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What are the World Financial Markets afraid of?

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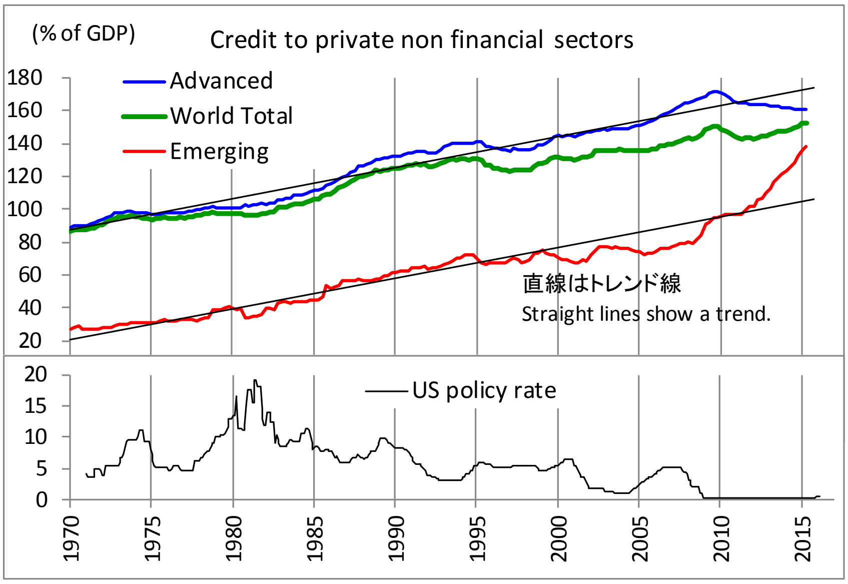
The world stock prices have fallen considerably since the beginning of this year. Three major reasons are often explained: decelerating Chinese economy, normalization of the US interest rates and negative impacts of falling resource prices to the producing countries. There are some regional reasons, too: a concern how far the BoJ can continue the current quantitative easing before succeeding in reflating the economy, fading expectation of the “manufacturing renaissance” in the U.S., geopolitical threats in the Middle East, the experiment of nuclear missile by North Korea, terrorist attacks in Paris and so on.

The biggest core concern among them

There is, however, a core concern among them which resonates others to make the sentiment of global markets gloomy: excessive debts in emerging countries which have accumulated during the accommodative U.S. monetary policy. The hike of the U.S. interest rate is in principle not a cause of concern but a result of normalization of the U.S. economy. A decline of oil prices should be good news for oil importers. Compared to these, the problem of the excessive debts is absolutely a negative factor standing at the most upper stream of a chain of concerns in financial markets and makes everybody unhappy.

Once debts reach to an excessive level, it is a tough job to reduce it. If you try to dispose it in a short period, economy would be depressed seriously. If you try to minimize the pain of disposal, it would take a long time. You may be trapped into deflation if other depressive factors emerge during the same period such as demographic change. Such difficulties are well known based on many studies on the Nordic banking crisis in 1991, Japan’s lost decades in 1990s, Asian currency crisis in 1997 and 1998, the global financial crisis in 2008 and European debt crises in 2010 (see the Appendix).

Chart 1: Debt outstanding in advanced and emerging economies (% of GDP)



(Source) BIS: total Credit Statistics, Federal Reserve, Datastream

Credit is a sum of loans, bonds, currency and deposits of each country. BIS releases the data quarterly in local currencies, US dollars and % of GDP.

Debt can be reduced in real terms by nominal economic growth, but the size of debts in recent years in emerging economies is so big that you cannot accomplish the reduction only by the help of growth.

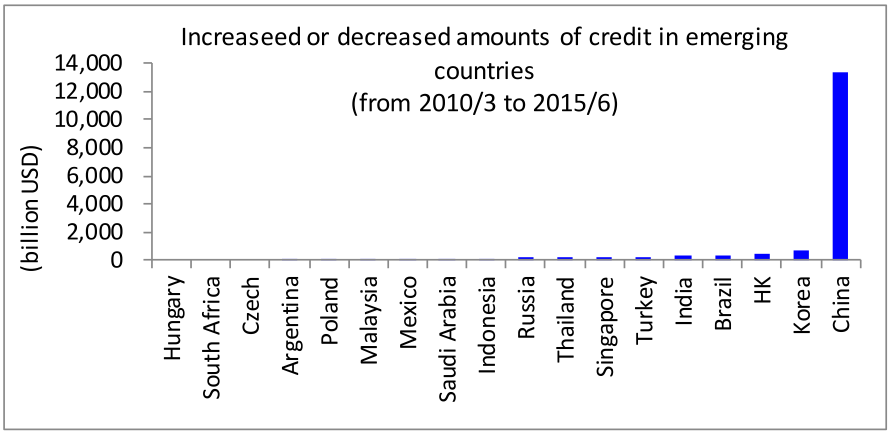
The debt is big not only in a comparative term to the GDP of emerging countries, but it is so in an absolute amount, too. The current level of debts in the whole world including advanced countries is as much as the level prior to the Lehman Brothers shock. It is all due to the recent increase of debts in emerging countries. Investors are worried because they can foresee a painful future they have to experience in the process of debt reduction.

Most of the increased debts are located in China

Most of the increased debts are from China. Domestic debts in China are to a large extent denominated in the renminbi, which is not influenced directly by the U.S. monetary policy. But China is opening its capital account. They are determined to proceed with this policy because it is in line with the internationalization of the renminbi and expansionary currency diplomacy linked to the Asian Infrastructure Investment Bank, a new multinational financial institution which China takes initiative. It is, therefore, impossible to leave the interest rates of the renminbi uninfluenced by the U.S. monetary policy.

Ongoing deceleration of China’s economy would lower the capacity utilization of manufacturers’ equipment and lower the yield of real estate investments, while the burden of debt service would increase. Lower returns and higher capital costs result in increases of non-performing loans, which in turn changes creditors’ attitude to be more conservative and slow down the economy further. A long lasting vicious circle will start as such.

Chart 2: Increased or decreased amounts of credit in emerging countries between 2010/3 and 2015/6



(Source) BIS: total credit statistics

We do not, however, know when this vicious circle starts. In the previous crisis, the U.S. started the hike of the policy rate in the middle of 2004, but it was not until 2006 when the sustainability of subprime loans was frequently questioned in the media. It was the summer of 2007 when so called "Paribas shock" shook the global financial market and it was even one more year after that when we had a climax of the crisis, the Lehman Brothers shock in September 2008. These actual problems happened when the U.S. policy interest rate reached above 5% and debtors bore the actual burden of debt services. It took place three years after the FRB started to raise the interest rate.

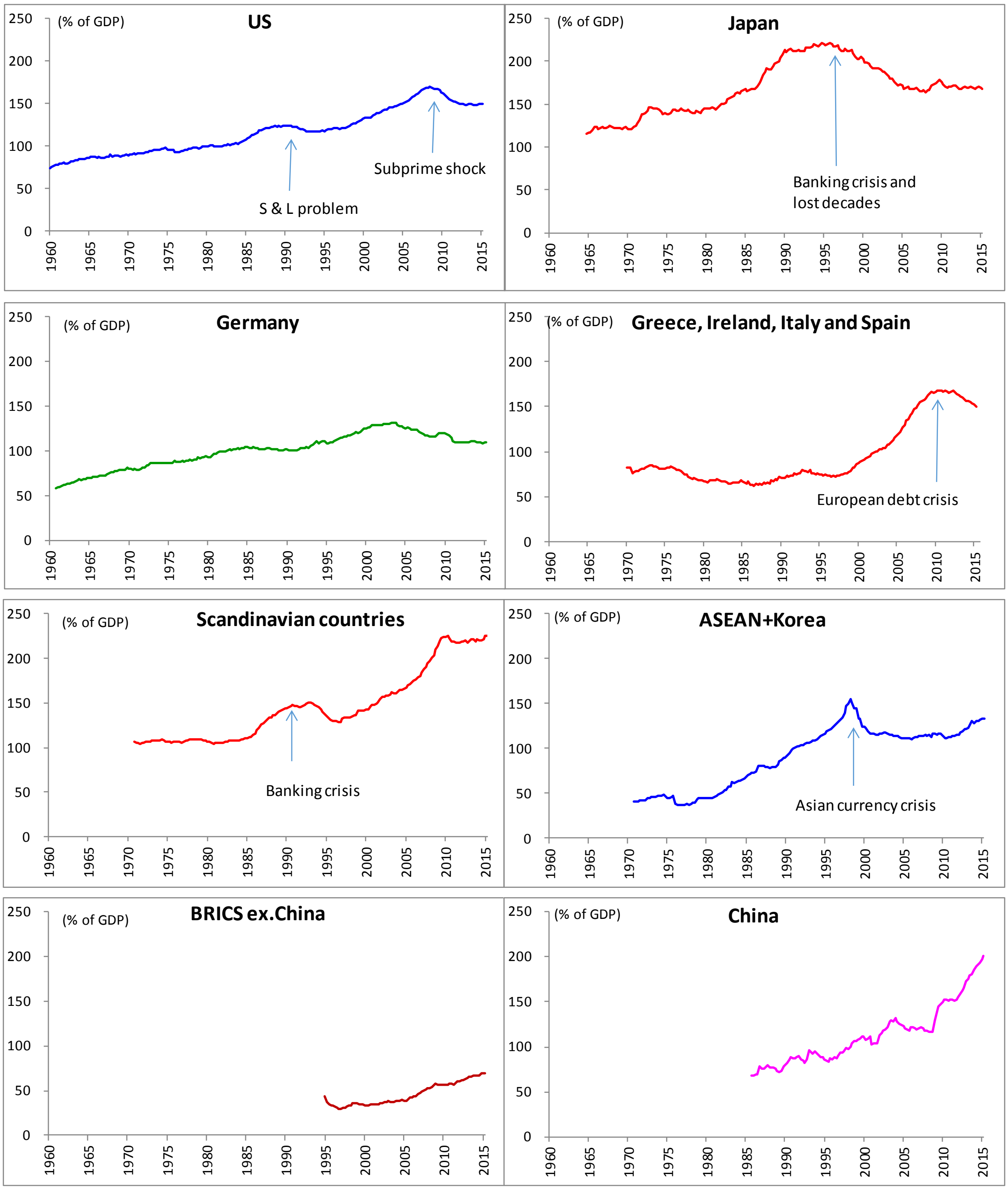
The FRB explains they would raise the interest rate at much slower pace than the previous time. Market sentiments may happen to recover somehow and the current worry of investors may disappear from the surface. But when the U.S. policy interest rate reaches to a certain level such as 3% or 4%, problem of credit expansion during the time of zero interest rate in the US is sure to burst.

The world is still in the aftershock of the global financial crisis

It was an extra-ordinary fiscal policy for four trillion yuan in 2008 that primed a pump of this credit expansion in China. If this policy had not been implemented, the contraction of global economy would have been deeper and longer. It would have taken some more time for the FRB to move to the normalization of monetary policy. In this regard, it is only in the U.S. that central bankers are ready to end the extra ordinary policy. The world as a whole is still deep in the aftershock of the crisis.

＜付属資料 / Appendix＞

各国・各地域の民間債務残高 GDP 比率 / Credit to non-financial sectors (% of GDP)



(Source) BIS: total Credit Statistics