

Highlights Leir Bubble Center 2014 Bubble Conference

Globalization, Bubbles and Too Big To Fail

September 19 -20, 2014

The Conference Participants met at the Leir Retreat in Ridgefield, CT that was formerly the estate of Henry J. Leir to discuss over two days various research presentations related to issues and concerns arising from an apparent increase since the 1970s in the frequency of financial bubbles and their impact on the global financial system. The topics covered ranged from the role of globalization or the reduction since the early 1970s in the barriers to international trade, investment and financial flows in creating bubbles to the creation of mega-banks that are deemed too big to fail when a bubble bursts.

While the discussion was wide-ranging three important policy issues stood out.

- 1) Mega-banks deemed too big to fail are a relatively recent phenomenon since the 1990s and were created through deregulation and ad hoc policy responses to financial crises where failing financial institutions were absorbed into larger healthier organizations. This approach is no longer feasible in the case of megabanks too big to fail since it is not clear any potential buyers would exist and if one did a merger or takeover would just create an even bigger potential risk.

Thus the new approach involves increasing the potential loss-absorbing cushion at the bank holding company level by a combination of debt and equity that would reduce the potential risk for insolvency at the subsidiary bank while the Fed would stand ready to provide liquidity to frozen assets. There also exists the expressed government intent to try and prudentially catch these issues before they impact the global financial system

through the use of stress tests and regulatory action. It was expected other economically important countries would follow the US holding company and stress test approach.

However even given this increased prudential approach there was concern that the derivative exposure of the megabanks even after netting was several times their capital. This was a serious concern because four very large US banks have very high levels of credit exposure due to their derivative trading primarily in interest and foreign exchange swaps closely tied to the fixed income markets [JP Morgan Chase, Citibank, Bank Of America and Goldman Sachs]. In addition their share of these exposures among US banks was over 90 percent.

When the group was polled about the possibility of a current bubble, the consensus was that there was a high probability that a current bubble existed somewhere in the lower credit sovereign fixed income markets. If one mega-bank's net exposure to this bubble were large the potential for a daisy chain or domino effect did exist through the possibility of both interconnectedness and the fact these institutions often have overlapping asset portfolios.

- 2) The Chinese economy is slowing much more than is commonly recognized. This is one reason Chinese companies are raising funds in the US market and wealthy Chinese are buying US assets. A signal to this effect is the declining price of steel rebar used in construction. Further the incentives for local governments and developers to take rice land out of production to build houses that are unoccupied is having the perverse effect of reducing real GDP while substituting high but fictional GDP growth in the form of housing construction. Since this is not sustainable Chinese growth will slow reducing global commodity demand and lowering inflationary pressures. This development in conjunction with increased US energy supplies could mean that low inflation and low interest rates in the US, Japan and elsewhere could persist for an extended period. It was not felt however that China represented any direct risk to the global financial system. This is because there is very little interconnectedness between Chinese

financial institutions and the large global mega-banks that are the focus of this risk.

- 3) While asset prices have risen everywhere as noted in a recent *NY Times* article the group did not feel this meant there were bubbles everywhere but only that excess capital in the advanced countries had driven all asset returns lower. Further the other Bubble indicators such as excess optimism were not yet apparent. However this was not true for the fixed income area as noted above and where money has been pouring in since 2009. This bubble risk could be linked to possible flows of money between countries that might impact interest and foreign exchange rates and the related derivative exposures.