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Global Risk Watch Newsletter

Worsening Allergies to “Uncertainty” in the Global Financial Markets, etc.

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

 # Worsening Allergies to “Uncertainty” in the Global Financial Markets (Tsuyoshi Oyama, Partner/Head of Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

Since February, several events in matured economy -- particularly Japan and Europe -- has shaken the global financial markets and thereby taken over the media’s front page from economic disarray in China and emerging countries. Actually, the recent stock price fall and exchange rate fluctuations have been manifested the worst way in Japan. Faced with a growing global risk-off sentiment, it is understandable that the demand for Yen has increased, which (somehow strange) has long been recognized as one of the safest assets. Still, it is surprising to see the Yen being appreciated so rapidly with a gain of around 8% against USD within only a 10 days in early February, and keeping strong value even after the statement of FRB Chair Yellen indicating the current tightening policy to be basically kept. Meanwhile, stock prices declined by more than 20% by mid-February year to date. In terms of stress testing, Japan’s stress scenario has already passed beyond the ‘caution’ stage, and is now gradually approaching the ‘warning’ territory. A little similarly, Europe also faced with an unprecedented market turmoil, with increasing concerns of credit risk condition of major banks including German. Simultaneously, such risk-off trends has also disseminated to southern Europe’s government bonds through widening credit spreads.

In last month, I pointed that out outright failure of the communication policy by the policy makers in China and emerging countries have materialized as ‘pouring oil into the fire’ and ignited the market turmoil. Ironically, the newly introduced negative interest rate policy by the Bank of Japan has produced the exact same results. The market interpretation of the effects of this policy is to further deteriorate banks’ earnings, and inhibit their financial intermediary functions. The market has also seen this policy as a sign of “limits” of further monetary loosening., This type of market reactions and concerns, which also include excessive demand for Yen, jump in credit spreads of major European banks, and emerging concerns of the US recession, however, might better been seen as the products of market’s ‘hypersensitive reaction’ to the uncertain future. To use an analogy, this is similar to hay fever in the up-coming allergy season that plagues many people each year. The problem is why this year’s hay fever is much worse than in previous years. Needless to say, the amount of pollen in the air (scale of uncertainty over the future) is much greater than in previous years. However, this cannot be a sufficient explanation as the real economy itself did not show signs of rapid deceleration. Another possible reason could be the doctor stop of taking medicine with strong side effects (interest rate hike by FRB in the US). More importantly, however, we need to understand that our allergic constitution itself is certainly getting worse (decline in market liquidity). Many market participants regard new regulations on banks forcing them out of many markets could be the core cause. To change the concurrent unstoppable risk-off sentiment, we cannot just to take the allergy medication again, or increase the dosage. Perhaps what we need is a fundamental treatment that improve our allergic constitution.