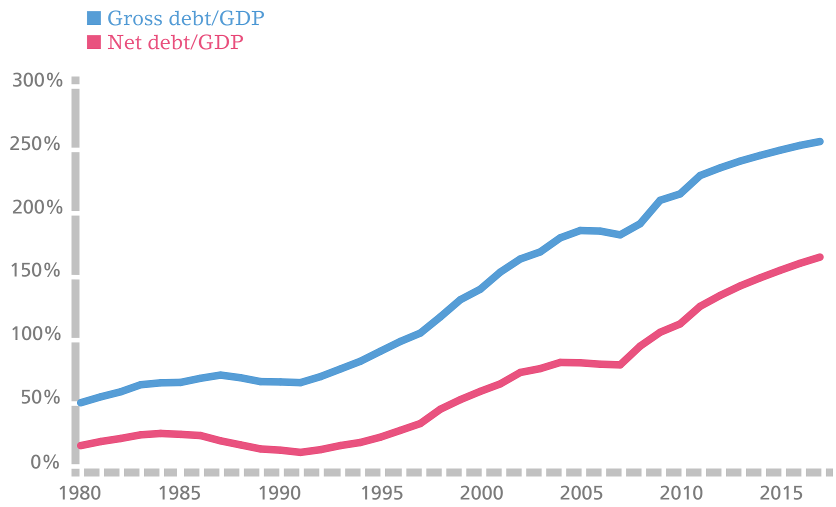
Japan's long march to collapse

To understand the pervasive nature of modern financial instabilities, start with the least discussed reckless situation in a major country today. Figure 1 shows the path of Japan's ratio of debt to GDP over the last 30 years, including IMF forecasts to 2016.

Japan has a rapidly ageing population. The average Japanese woman today has 1.39 children, far fewer than is needed to replace the elderly. This means that the total population is set to decline by 26% by 2050. Having peaked in the mid-1990s, the country's working age population will decline by a staggering 40% between 1995 and 2050. Naturally, many of the

Figure 1:

Japan gross and net general government debt as a percentage of GDP



Source: IMF

ageing Japanese have been saving for their retirement for decades. They deposit those funds in banks, buy government bonds, hold cash savings or buy Japanese equities.

With an ageing population and slower growth, the broad outlines of responsible policy are straightforward. Japan should become a big investor in countries with younger populations, providing the capital investment needed to generate growth. Those countries can then return the savings to the Japanese as they retire. Singapore's government does just that via one of the world's largest investment funds.

Instead, for the last two decades, Japan's government has been running large deficits, borrowing and then spending the savings of the young. When the elderly finally demand their savings back in the form of pensions, the government will need to reduce its budget deficit of 8% of GDP and start running a sizeable budget surplus. Unless there is a sudden burst of romance and fertility, there will be far fewer Japanese taxpayers in the future to pay this debt.

Bailouts have encouraged reckless behaviour in the financial sector, which builds up further risks

The government has not been willing to raise taxes in a timely manner to match its spending. The latest agreement is for a modest (5%) increase in the retail sales tax, which would only be fully implemented in 2015. Why would it do so in the future when the burden on the remaining workers will need to be ever larger?

Japan is saved from immediate pressure by the fact that about 95% of its government debt is held by domestic residents. As long as these investors are satisfied with very low – or perhaps negative – real rates, this situation can continue.

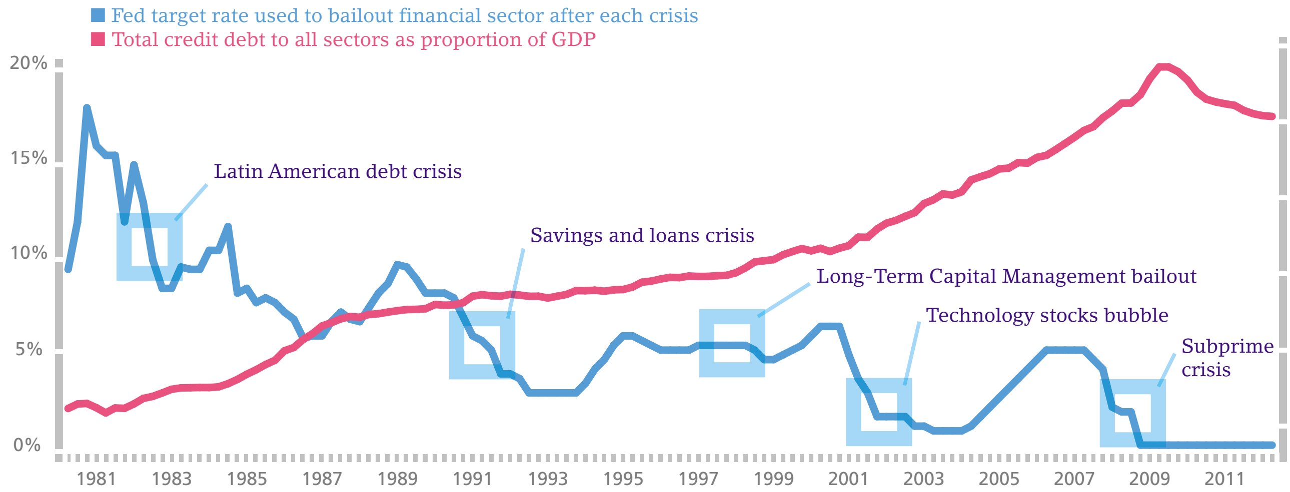
But sooner or later, Japan's dreadful fiscal mathematics will catch up with the government. There is no sign yet of a broad loss of confidence, but major shifts in market sentiment are not typically signalled in advance.

America's reckless private finance

In the United States, the symptoms are different. Figure 2 illustrates the US version of the doomsday cycle: the rise of total credit as a fraction of national income. Major players in the financial system have become too big to be allowed to fail – and consequently receive large subsidies.

The latest crisis has led to the largest monetary and fiscal bailouts on record. The Congressional Budget Office estimates that the final fiscal impact of the crisis of 2007-08 will end up increasing debt relative to GDP by about 50 percentage

Figure 2:
US ratio of credit to GDP and Fed target rate



Source: IMF

points. This is the second largest debt shock in US history: measured in this way, only the Second World War cost more. (For more detail, see Johnson and Kwak, 2012.)

The alliance that leads to unsustainable finance here is simple: the US financial system earns large 'rents' (excess returns to labour and capital) from the implicit subsidies offered by taxpayers. These rents finance a massive system of lobbyists and campaign donations that ensures 'pro-bailout' politicians win elections regularly.

Each time the United States has a crisis, politicians and technocrats admit their errors and buttress regulators to ensure that 'it never happens again'. Yet still it happens, again and again. We are now on our third round of the so-called Basel international rules for banks, with the architects of each new reform admonishing the previous architects for their mistakes. There's no doubt that the United States will someday soon be correcting Basel 3 and moving on to Basel 4, 5, 6 and more.

The problem that the country faces is that with each crisis, the financial risks are getting larger. If continued in this manner, bailing out the system will eventually be unaffordable. When the United States finally runs out of enough savers to buy the bonds needed to bail out the system, it will suffer the ultimate collapse. (For more detail, see Schularick and Taylor, 2012.)

Roughly half of all US federal debt is currently held by non-residents. So US fiscal policy remains viable only as long as the dollar is seen as the ultimate safe haven for investors. But what is the competition? Japan is not appealing today as a haven and it is unlikely to become more appealing in the near term. A great deal of the prospects for the US budget and growth therefore rest on what happens in the euro area.

The euro area: flawed dreams

There is no sign that the euro area will emerge from crisis any time soon.

The incentive structure of the euro system ensured that each country's financial sector clamoured to join it. The key feature that made it so attractive was the liquidity window at the European Central Bank (ECB).

For smaller countries, the ECB is a modern day Rumpelstiltskin. Rather than spinning straw into gold, the ECB converts unattractive government and bank-issued securities into highly liquid 'collateral' that can be readily swapped for cash from the ECB. This feature instantly made sovereign and bank bonds very attractive debt instruments. Knowing that the borrowers had essentially unlimited access to liquidity from the ECB, investors became willing lenders at low interest rates to all banks in the euro area.

Given such attractive features, it is easy to understand why 17 countries mastered the political debate to join the euro system. It is also easy to understand how the system got abused and why it will be so difficult ever to make it 'safe'. If the Japanese can't control their public finances and if the United States can't control its too-big-to-fail banks, the added complexity of merging 17 regulators and 17 national governments into a system where someone else can be made responsible for bailing out the intransigents seems a financial and regulatory nightmare.

Such a system is sure to be crisis-prone. The Federal Reserve and the federal

The next turn of the global cycle looks likely to hit Europe again – and probably harder than before

This system poses great dangers to global financial stability. The euro area faces myriad problems, including insufficient bank capital, high levels of private and public debt and the chronic inability of some member countries to grow.

It is now common to hear policy-makers blackmailing populations: unless the euro area survives, tragedy will result. And it is true that tragedy will result: we only need to look at the rise of complex derivatives and the dangers they pose were the euro area to dismantle. (For a broader discussion of Europe's problems, see Boone and Johnson, 2011 and 2012.)

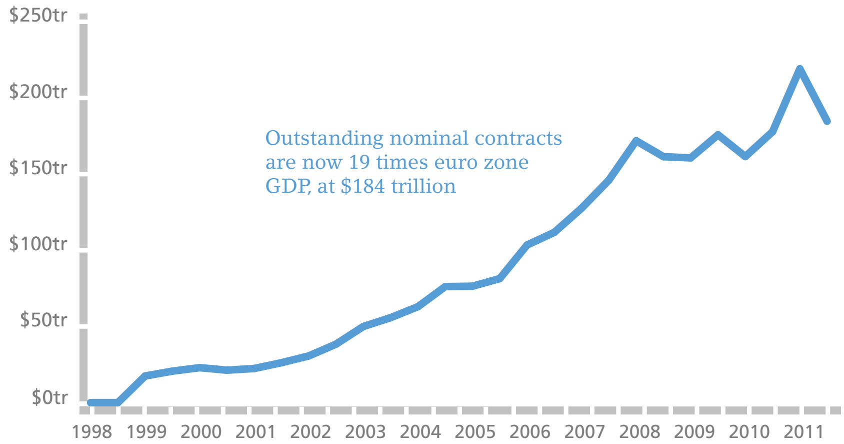
Figure 3 illustrates the growth of euro-denominated interest rate derivatives, the notional value of which now totals more than 10 times the GDP of the euro area. Regulators commonly use net figures when they consider ultimate risk for banks and this makes sense under the usual circumstances of bankruptcy. But when a currency area breaks up, the practice of netting off contracts needs to change dramatically and banks will be facing far more risks than regulators and risk officers currently report.

For example, if a German bank has a contract with a French bank and an opposite identical contract with a German pension fund, it can net those two contracts and report the ultimate risk as zero. (Of course there is counterparty risk, but under standard agreements, government attempt to provide bailouts when there is trouble in the United States. But in Europe, the bailouts are only partial. No country has a 'lender of last resort' like the Federal Reserve or the Bank of Japan – so markets are now learning that large risk premia are needed to reflect default risk in troubled countries.

Flexible exchange rates would undoubtedly make it easier to manage these crises. Devaluations instantly reduce wages and raise countries' competitiveness. If Greece had managed a large devaluation, it could probably have avoided much of the unemployment and social turmoil we see today. Instead, each troubled country in Europe now suffers when having to force down wages and prices during adjustment.

Figure 3:

Outstanding interest rate swaps denominated in euros ($ trillion nominal value)



derivatives are cleared instantly at liquidation so the counterparty risks can be netted).

But if investors start to believe that there will be new currencies in each country, then the two contracts in this example are no longer offsetting so they must not be netted. It is reasonable to think that after any demise of the euro, the contracts between two German counterparties will be converted into deutsche marks, while contracts with international partners will be disputed or maintained in a euro proxy.

As a result, risk officers at banks should understand that if the euro area breaks up, all banks in Europe face enormous and unaccountable currency risk. Each of their 'euro' assets and liabilities needs to be examined to understand into which currency it would be converted. (For more discussion on redenomination issues, see Nordvig and Firoozye, 2012.)

The threat of future crises

The tragedy of the euro area appears unavoidable, but it reflects far greater risks that will spread to Japan, the United States and other advanced economies.

Through our financial systems, we have created enormous, complex financial structures that can inflict tragic consequences with failure and yet are inherently difficult to regulate and control. We are at the behest of our politicians and financial sectors to prevent them from creating dangers. Yet around the world, our political and financial systems have aligned to build these dangers rather than suppress them.

The continuing crisis in the euro area merely buys times for Japan and the United States. Investors are seeking refuge in these two countries only because the dangers are most imminent in the euro area. Will these countries take this time to fix their underlying fiscal and financial problems? That seems unlikely.

The lesson from all these troubles is clear: the relatively recent rise of the institutions of complex financial markets, around the world, has permitted the growth of large, unsustainable finance. We rely on our political systems to check these dangers, but instead the politicians naturally develop symbiotic relationships that encourage irresponsible growth.

The nature of 'irresponsible growth' is different in each country and region – but it is similarly unsustainable and it is still growing. There are more crises to come and they are likely to be worse than the last one.

The continuing crisis in the euro area merely buys times for Japan and the United States

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They are co-founders of *The Baseline Scenario*, a leading economics blog (http://baselinescenario.com).

Further reading

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