SPECIAL REPORT

Spotting the black swans

The next crisis could start a long way from New York

The recovery of the rich world now threatens overextended developing economies.

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TURKEY'S LARGEST city, Istanbul, is intimately linked to the Bosporus. In the year 324AD, the emperor Constantine established a new capital for the Roman empire on the western side of the strait of water that connects the Black Sea with the

Aegean. The location was perfect: easily defensible and strategically invaluable, at

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If one Bosporus is a strategic asset, two are even better, reasoned Suleiman the Magnificent, sultan of the Ottoman empire in the 16th century. So he proposed to dig a canal to Istanbul's west, providing a second sea route across the Eurasian isthmus. His plan did not come to fruition, but it is back on the agenda now. In 2011 Recep Tayyip Erdogan, another Turkish leader with grand visions, announced a $20bn project called "Kanal Istanbul" to provide a route parallel to the existing strait. It is an example of what Mr Erdogan himself has called "crazy projects": monumental building feats to reflect the greatness of his regime.

No one is sure if the canal will be finished. But the economic tailwinds that made such grandiose plans possible have abated, so Turkey is now facing an economic reckoning which could threaten the canal's completion and is starting to threaten other emerging markets, too. After the global financial crisis, money draining away from stricken advanced economies flooded into emerging markets. Some of them borrowed too enthusiastically and kept an imprudently loose rein on banks and firms.

The recovery of the rich world, and the withdrawal of monetary support, now threatens those overextended developing economies. Every struggling emerging market founders in its own way, and Turkey's troubles have been exacerbated by its own particular economic and political woes. But the broad shift in financial conditions that is now squeezing the emerging world will inevitably induce some familiar crises.

> **"Italy, in particular, is a ticking time bomb**

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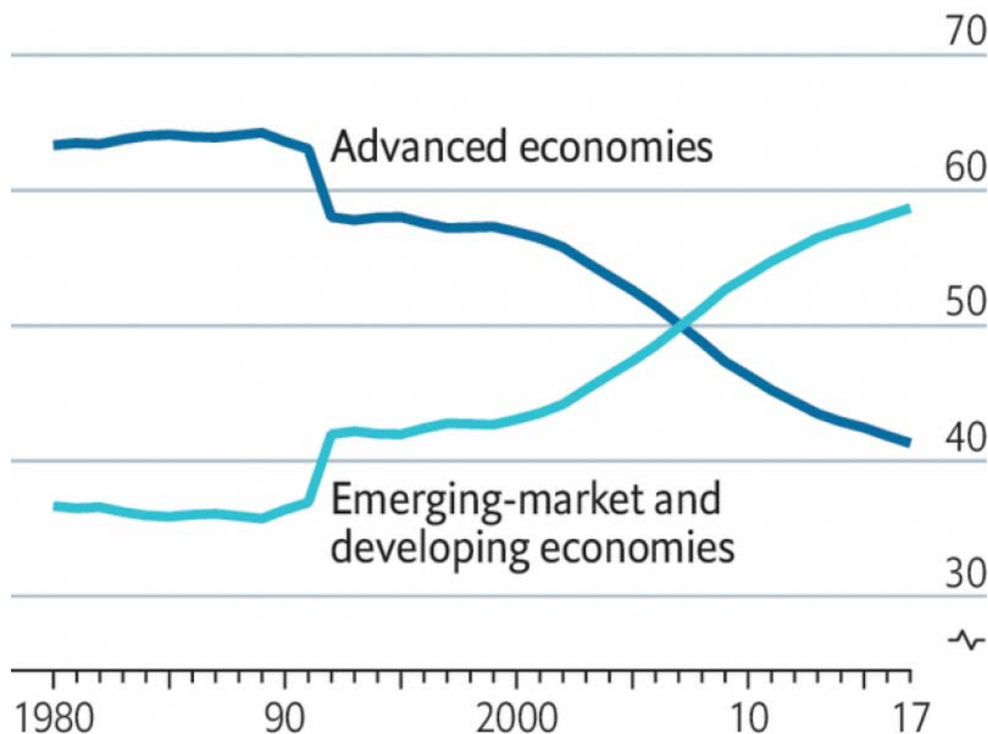
Business cycles are a matter of feedback loops. In good times, people spend and invest more. Asset prices rise, worries about risk recede, and banks open their credit taps. Easier credit underpins spending and investment, and on the cycle goes. Governments try to moderate booms but often overdo or underdo it. Eventually some error flips the cycle from expansion to contraction. Nervous consumers cut back, firms shelve investment plans, asset prices fall and banks curtail credit. Lending which looked sensible one day becomes a danger to the economy the next.



The integration of the global financial system has turned national financial systems into a vast single sea of money that rises and falls with changes in saving and investment around the world. In the 2000s, for example, the international banking system channelled massive savings accumulated by oil exporters and large emerging markets into rich-world property markets. If such shifting tides are mismanaged, they almost invariably cause economic trouble. Today, the tide is on the move again.

It is most easily observed in the emerging world. Developing countries bounced back from the global financial crisis relatively quickly, buoyed by an explosive Chinese recovery. As quantitative easing in advanced economies depressed the yield on rich-world bonds, investors increasingly looked to the emerging world for better returns. The double boost of Chinese demand and rich-world capital threatened to create unmanageable credit booms in some emerging economies, which have long viewed such inflows of capital with a wary eye. Reversals in the past often left the unlucky ones with piles of unaffordable debt.

The recent experience of some developing countries such as Turkey may foreshadow a return of the sort of woes experienced by emerging Asia in the late 1990s. Turkey has been running a large current-account deficit (indicating heavy reliance on capital flows from abroad), has borrowed heavily in dollars and has an alarmingly low level of foreign-exchange reserves. A loss of market confidence could lead to a dramatic depreciation, waves of defaults and painful adjustments in the Turkish economy. Turkey is not big enough to cause global economic trouble all on its own. But should the forces squeezing Turkey drag down a broader swathe of emerging economies, governments around the world could have a serious problem on their hands.

In the past, torrents of money from abroad proved irresistible to governments in the emerging world. Most have since learned to borrow more carefully and in local currency, and to accumulate a war chest of foreign-exchange reserves. Even so, borrowing by emerging-market firms (not banks) through issuance of dollar-denominated bonds has increased by an average of more than 10% per year since the financial crisis. It has roughly doubled in Brazil and Mexico, tripled in South Africa and Indonesia, and quadrupled in Chile and Argentina, according to a recent analysis published by the Bank for International Settlements (BIS).

Borrowing from abroad has gone hand in hand with large current-account deficits; net flows of foreign money into a country allow it to consume more than it produces. But as the American economy has strengthened and the Fed has tightened, capital flows into America have grown and the dollar has appreciated. The first big round of post-crisis appreciation took place in 2014, in the wake of the "taper tantrum", as the Fed phased out the stimulative bond-buying it had undertaken in the early 2010s. As a result, emerging-market currencies dropped and growth in trade, borrowing and GDP slowed. Now monetary policy across rich economies is becoming tighter and the rise in the dollar has resumed.

The problem, says Hyun Song Shin, of the BIS, is that dollar borrowing by emerging-market firms effectively expanded the monetary reach of the Federal Reserve. Higher American interest rates and a stronger dollar will place financial pressure on big emerging-market firms, forcing them to cut back on investment and spending. Foreign-exchange reserves held by governments are probably sufficient to prevent financial stress at big corporations from translating into a broader panic; but the closing of the credit taps, and pressure on firms to deleverage, will cause a sharp contraction in much of the emerging world that will

be felt in advanced economies, too. For countries which have been running current-account deficits, that means buying less from the rest of the world and selling more. Advanced economies will be affected as the value of their investments abroad declines and their exports shrink.

China is not normal

Just how much all this will dampen growth will depend on what happens in China. Although it shares some features with other emerging markets, it is so vast and so unique that it represents its own sort of threat. The economic collapse of China's main export markets during the global financial crisis raised the risk of a sharp slowdown, rising unemployment and political instability. Its leaders responded with a massive fiscal stimulus directed primarily at investment, estimated at around 12.5% of GDP and financed mostly by borrowing, much of it by local governments and large firms. Overall, Chinese debt rocketed after the crisis, from about 175% of GDP in 2009 to more than 300% now. To make matters worse, borrowing has become less efficient over the past decade as more of it has been done in places and by firms with declining growth in productivity. In more recent times the government has tried to rein in, though not stop, the credit boom.

Such an extraordinary rise in debt, and particularly in credit used unproductively, would normally ring alarm bells. But China is not a normal country. Highly indebted emerging economies usually worry about servicing foreign-currency-denominated debt as capital flees the country. But China tightly controls its capital account, and both the government and Chinese banks maintain large asset piles. Moreover, the government has far more control over the economy than in most countries and is determined to avoid the emergence of any kind of destabilising crisis.

Even so, China's debts are hardly problem-free. Economic growth has decelerated steadily since 2010. Still, it continues at more than 6% per year, which adds about $1.5trn to the global economy each year (a Russia, give or take). To maintain growth at that clip requires a steady increase both in the economy's supply capacity and in demand. Increasing capacity has long ceased to mean adding new factories, railways and skyscrapers; instead, it involves the difficult business of technological advancement and reallocation of resources to sectors with higher productivity. Maintaining political support for the reforms needed to make this possible has proved hard, even for a powerful leader like Xi Jinping. On the contrary, recent borrowing props up low-productivity firms and sectors that ought to have shrunk.

And if China were to succeed in boosting the supply side of the economy, demand might become a problem. Culling unproductive businesses would mean less spending and fewer jobs. Households would be obvious candidates for replacing lost demand, but progress on shifting to a more consumption-based growth model has been slow and has relied in part on increasing levels of household debt. Besides, setting monetary policy in such a way as to reduce borrowing by weak firms but encourage household credit growth is tricky. Rising household incomes

could help, but China has had difficulty in achieving this; household incomes as a share of GDP have fallen since 2016.

If China's exchange rate were to weaken sufficiently, the increase in sales to foreigners could help offset weak domestic demand. But that risks enraging America, and encouraging Mr Trump to intensify his trade war. A drop in the yuan would also add to the financial stress on Chinese firms with large dollar-denominated debts. And China exporting its way out of trouble might place an undue burden on the rest of the global economy.

In the past, rich countries could shrug off the sort of adjustments in emerging markets that appear to be looming. But times have changed. China's last real economic dip occurred during the financial crisis, when the entire world was reeling. The last serious growth hiccup before that was after the Tiananmen Square unrest in 1989. At that time Chinese GDP was about 4% of the global total; now it is 19% (measured at purchasing-power parity, or PPP). Over the same period emerging markets' share of world GDP has risen from 36% to 59% at PPP. Those markets could cause a downturn in the global economy all by themselves.

Yet not everything is rosy in the rich world either. Although the euro-area economy enjoyed faster growth in 2017, the boom has since cooled, even as the European Central Bank (ECB) has moved toward monetary tightening. An end to quantitative easing by the ECB, set for the end of 2018, and the prospect of rate increases, probably would not be enough to endanger the euro-area recovery. But an end to asset purchases could make markets react faster to political changes that threaten to reignite the euro crisis.

Italy, in particular, is a ticking time bomb. The election of a populist coalition in March rattled bond markets. With Italian government debt at around €2trn, or 130% of GDP, it would not take much to set off a new crisis, which would be extremely difficult to control. Panic in Italy might radiate out across financial markets, putting a chill on investment and growth worldwide.

America has its own vulnerabilities. The ratio of non-financial corporate debt to GDP has reached an all-time high of more than 73%. A worryingly large share of recent borrowing has come in the form of leveraged loans, an alternative to bonds. The business is reminiscent of the mortgage-backed security market which featured prominently in the global financial crisis. Investor demand for such securities has rocketed in recent years, because payouts vary with interest rates, which have been rising. The size of the market has doubled since 2010, to more than $1trn, and is now nearly as large as the market for high-yield bonds. Expansion in lending has come at the expense of credit standards. The share of new leveraged loans considered to have weak protections against default is growing; in the first quarter of 2018 it exceeded 80%.

Despite the parallels with pre-crisis mortgage lending, a meltdown in this market is unlikely to generate the same havoc. But an outbreak of defaults could contribute to a rapid contraction in lending to firms and a tightening of credit—sufficient,

perhaps, to touch off a new American recession. One of the lessons of the crisis is that panics can be caused by things hidden until it is too late.

One such surprise might be a rise in the cost of oil. Prices have crept up over the past year, from $50 per barrel to around $80. Politically generated disruptions to supply in Venezuela and Iran could strain the market further. A number of other black swans may be heading upriver even now. Costly frauds may be hiding within underexamined corporate balance-sheets. Elections could go one way not another. Global pandemics might erupt.

Once credit, spending and optimism have reigned for a time, the interplay of foreseen and unforeseen circumstances may cause them to stop doing so. At that point behaviour which seemed reasonable and responsible will start to look like folly, the "crazy projects" of the world will seem unconscionably reckless, and the world will be in trouble again.

Correction (October 12th 2018): *The original version of this article claimed that Italian government debt was around €200bn. We should have said €2trn.*

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