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Global Risk Watch Newsletter

Yellow Light on US Economy? / High Alert for Liquidity Illusion etc.

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

◆Yellow light on US economy? (Tsuyoshi Oyama, Partner/Head of Centre for Risk Management Strategy at Deloitte Touché Tohmatsu LLC.)

Since the second half of last year, the trend of world economy and finance mainly reflected the following factors: (1) resilient US economy: (2) QE and gradually recovering EU and Japanese economy on the backdrop of (1): (3) structural slowdown of Chinese economy, and: (4) intensified geopolitical upheaval in Ukraine / Middle East. (1) & (2) with global overheated asset market and the expectation of interest rate hike in US will eventually lead to capital outflow in the emerging market. Meanwhile, (3) led to decline in crude oil price and economic slump of emerging countries (especially resource- rich countries). Thus, the macro-trends of (1)-(3) have set the tone of world economy even though, at times, escalating geopolitical upheaval could influence crude oil price and the outlook of EU economy in the opposite directions.

In this environment, three major features observed in the past month warrant some attention. Firstly, the employment growth rate published in the beginning of April was exceedingly low. US have maintained a great momentum of employment growth regardless of relatively weak indicators in productions or retail sales up until now. At last, its employment started to show the shadow of 'soft-patch'. Certainly, single month of employment figure cannot conclude the course of US economy. However, the genesis behind such weak indicators is not only limited to temporary factors such as weather and the west coast port labor strike. The slump in the energy sector due to decline in crude oil price and the manufacturing industry as the result of dollar appreciation were also major factors. Considering these circumstances, it might be difficult to expect a single US economy to maintain its strong momentum to lead the global economy. Should US delay to raise interest rate, negative effects may spread to Japanese & EU economy, which were the major beneficiaries of currency depreciation up until now with expectations of wider spread over US rate. Although, the likelihood of US economic downturn scenario is still very low, the outlook must be carefully monitored as the ripple effect will be significant.

The second major feature is the turmoil in Greece. Greece once agreed its bailout extension with EU at the end of February. However, Greek government was not able to propose austerity measures to satisfy EU, thus failed to receive funding from EU creditors and is eventually facing the risk of default. Currently, the most anticipated focus is whether Greek government could agree the austerity measures with euro zone countries; receive the funding from the creditors to meet its IMF repayment deadline on May 12th. After all, it seems that only solution for Greek government to accept the austerity measures proposed by euro zone countries is to remove a group of radicals in the ruling party, and form a new coalition with the opposition parties, but this scenario is quite hard to be seen. The difference between the last Greek crisis and this time around, however, is that there are no signs of chain effects to other southern European countries at this moment. The reason behind this is the combination of recently implemented QE by ECB and the formation of risk share framework within euro zone countries. Thus, the risk of Greek default is increasing, but also very unlikely to engulf the entire Europe as long as this 'decoupling between Greek crisis and periphery markets' to remain in place.

The third major feature is the worsening slump in Chinese and emerging economies. Chinese economy continues to slowdown despite repeated monetary easing measures taken in place. The import indictor that often reflects the economic condition declined by double-digits year on year, and electricity production has also been stagnant at a low level. Q1 GDP growth has slowed to 7% year on year but even this number seems to be 'high' compared to the poor results as indicated by those raw data. Meanwhile, first ever default on the principal of the corporate bonds occurred in China. In the past, defaults on interest payments have occurred, while defaults on the principal have been bailed out. Moving forward, the focus is to determine how much of such defaults the Chinese government can accept, and whether these defaults could lead to unforeseen circumstances and spread as financial crisis or not.

2.Overview of Development in Financial Regulations (Trends & Topics)

◆High alert for liquidity illusion (Koichi Iwai, Senior Manager, Centre for Risk Management Strategy at Deloitte Touché Tohmatsu LLC.)

Looking over the internal and external financial regulatory changes in the past month, two regulatory tightenings deserve some attentions. The first is strengthening of stress testing carried out by authorities. In particular, Bank of England published its guidelines for stress testing on March 30th and announced that leverage ratio will be included as one of the numerical thresholds in addition to Common Equity Tier 1 ratio and 'misconduct' will be taken into account in the stress test. Misconduct refers to behaviors by financial institutions, which destruct the promotion of healthy competition and protection of consumers. The decision by BOE could reflect authorities' stance to progressively focus on stress testing as a supervisory tool. The second is the discussion in Europe to strengthen risk evaluation for sovereign exposures. European Systemic Risk Board (ESRB) chaired by ECB governor Draghi recently published a report, which indicates that risk evaluation for sovereign exposures in bank & insurance regulations is not sufficient. The report proposes the necessity to fundamentally revise those regulations. Moving forward, such argument to further regulate sovereign exposures is expected to spread across the globe.

While the trend of regulatory tightenings have been observed, the unintended consequences of regulatory reforms for the past years and accommodative monetary policies by central banks have also gained attentions this month. In particular, FRB vice chairman Fischer, SEC commissioners, BOE Financial Policy Committee, and IMF in sync alerted to the liquidity decline in advanced countries' bond markets and excessive liquidity in emerging countries' bond market and high yield market in US&EU (Liquidity illusion). The first case is mainly as the result of regulatory tightenings, and the latter is the consequence of continuing monetary easing. Both arguments show concern that market liquidity is diverging away from a normal level. Moving forward, if any shocks occur, such as FRB's rate hike, market liquidity will be forced to sharply adjust to the shocks and some contagious risks will spread over global markets.

In this month, we also observed some regulatory changes that might directly/indirectly affect Japanese firms. For example, EBA's proposed guidelines aimed at regulating bank's exposures to shadow banking might impact on some Japanese firms. Also, US regulators expressed tough evaluation on foreign banks' resolution plans, which should also force Japanese financial institutions to be alert. In addition, discussions on cyber and conduct risks were also very frequently observed over the past month.
