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The Greatest Risk Facing the International Banking System

Richard Cloutier
Swiss Management Center University-Transknowlogy Campus, Vorstadt 26a, 6300 Zug, Switzerland
E-mail: richard.cloutier@student.swissmc.ch

Abstract

The 2008 financial crisis created a drop in liquidity around the globe and created an international banking system failure producing a recession that extended to all major markets. In response, governments and central banks added stimulus to stave off further reductions in economic output. As a result, global debt has increased. To contribute to the body of knowledge, this paper examines the debt and growth of debt in the major economic centers around the world. History is replete with evidence of unchecked growth leading to economic chaos. Therefore, an examination of debt levels is vital to assess the risk to the global economy. The findings of this paper reveal a significant expansion in debt, increasing the risk of another international banking crisis.

Keywords: Global debt, International banking, Japan, China, United States, European Union

1. Introduction

There are a number of threats facing the international banking system, including new technology that circumvents the established banking system (e.g. Apple Pay, Google Wallet, and PayPal), cryptocurrencies that bypass central banks and monetary authorities (Hayes, 2015), and cyber threats (Symantec, 2014). However, the greatest risk facing the international banking system today is the amount of debt that has been accumulated around the globe. History has shown us the outsized role that debt has played in creating boom-bust cycles: Latin America in the 1980s, Asia 1997-1998, and Argentina 2005 are a few examples (Reinhart& Rogoff, 2008). A heavy reliance on borrowed money makes the banking system more vulnerable to economic shocks. At the end of 2014, total world indebtedness amounted to $223.3 trillion, or 286% of global GDP. This is up from a debt-to-GDP ratio of 269% in 2007 (Philips, 2016). Rapid growth in sovereign debt led to the Asian financial crisis in the 1990s, and extensive debt instigated the financial crisis in 2007. Central banks continue to be accommodative; however, the accumulation of debt could lead to the next banking crisis.

2. Japan

Japan's experiment in debt began after the 1985 Plaza Accord, arranged to correct trade imbalances by lowering the US dollar's value (Frankel, 2015). The resulting 50% rise in the yen forced Japan into a recession; since that time GDP growth in Japan has been anemic, averaging less than 1%. The adoption of a zero interest rate policy in 1999 did little to improve results.

More recently, the Bank of Japan introduced negative interest rates. In addition, the Bank of Japan has been buying $67 billion of Japanese debt each month. This compares to the Fed's purchases of $80 billion a month; however, the US economy is about three and a half times larger. Today, Japan's debt relative to its economy is by far the highest in the world. Its government debt-to-GDP ratio stands at 250%. This compares to the US's ratio of 106% and to Greece's of 179% (Japan Government Debt to GDP, n.d.). Its total debt to GDP ratio stands at an astounding 400% (Irwin, 2015).

The reason Japan is buying debt is to push interest rates lower, which should cause investors to move into riskier assets — just as the Fed did in the US. But, with a budget deficit of over 50%, the Bank of Japan has to buy $300 billion in government debt just to cover the budget deficit, meaning a good portion of the buying has little impact. In addition to debt purchases, the Bank of Japan is spending about $27 billion a year buying Japanese equities via ETFs.

Unfortunately, these purchases, as well as moving to a negative interest rate policy, will probably have the same effect on the economy as moving to a zero interest rate policy had. Lowering interest rates to negative levels will not spur additional borrowing if the economy looks precarious. Additionally, adding debt to a debt-riddled nation will not address the problem of Japan's growth.

The problem with Japan's growth stems mainly from an aging population and a smaller workforce, not a lack of capital. Japan's working population is shrinking and is projected to shrink by about 750,000 a year until 2060 (Shimasawa, 2014). Accepting immigration could help solve this problem, but given a long-standing cultural aversion to inflows of foreigners, and one of the world's most rigid immigration policies, this solution seems to have little chance.

The rise in corporate earnings versus its stagnant GDP growth highlights the problem. Japanese earnings have grown over 500% in the last twenty years, which compares favorably to corporate growth during that period here in the US. To achieve this growth, Japanese companies have grown abroad where labor is more abundant. Japan has grown profits from its global operations while its domestic economy has languished.

While increasing debt may not stimulate its economy, luckily for Japan it does not face the same challenges Greece faces with its debt. Greece has to rely on foreign investors to buy its debt. Hence, when investors lost confidence, interest rates rose and Greece was essentially shut out of the credit markets. Japan, however, buys most of its own debt. The Bank of Japan has been (by far) the largest buyer and will continue to be. So the Japanese government needs debt to cover its huge budget deficit, and the Bank of Japan buys this debt, and this cycle continues. Should Japan need foreign buyers to support its debt, the fate that befell Greece could also befall Japan. As the third largest economy, reverberations around the globe would be large.

3. China

The world's second largest economy, China, is also awash with debt. Thirty-four years ago, China maintained policies that kept its economy poor, stagnant and inefficient. However, in 1979 China began to open up to foreign trade and foreign investment. China also began to implement free market reforms.

As a result, China became one the world's fastest-growing economies, realizing, on average, double-digit growth through 2012 (Kuijs, 2015). The growth over the last three decades is attributable to the fact that wages in China were far below those in the western world. This allowed the Chinese to produce and export goods at a cost that was not possible in the West. So China's exponential growth was driven by exports.

However, the financial crisis of 2008 was a catalyst for change. Global growth immediately cooled, and, with it, demand for Chinese goods. Consequently, millions of Chinese workers lost their jobs, alarming Beijing. The fear of social unrest is rational for Chinese leaders since it provided the catalyst for the Communist Party to wrest control from Chiang Kai-shek in 1949 (McDougal Littell.2003).

Therefore, to keep unemployment low and reduce potential social unrest, a $586 billion stimulus package was passed. This stimulus enabled China to keep growth close to double digits through 2012. Now, China's growth is predicated on debt. Its debt is approaching $30 trillion. Since 2007, the nonfinancial debt-to-GDP ratio has grown from 145% to 255% (Wang, Wu, & Odenwalder, 2017). To put this in perspective, China has taken on more debt than the US, Japanese, German, and Indian commercial banking systems combined.

Total debt to GDP surpassed 300% this year (Ma, Tiftik, & Gibbs, 2017). The size of the debt is not the main concern, but the rapid growth of that debt is, especially when a large portion is owed by unproductive and overleveraged state-owned entities. Earlier this year, Moody's downgraded China's debt and had previously warned that China's state-owned entities have alone racked up debts of 115% of GDP, and a fifth may require restructuring (Paton, Maqutu, & Mashego, 2016). The defaults are already spreading up the ladder from state-owned entities to the bigger state behemoths.

For China to continue to grow, it has to transform its economy from export-driven to consumer-driven. In 2000, monthly wages in China averaged $94 while wages in Mexico averaged $311. Now average wages in China are 33% higher than they are in Mexico. The relative growth in wages holds true in other countries like Vietnam and the Philippines as well. These rising labor costs, coupled with an appreciation of the exchange rate, has weakened China's advantage in the low-skilled manufacturing sector (Han, 2017).

Transforming to a consumer led economy will not be easy. Many of the Chinese have not benefited from the boom and China remains overwhelmingly poor (Perryman, 2012). According to Friedman (2013), "nine hundred million people have an annual per capita income around the same level as Guatemala, Georgia, Indonesia or Mongolia ($3,000-$3,500 a year), while around 500 million of those have an annual per capita income around the same level as India, Nicaragua, Ghana, Uzbekistan or Nigeria ($1,500-$1,700). China's overall per capita GDP is around the same level as the Dominican Republic, Serbia, Thailand or Jamaica." Therefore, transforming the economy to be consumer driven will be particularly difficult. Most of the populace lives in extreme poverty and cannot afford the goods the Chinese factories produce. As a result, economic stimulus will do little to increase consumption.

The Chinese are therefore in a precarious position. If they continue to support failing businesses financially, they increase inflation. Increased inflation will make Chinese goods less competitive abroad. However, withdrawing financial support will cause many businesses to fail, increasing unemployment, and leading to social unrest. Over the short term China's central bank has the ability to cover the losses, so there is little chance of a liquidity crisis like the 2008 crisis in the US — as long as the government continues to back the banking system. However, without effective structural reforms over the long term, China's financial resources will be exhausted.

In other emerging markets, although debt levels are lower, indebtedness is on the rise. Excluding China, emerging market debt grew 5 percentage points last year (Ma, Tiftik, & Gibbs, 2017).

4. United States

In the US, where the 2007 financial crisis began, the Federal Reserve quickly stepped in to supply liquidity. While it was necessary for the Fed to step in to avoid a deeper crisis, it could be argued that the Fed's policies during the previous 20 years induced the crisis. Early on as Fed Chairman, Alan Greenspan (Ben Bernanke's predecessor) faced 1987's Black Monday, in which the Dow dropped more than 500 points. To ensure liquidity, Greenspan lowered rates and was credited with saving the US from a repeat of 1929; however, he also set a precedent for intervention even before signs of any economic impact (Matthews, 2012). Then, in 1997, the Federal Reserve intervened again and bailed out Long-Term Capital. In addition, Greenspan quickly reduced rates three times in the coming weeks. These interventions became known as the "Greenspan put". Investors learned to rely on Greenspan to rescue the markets if trouble developed. Following the bailout, the Tech Bubble ensued. When it exploded, Greenspan again reduced rates, and when 9/11 occurred in the following year, interest rates were again lowered with a series of cuts. While the economy was spared, the availability of cheap credit provoked the US's first real estate bubble.

During this period, Bernanke replaced Greenspan as Chairman with a promise of staying the course. But of course, the real estate bubble burst, the stock market plummeted, and the economy dropped. The cause of this woe was the massive growth of debt — by consumers, banks, and investment banks alike. To keep the system from collapsing, Bernanke nationalized Fannie Mae and Freddie Mac, bailed out the banking system, and reduced rates further. In addition, the Fed began its quantitative easing (QE), whereby it bought government debt and poured money into the banking system. As a result, through 2014, corporate and household debt declined 20%, but the Fed's balance sheet grew 35% (Dobbs, Manyika, & Woetzel, 2015). Since that time, though, household debt has climbed and, as of the second quarter of 2017, stands at an all-time high of $12.85 trillion (Federal Reserve Bank New York, 2017). When compared to household income and servicing costs, it is still below crisis levels. But, if rates rise, servicing costs on government and household debt could become onerous.

Fortunately, the US economy has grown in the 2% range for the last several years and interest rates have remained low, allowing the Fed to begin reducing its balance sheet. Should the economy continue to grow for an extended period, the Fed could return to normality. If, on the other hand, the economy were to stall in the near future, the Fed would have fewer tools to assist.

5. European Union

Highlighting how intertwined international banking is, the US financial crisis led to the European debt crisis. The economic slowdown quickly illustrated how heavy debt burdens can exacerbate the situation. The resulting debt crises in Greece, Ireland, Spain, Portugal, Italy, and Cyprus serve as examples. In 2010, The European Central Bank, the International Monetary Fund, and European nations stepped in to alleviate the situation. As a result, the European Financial Stability Facility and the European Stability Mechanism were created, along with the ECB's quantitative easing and negative interest rate policy. As a whole, the European economy appears to have troughed, but it remains in a precarious state. While government debt as a percentage of GDP has fallen to 89%, it still remains above its 2007 level of 65% (Euro Area Government Debt to GDP, n.d.). In addition, the ECB's balance sheet has grown over 200% since 2007 and is now larger the Fed's. The European debt crisis exposed the weakness in harmonizing monetary policy without coordinating fiscal policy. Without a coordinated fiscal policy, which will be difficult due to national interests, the economies of many individual countries remain at risk, and weaning off central bank assistance may be difficult.

6. Conclusion

On a positive note, although worldwide debt is increasing, the financial sector has been deleveraging. Financial sector debt per GDP has declined in the US and a few other crisis countries, and has stabilized in other advanced economies. In addition, banks have raised capital and reduced leverage, thereby strengthening their financial position.

Nevertheless, global debt continues to increase and in some countries debt is rising quite quickly. The financial crisis taught us that a country with a heavy debt burden could get into economic trouble regardless of whether its debts are held by the government (Greece, Italy), households (Spain, the United States), or financial institutions (Ireland, Britain).

Central banks have been accommodative which has kept interest rates low, making it easier for borrowers to service this debt. However, if central banks achieve the desired results, growth will ensue, inflation will increase, and rates will rise. As a result, servicing this debt could become difficult and fiscal budgets could become strained. On the other hand, if economic growth is not achieved, debt could rise further and would then increase risk in the banking system.

Further research is needed to analyze how current government policy, in each of the major financial centers, will affect debt; thereby, identifying whether this risk will increase or decrease. In addition, research is needed to explore the stress on national budgets should interest rates increase given current and estimated future levels of debt. Finally, research should be conducted to examine the potential effects on the emerging economies should these financial centers work to reduce debt and the potential threat that could pose to the international banking system.

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