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Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.

Global Risk Watch Newsletter

The world after the coming recession, etc.

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1. Overview Macroeconomic and Financial Risks (Trends & Topics)

 # The world after the coming recession (Tsuyoshi Oyama, Partner/Head of Center for Risk Management Strategy (CRMS) at Deloitte Touche Tohmatsu LLC/Deloitte Asia Pacific Risk and Capital Management Leader)

Developed countries, especially Europe and Japan, continue its strong growth streak. On the other hand, there is no sign yet that indicates the rise in prices and wages will accelerate in the United States and Japan. Against this backdrop, long-term interest rates that showed signs of temporary rise in July have now returned to its original low levels. I pointed out in the last issue the possible concerted policy change towards hawkish by major central banks being recognized by market participants but this viewpoint has gradually faded out partly due to the “fireman remarks” from the executives of the central banks. As a result, the price of risky assets such as equity has become bullish again.

It was the rise of geopolitical and political risks that brought a freeze to the markets recently. The situation in North Korea is getting more tense and military action by the United States became increasingly possible. In addition, the degree of confusion of the US Trump administration tends to deepen, and anxiety surrounding the administration’s ability of carrying out the policies is rising in magnitude. Currently the stock market has stopped short of seeing its massive price adjustments as its participants see those risk rising as a temporary phenomenon. At the same time, however, they seem to look for excuses to quietly get rid of the dance party as they are increasingly feel uneasy to keep dancing so long as the music is playing.

Now, the expansion of the US economy has already entered its ninth year, and the expansion of the Japanese economy is also at its momentum that overtakes the "Izanagi boom" or the second longest boom after the war. As there has been no economy that has continued to expand forever, it will be natural to presume that we will soon see the turnaround of business cycle. The problem is whether the economic recession after such a long economic expansion could end just as a retreat of the same scale as before or not.

In the past, the economic downturn is usually triggered by, for example, inventory adjustment or monetary policy tightening due to rising prices. Most recently, as inventory adjustment technology advances and the role of inventory in the economy decreases, the inventory weakens the power to influence the economy. Furthermore, even if the labor market has become extremely overheated, prices have become unshaken recently. As a result, the expansion phase of the economy has prolonged, and this with long sustained low level interest rates entailed overheating asset markets in the advanced nations before 2006. And this long continued economic expansion finally ended when mice (subprime loan and non-performing securitized products) created such panic in a “dance party” that many rushed to escape away from the party (risky asset markets) , which eventually resulted to the financial crisis. At that time, this financial crisis was supposed to be caused by a very special factors such as the structural flaws in the financial system and greedy bankers backed by their moral hazards. And in order to prevent such a crisis from reoccurring, policy makers introduced new regulations such as Basel III to financial institutions. Whether the “root cause” of the financial crisis, or a sudden end of the long continued economic recovery was really due to "structural deficiencies in the financial system" or "greedy bankers ", however, still remains doubtful.

Now that many elements which are very common with the situation in 2006 are observed, the asset bubble or “magma of volcano” has swollen again thanks to the long economic expansion. And if the recession will emerge owing to the events that trigger an eruption of volcano or asset bubble bursting, “what this trigger event is” is not really a very important issue. This trigger may be a financial crisis similar to the previous one, or a possible geopolitical or political risk factor for instance amid current time. What is rather more important, however, is the factor that swells this magma (asset bubble), that is, the ultra-easy monetary policy during the economic expansion period. That may be the reason why many major central banks seem to have simultaneously changed their stances toward hawkish. And if it turns out to be a wrong observation and major central banks will again contribute to the expansion of bubble to be burst in the violent way at some point, this time it may be difficult for them to shift this responsibility to the parties that trigger the events (it was major financial institutions last time, and this could be North Korean president Kim Jong-Soo or the US president Trump this time). In this case, we should also brace for the situation where the basic rules of the monetary policy could also change significantly.