Global Economy, Country Risk

Winter is coming

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In economics, as in other sciences, history helps us anticipate the shocks that might derail expansion phases such as the current one. Some of the biggest crises have originated with US Federal Reserve rate hikes. This time around, normalisation is being carried out gradually and steadily, with communication geared to avoiding unnecessary scares. But the risk of accident increases as the costs of financing reach levels that start to compromise debt servicing.

The world is much more heavily indebted now than it was in 2007, and there is a high degree of dependence on financing in dollars in the majority of emerging countries. A misstep by the Federal Reserve would impair global financial conditions and affect US domestic demand just as the country seems to be entering the final straight of its expansive cycle. The scenario is further complicated by the fading of the fiscal stimulus in 2020 and the deterioration in the indebtedness indicators (in which context particular attention should be paid to the credit market) and consequently a significant slowing of US growth emerges as one of the main potential sources of risk.

Another eventuality that we need to envisage is that of a de facto trade war among the major economic blocs. Its effects may not be immediate like those of the aforementioned scenarios, but in the medium term they may be more disruptive, due to inefficiencies in the allocation of resources.

Furthermore, the need to combat the protectionist risk may cut short the path embarked upon by China to clean up its corporate sector. The ratio of private debt to GDP started to increase again at the beginning of 2018, and the recent measures in support of lending point to further increases. Household and local government debt continues to grow, and the real estate market is showing signs of overheating. Turning once more to history, there are several examples that might lead us to suppose that an orderly adjustment, without a banking crisis, is unlikely. China is a special case. It has the tools with which to avoid a hard landing, but the clean-up will have to be carried out sooner or later, and then the world will feel its ripple effects.

Closer to home, political uncertainty (Brexit, Italy) continues to head the balance of risks. A renewed flare-up of tensions in the peripheral bond markets cannot be ruled out, and is shaping up as the latest of the major global risk events.

It is in this context that the emerging market crisis should be seen: we do not consider it a global risk factor per se, but the result of the partial materialisation of some of the events referred to. There is a high degree of interconnection among global risks, so we need to identify their triggers and transmission paths if we are to have any hope of combating them when the time comes.

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