Financial Markets: A World of Risk

Jayanth Varma looks at the four major global areas of risk to watch out for in 2017

After the rollercoaster year that was 2016, and with the tenth anniversary of the GFC just around the corner, one might expect that the worst is finally over for financial markets. Yet almost by the day, more bad news seems to crop up. This raises the possibility that 2016 was merely a curtain-raiser for what lies ahead. Over the next 12-24 months, there are four major global risks to watch out for: Donald Trump's economics; Europe's politics; China's economic rebalancing; and the geopolitics around the South China Sea. How these risks play out and interact with each other will shape the domestic and world economies, as well as financial markets, in 2017 and beyond.

Mr Trump's economics

In the brief period that Donald Trump has been in power, the world has seen his politics, but not yet his economics. Expecting a major 'reflation', investors have welcomed him with a 'big bang', with most stock markets up 5 per cent or more since the election, US 10-year Treasury yields jumping from under 2 per cent to nearly 2.5 per cent, crude oil prices up from the mid 40s/barrel range to the mid 50s, gold prices dipping 5 per cent, and the dollar, though volatile, rising by about 2 per cent. Clearly, markets are expecting a big fiscal stimulus, which, coming after 10 years of severe austerity in America and Europe, would be welcome.

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Indeed, if history is any guide, populist policies tend to 'work' in the short term – even Adolf Hitler's first term was 'good' for Germany, at least economically – but usually end in catastrophe. The best case, then, would be for Mr Trump to have a single term in office, during which he might address some of the 'sacred cows' that others are afraid to touch, and then be replaced by a more 'sober' set of hands. Whatever his politics may be, the markets believe that a 'Trump reflation' will be good for America, and for the rest of the world.

The problem with this view is that it ignores the very real possibility that Mr Trump's 'reflation' will come saddled with a heavy dose of protectionism. If the new President follows through on his 'Make in America' plan with vigour, it would only benefit the United States, while hurting countries like China, Germany and Japan, which run a trade surplus with the US. India could also take a hit in its most vibrant services sectors, including IT. The upshot is that while the US economy would boom, the outside world would gain nothing. Whether this scenario actually comes to pass is unclear, particularly because the Cabinet Mr Trump has put together is, on balance, very competent – more so, perhaps, than any since the Reagan administration. How far he and his team are will go down the protectionist route therefore remains to be seen.

An even more alarming possibility is one where the US descends into 'chaotic stagnation' under a lame duck Presidency. The American political system is built around checks and balances, and, for major legislation to get passed, it takes at least two branches of government to work together. Should Mr Trump not be able to make common cause with his own party on infrastructure spending, his 'reflation' agenda might get stuck in Congress. He would then be forced down the path of least resistance: cutting income taxes at the top end, which would cause the fiscal deficit to balloon and interest rates to soar. Meanwhile, serious 'skirmishes' abroad would trigger trade and currency wars, driving the whole world into recession.

Historically, EMs tend do well when the dollar is weak and interest rates are low. However, under any of the above scenarios

– both 'good' and 'bad' – there is a strong likelihood of the opposite happening: that the dollar will continue strengthening, and that interest rates will keep rising. With US investments becoming relatively more attractive, less money will flow into EMs, drying up liquidity and pushing up the American currency. In fact, the US economy would need to do unexpectedly badly for the dollar to fall from current levels. India, which is heavily dependent on foreign capital flows, might be among the worst hit.

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European politics

A second major risk emanates from Europe, where a whole series of elections are due this year and next. An optimistic reading suggests that populism may have peaked in mid-2016 with the Brexit vote, and is now in retreat. After all, Donald Trump actually lost the popular vote in November, and in December, Austria decisively rejected the far-right candidate, who had been running neck-and-neck with the eventual winner. Going by this 'trend', voters in France, Italy and the Netherlands might also reject their fringe parties. On the other hand, they could bring about a 'horror' scenario where Marine Le Pen seizes the French Presidency, the 5-Star Movement wins Italy, and Geert Wilders gets a majority in the Netherlands. Germany could also produce a surprise, even as Angela Merkel remains ahead in the polls, and Brexit might unfold chaotically. Should either Italy or France go down the populist route, it would be disastrous for the future of the European Union, and specifically, for the single currency. The economic fallout for Europe would be worse than the GFC, and possibly worse even than the Great Depression. For the rest of the world, given how deep financial inter-linkages run today, the entire global banking system could seize up. There would also be massive flight to safety towards the dollar, yen and Swiss Franc, leaving many EMs stranded.

A Chinese rebalancing

China is working hard to fix its major economic balances, and three in specific: excessive investment and too little consumption; an over-reliance on exports; and unsustainable credit growth. Should its leadership manage to sort out these issues (the 'bull case'), China would switch to a consumption-led growth path, in which it stops

exporting deflation to the rest of the world. However, should it instead fail (the 'bear case'), the consequences for other EMs would be severe – though perhaps not as bad as during the GFC. The worry is that China has already run out of 'good choices', and its problems may simply be too big to resolve without creating other issues. It may, for instance, have to choose between a growth collapse and political instability; or between unsustainable credit growth and asset price bubbles. A full-scale crisis, marked by capital flight and a sharp currency depreciation, is very possible. The other possibility is that, like Japan after 1989, it could, weighed down by debt, see one or more 'lost decades' of very low growth. For the rest of Asia, this would look very much like a Second Asian Crisis.

Geopolitics in the South China Sea

Following the Vietnam War, Asia has enjoyed over 40 years of relative peace and prosperity, with no major conflicts occurring anywhere East of Afghanistan. However, China, Japan and the US are now turning increasingly nationalistic, and there is a new warmongering underway. Mr Trump appears to have a major grudge against China that is at

A Broader Perspective: Q&A

Is there a positive side to the global picture today, and how can India leverage it?

Under a 'bull scenario', Trumponomics would reflate the US economy without being excessively protectionist, and US trade policy would remain reasonably liberal, with the current hostility to outsourcing confined to the H-1B issue (which would drive up costs, but still allow outsourcing to continue). At the same time, European voters would reject the populists in favour of the mainstream parties, and China would limp along, becoming more domestically-focused, and less of a threat to the rest of the world, including India. However, the odds of all of these things happening are low, requiring several things to work out right. In any event, Indian industry, which has not yet fully adjusted to the post-2007 world, will need to restructure itself in line with an environment that requires business to run a much leaner and tighter ship than before.

On the risk of a fresh Greek default, and its possible exit from the EU:

This is still an open question, particularly because there is huge resentment in Asia against the 'differential' treatment accorded to Greece. South Korea and Thailand still remember the harsh conditionalities imposed on them by the IMF in 1998, and the fact that they were not offered any concessions. In comparison, Greek loans have been continually extended, with no serious thought to sustainability. Consequently, the Europe-Asia divide inside the IMF has become very intense, and there are also serious conflicts of interest involved in having Europeans run the bank while its biggest borrowers are European. Default is still a possibility, but most Greek debt is now in the hands of the ECB, Germany, and other sovereigns, so the contagion impact will be limited, and far less serious than it would have been a few years ago. That said, if a very large amount must be written off, it will certainly influence the French and German elections.

What might counter the risk of large capital outflows from India?

Broadly, there are three or four 'props' that would help do this. First, India needs to focus urgently on fixing the banking system, and it is surprising that the Finance Minister allocated so little to recapitalising banks in his recent Budget. The only reason this is not even more of an issue is the limited demand for loans right now – and what demand there exists is being met by NBFCs, who are today doing much better than banks. However, NBFCs cannot replace the banking sector, and the problem will have to get addressed. The second prop, and a saving grace so far, is domestic flows into equity markets. An enormous amount of retail money, mainly through SIPs, has bolstered the markets at a time when FIIs have been selling. The third prop, which this government seems to be keen on, is a 'Commanding Height 2.0' vision of the economy, in which the public sector acts as a counter-point to a private sector that is unwilling to invest. Holding up all three of these props should suffice to prevent huge outflows.

On whether the Renminbi can become the world's reserve currency:

Unless China dissolves into chaos, it will over time become the world's largest economy, and at some point, lay claim to reserve currency status. However, this is a process that might take 25 years instead of 5-10, because several things must happen first. To begin with, the currency needs to be freely convertible, whereas last year, it least partly personal in nature. (He lost a court case over ownership of the 'Trump' brand in China.) Conceivably, the US President could do a 'reverse Nixon'. Seeking to contain Russia, Mr Nixon did the unthinkable by making peace with China, whereas Mr Trump might end up making peace with Russia to contain China. President Xi's aggressiveness, for its part, could provoke an anti-China alliance that includes India, the US, Vietnam, and possibly Russia. Any miscalculation could quickly escalate into armed conflict, and for the first time in decades, India risks being sucked into the maelstrom of war at the regional level.

Weighing the odds

With four major global risks at play today, it is impossible to say which of them – if any – will materialise. A useful starting point is to use the tools of probability to assess the chances of none of them – or alternatively – at least one, coming to pass. Assuming that each risk has a 50 per cent chance of having a 'bad outcome', there is only a 10 per cent chance of all four occurring, but a 90 per cent chance that at least one will. Lowering the probability to only 25 per cent each – or, even more optimistically, 10 per cent – there is still a two-thirds (one-thirds with a 10 per cent probability) chance of at least one risk materialising. Given how high the stakes are, this is sobering news indeed. ■

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actually doubled-up on its capital controls, which were already much tighter than India's, an economy one-fourth its size. For a currency to be global, there cannot be any controls, because it necessary to be able to freely lend and borrow in it. That actually looked more likely 2 years ago, when the currency seemed to be on a one-way street to appreciation, and China was confident enough to throw out all controls at that time. Today, if controls are eased, even its several trillion dollars of reserves will not last very long. Finally, the amount of Yuan in circulation abroad is simply insufficient, and will take time to build up. To be a true international currency, like the dollar is, a significant share of notes by value (70 per cent in the US case) must lie outside the economy.

Is India doing enough in policy terms to manage the risk of large capital outflows?

There is a certain amount of complacency on this score today, stemming from the belief that, by and large, all is well with India, and not much needs to be done. There is no sense of urgency about the burning problems that have to be fixed quickly, which is worrisome because time is running out, and the world does not tolerate those unwilling to fix their problems. All of this is visible in how casually the NPA issue is being handled, whereas fixing the banking sector should really be India's number one priority. For its part, the corporate sector seems to believe that matters like over-capacity and low growth will sort themselves over time, and is not focusing on the painful things it may need to do to become truly competitive. Far too many business leaders think that the heady days of 2005 will return – but in fact, even under the most bullish scenarios, those days are forever gone. Policies that worked then in terms of building capacity ahead of demand and profit, and not focusing aggressively on cost-cutting, no longer work. On the whole, India also needs to be more 'brutal' about resource allocation. Around the world, there are half-completed buildings, and projects that get abandoned mid-way. This is actually a good sign – that people are not willing to throw good money after bad. It is better to stop at the 10th floor when the other 40 will stay vacant, and preferable to stop building a road to nowhere. In India, by contrast, keeps bleeding to complete weak projects, causing good ones to suffer for lack of money. In that respect, Indian businesses, and the government, need to learn from the private equity world about being brutal and shutting bad projects down quickly. ■

This paper is based on a presentation by Jayanth Varma, Professor of Finance, IIM Ahmedabad and Former Member, SEBI, at the 21st Annual CFO Roundtable in Mussoorie in February 2017