THE PREPONDERANCE OF THE FINANCIAL CYCLE AND THE PERSISTENCE OF FINANCIAL FRAGILITIES IN NEOLIBERAL CAPITALISM

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Theoretical underpinnings

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From the search of information to the power of money

- Stiglitz stresses the failure of the attempt to reconcile microeconomics based on utility value theory and macroeconomics.
- The essential characteristic of the utility value that supports the existence of the general equilibrium is the independence of the agents‘ behaviours, which implies perfect knowledge of the characteristics of the goods and of the desires of each subject with respect to the goods, guaranteeing that individuals have a complete choice.
- Stiglitz shows that this cannot be the case because all individuals are dependent on a public good in the formation of their choices, i.e. *information*. It means that utility is constantly redefined by social interaction.
- Without the independence of choices amongst individuals, the coordination of exchanges requires a crucial institution, money as a network: *the system of payments.*
- *The finality of payments* is the means by which society gives recognition to economic actors for what they brought it through their activities→ *the payment system is the institution that realizes value as a pure social relation.*

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The pivot of financial markets is not fundamental value; it is liquidity

- The hypothesis of *efficient finance* in the context of a perfect competitive equilibrium removes uncertainty. Since risk is assumed to be perfectly priced, there cannot be any hidden risk accumulating in balance sheets.
- Introducing "frictions" is an ad hoc hypothesis incompatible with the utility theory of value. In a market economy controlled by the finality of payments, the key concept that guides behaviors on the financial markets is *liquidity.*
- Liquidity is ambiguous because it is self-fulfilling, i.e. *the creation of the desire for it,* since the acceptance of money proceeds from the expectations that it will be desired by all others as a public good.
- Therefore under uncertainty money constitutes both protection for everyone in a crisis situation and a desire for appropriation that is not subject to a condition of saturation since appropriating money as an aim gives power→ the logic of financial markets is to *make money with money.* It is a logic of *momentum.*
- Consequence: the financial markets do not operate like ordinary markets. In the latter, the two sides of the market have opposing interests with regard to prices, which guarantees a supply curve that rises with prices and a demand curve that falls. In financial markets, any actor can be a seller or a buyer any time, alternating euphoria and panic, whereby the demand curve ↑or ↓ with prices.

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The logic of momentum and the financial cycle

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The financial instability hypothesis: financial cycle

- The dynamic of financial cycles proceeds from the interaction between the changes in private debts and asset prices. This dynamic is a *momentum,* in the sense that it is self-reinforcing, because it does not involve an expected ~~return~~ on pre established and known fundamental values (Hyman Minsky).
- The financial cycle can be described in five sequential phases: *boom; euphoria; climax and crisis; ebb and the onset of pessimism; debt deflation and the restructuring of balance sheets.*
- The boom phase generates behaviors that weaken the financial system, while the worsening of credit conditions is hidden from the actors, because the euphoria of the asset markets blurs the quality of price information. Fragility creeps in when borrowers, who perceive opportunities for capital gains on assets, resort to using increasing debt to maximize them.
- For their part, lenders may be subject to the illusion of apparent solidity in a phase of steadily rising asset prices. They expect that the value of the assets that constitute the collateral for their loans will appreciate, thus guaranteeing their debts. In this situation, competition drives them to approach potential borrowers because the collateral is both a source of wealth for the borrower and insurance for the lender.

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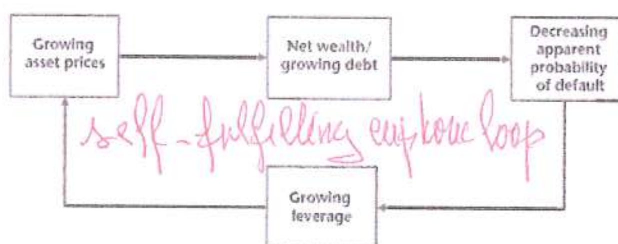
The infernal cycle of runaway euphoria

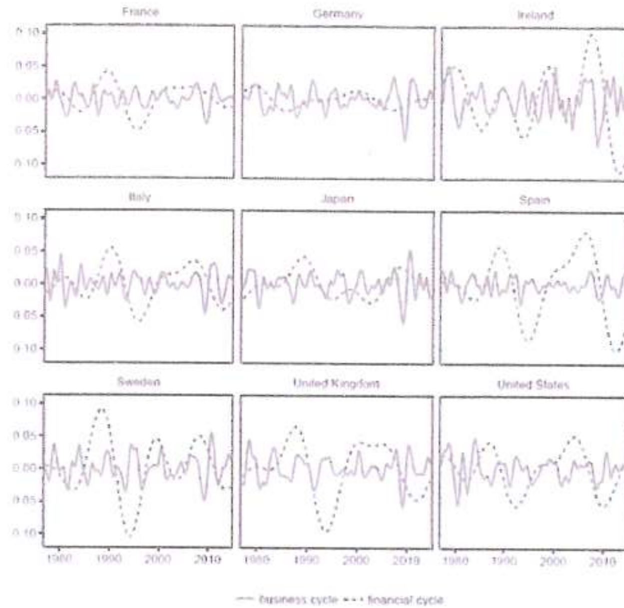
- There is a reciprocal feedback loop without mean reversion when the anticipation of the rise in asset prices is the main determinant of credit expansion because the simultaneous increase of supply and demand of credit prevents the interest rate from rising while the demand for credit increases.
- Consequently the cost of credit cannot regulate the demand for credit by slowing its growth. Supply and demand curves shift upwards because credit providers and credit borrowers have the same optimistic view of the asset market.



The dangers of balance sheet deflation

- The downturn in the financial cycle is dominated by the deflation of the balance sheet. The behavior driving the contraction of the private sector in this phase is the need for *deleveraging.* But nothing is more difficult to achieve than an orderly reduction in debt leverage.
- In a downturn in a market subject to an asset price bubble, the debt-to-market value ratio of assets increases sharply because the values of assets crash, while the value of debts has not yet fallen. The financial situation of businesses and households deteriorates despite efforts to improve the balance sheet structure. The constrained rise in the weight of indebtedness in a recessionary phase is the crucial characteristic of *financial deflation*. There is clearly a *"coordination failure"*.
- This is why the process of restructuring the balance sheets is long and fraught with difficulty, especially since the deterioration of borrowers' balance sheets has repercussions on the lenders. Given an unchanged economic policy, this leads to an increase in the cost of credit and a rationing in its volume, which makes it all the more difficult to refinance debts and puts an immediate liquidity constraint on the indebted agents.

Financial cycle and business cycle in advanced countries



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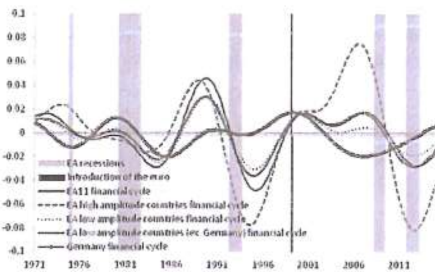
Financial cycle and business cycle in euro area

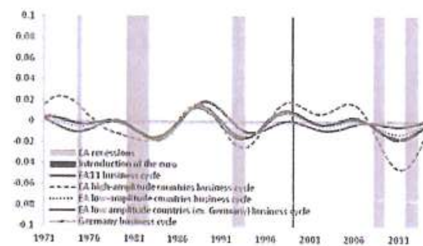
Financial cycles

In Germany, financial cycle subdued and asynchronical. Divergence has ↑ since the creation of the euro zone



Business cycles

Concordance between business cycles.



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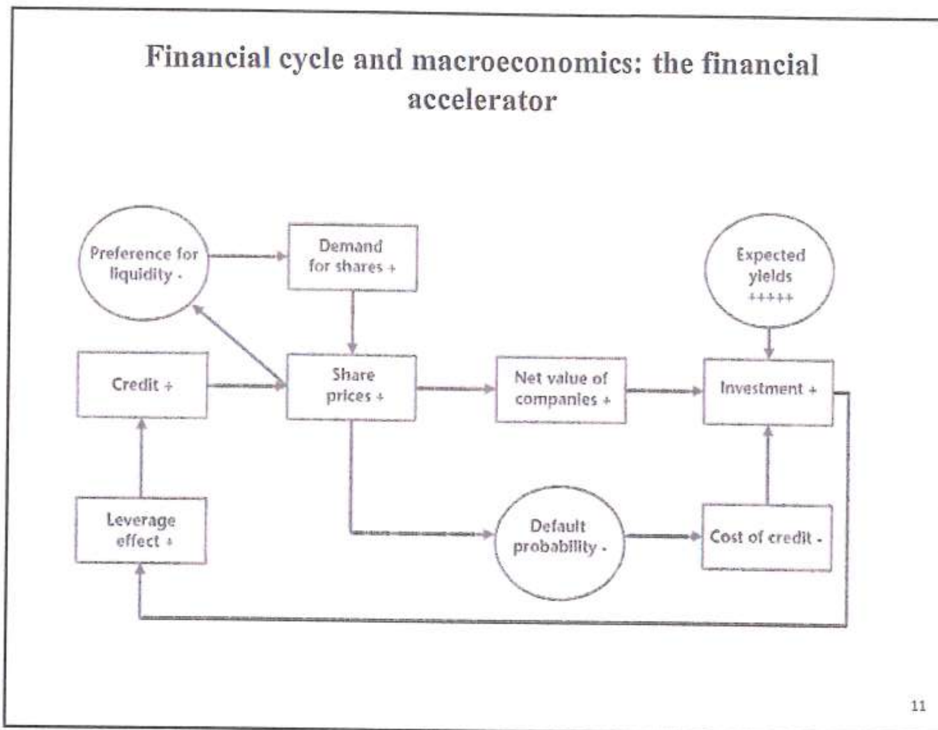

Financial cycle and macroeconomics: the possibility of a stable equilibrium of stagnation

- Liquidity preference stems from uncertainty about future prospects. It is influenced by the financial cycle. After its turndown, it is the magnitude and the length of deleveraging that determines if the slowdown in economic activity is temporary or persistent.
- The change in the debt constraint measured by the spread risky/safe assets indicates the strength and length of deleveraging from the euphoric to the depressive stage. It impacts investment decisions and aggregate demand→ ↓in inflation. If the nominal interest rate gets stuck at 0, the real cost of the debt ↑ and can trigger an inversion of the slope of the aggregate demand curve if ↑in the spread of risky assets combines with ↓in inflation.

Weak and short deleveraging — P, AS, AD, Y

Strong and long deleveraging — P, AD, AS, Y

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Persistence of financial fragilities and policy implications

Corporate exposure to leveraged loans

- The April 2019 GFSR has diagnosed a financial cycle in its expansion stage. 3 types of structural fragilities:
  - High corporate indebtedness in advanced countries, principally in US.
  - Comeback of the doom loop banks/ sovereign in Italy threatening unity of EA again.
  - Debt vulnerabilities in EMEs facing passive international investors
- In the US profit margins swelled with the 2017 tax reform. They used them leveraged with more debt to finance M&As, buyback shares and extra dividends but no more productive investment → more fuel in overvalued Stock market coincident with a 10-year expansive business cycle.
- The amount of corporate bonds issued by ≤ BBB-rated firms is > twice the amount of high-quality bonds. If a recession → downgrading of those cies, credit risk premia would↑, making debt turnover hazardous.
- The leveraged loan market is critical. Because the size of the market reached $1,3trn end-2018, pointing out the deterioration of credit standards.
- Furthermore most of those loans are pooled and securitized in CLOs to investors; The danger is the migration of credit risk in part of the financial system escaping well-structured scrutiny

The danger is once more the possible coincidence of turn around in financial and business cycles

→ ≠ types of inv funds: mutual funds, hedge funds, exchange traded funds

Perennial vicious circle between public finance and banks in EA and financial fragilities in EMEs

- Self-inflicted fragility due to the incompleteness of the euro. Italy again threatened by the fiscal curse→↑in sovereign rates. Meanwhile NPLs still stagnate in banks of several countries. The possibility of contagion to other sovereign debts is substantial if a hawkish ECB president refuses to do "whatever it takes". The EA might not survive this time. Such Armageddon might happen under a severe global slowdown.
- Private debt in EMEs has swollen with the huge amount of $liquidity injected after the financial crisis. Most debt has taken the form of $bonds by passive international investors in search for yield after the financial crisis. Benchmarked funds have reached $800bns constituting a single asset class in the mind of those investors.
- China's bond entry in MSCI indexes makes vulnerabilities in China's financial system more prone to be transmitted in EMES' financial markets via ↑correlation that can be amplified by fragile countries whose BoP financing depends on short term capital inflows (Argentina, Turkey, Mexico and South Africa).

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Present-day unease in financial markets against uncertainty

- /Market volatility subdued while investors believe the Fed will cut its policy rate 3 times this year. The Vix has ↓ this year.
- /However, the slope of the yield curve turned <0 flashing a 30% prob of recession this year.
- /The VVix (implied volatility of the Vix) has. It means that markets exhibit calm spans of time interrupted by more frequent violent shock. This a symptom of ill-priced uncertainty.
- /These are symptoms of drying liquidity in risky markets: the spread of junk bond and leveraged loans CLOs/ safe Treasury bond rate has substantially ↑.
- -This is characteristic of *bifurcations* in market dynamics due to brutal unexpected changes in market liquidity. A bifurcation is one-day drop 5 standard deviations>daily average movement of a market over the past month. There has been 5 such discontinuities since 2016. There haven't been so many disruptions in a 3-year period since the 1940s

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Policies to hedge systemic risk

- The resiliency of the financial system depends on hedging against hidden vulnerabilities accumulated in balance sheets in the euphoric stage of the financial cycle. Surveillance and regulation of banks have been strengthened under G20 monitoring.
- However, other financial actors are weak links because of evasive financial regulation and refinancing by systemic banks in the wholesale money market. In such financial architecture the neoliberal dogma of efficient market and neutral money must be discarded entirely.
- Macro prudential policy must be compatible between countries and coordinated with monetary policy. Central banks must be collectively responsible of the global wholesale liquidity market in the main convertible currencies.
- Moreover fiscal capacity is all important while the financial cycle is turning down. It is imperative both to counter the falling global demand and to repair bank balance sheets. An international lender of last resort is necessary but not sufficient. Coordinated borrowers of last resort are needed.

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