Flash Economics

09 August 2018 - 886

Risk of a financial crisis: Could it stem from the Federal Reserve's rate hikes or from the fact that other central banks are not raising their interest rates?

There is often concern about the risk of a financial crisis (debt crisis, emerging crisis, falling asset prices) linked to a possible excessive increase in the Federal Reserve's interest rates. But perhaps the risk of a financial crisis is rather linked to the fact that other OECD countries (euro zone, United Kingdom, Sweden, Japan, Canada) are not raising - or barely raising - their interest rates, thereby enabling a continued increase in debt and asset prices?

In other words, is it still time to hike interest rates to prevent financial imbalances and a financial crisis (US strategy) or is it already too late and should central banks refrain from raising interest rates since rate hikes could trigger a financial crisis (other countries' strategy)?

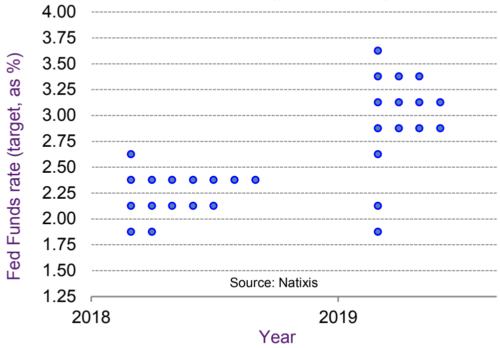
Patrick Artus
Tel. (33 1) 58 55 15 00
patrick.artus@natixis.com
@PatrickArtus

www.research.natixis.com

The risk linked to the Federal Reserve's rate hikes

Chart 1 shows **the projection of hikes in Fed Funds rates** announced by the Federal Reserve itself.

Chart 1
United States: Forecast of Fed Funds target by FOMC members (13 June 2018)



Many observers are concerned about **the risks linked to an excessive rise in interest rates in the United States**: end of bond issues by companies that finance share buybacks **(Chart 2)** and therefore falling share prices; declining real estate prices **(Chart 3A)** and rising defaults on mortgage loans **(Charts 3B and C)**; rising default rates on consumer loans **(Charts 3D** and **E).**

Chart 2
United States: Net issuance of equities and bonds by non-financial corporations (as % of nominal GDP)

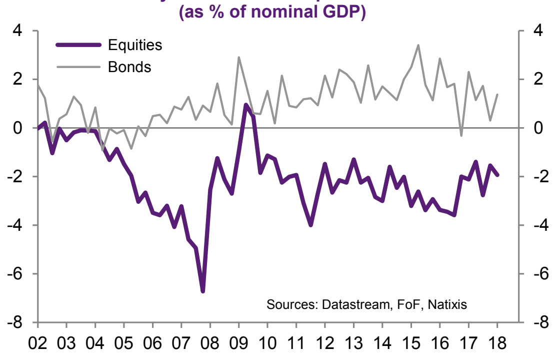


Chart 3A
United States: Real estate prices (2002:1 = 100)

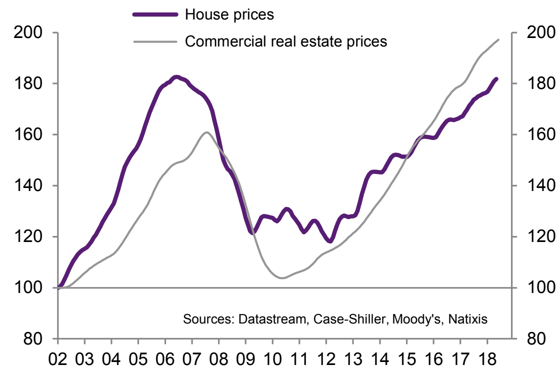


Chart 3B
United States: Mortgage default rates (as %)

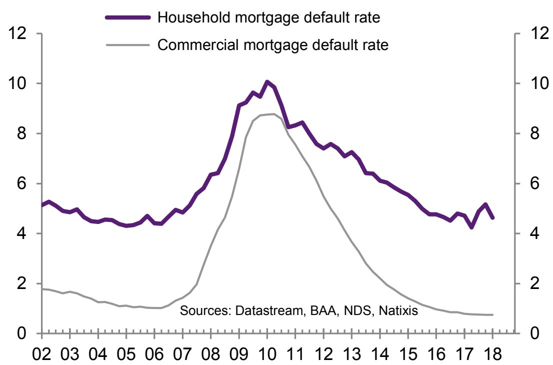


Chart 3C
United States: Outstanding loans (in USD bn)

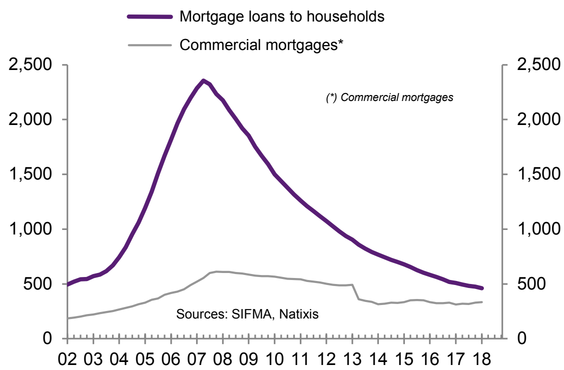


Chart 3D
United States: Household default rate (as %)

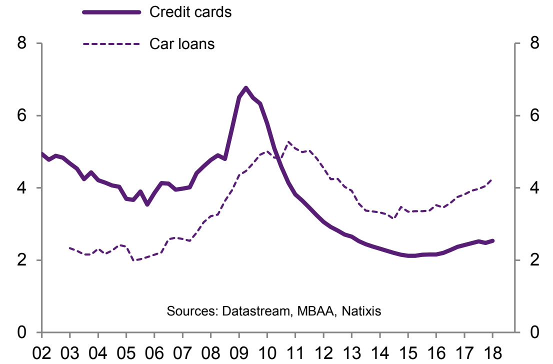
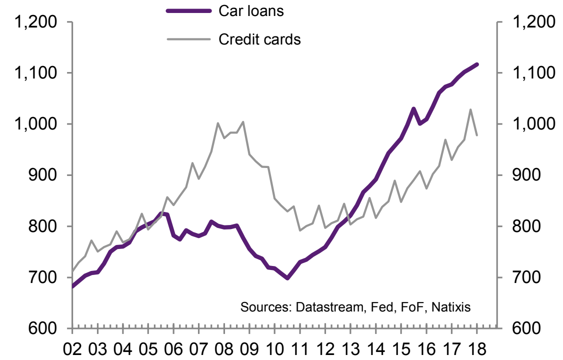


Chart 3E
United States: Outstanding loans (in USD bn)



There is also concern that a sharp rise in US interest rates **would amplify capital outflows from emerging countries (Charts 4A** and **B),** thereby leading to **a liquidity and currency crisis in emerging countries**; we can now already see a marked depreciation of emerging countries' exchange rates **(Chart 4C).**

Chart 4A
Emerging countries as a whole: Purchases of equities + bonds by non-residents (USD bn)

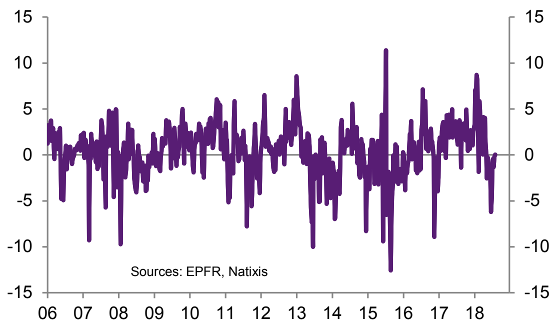


Chart 4B
Emerging countries as a whole: Purchases of equities + bonds by non-residents (USD bn)

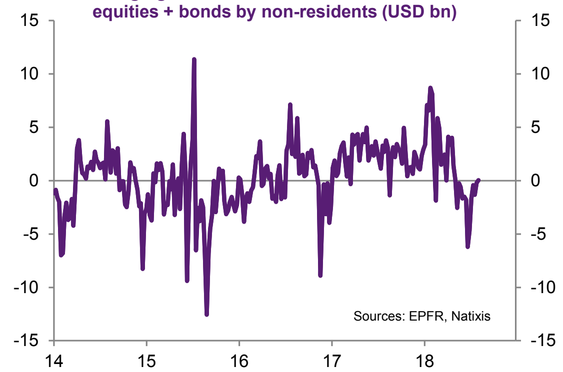
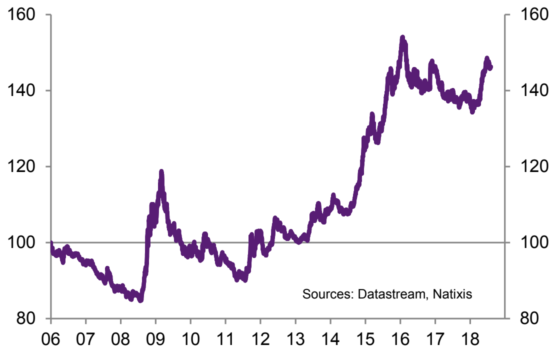


Chart 4C
Emerging countries as a whole excl. China: Exchange rate against the dollar (2006:1 = 100)



But we should also be concerned about the countries where central banks are not hiking their interest rates

In the euro zone, Japan, Canada, Sweden and the United Kingdom, central banks, unlike the Federal Reserve, **have not - or almost not - raised their interest rates (Charts 5A** and **B).**

Chart 5A
Central banks' key interest rate (as %)

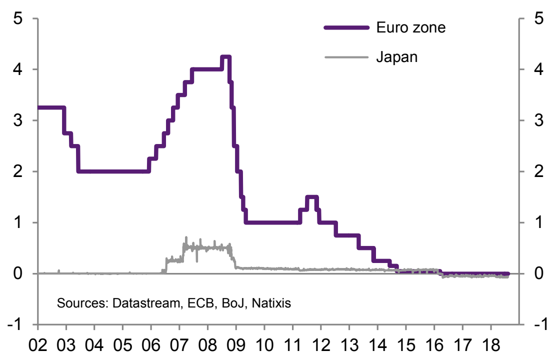
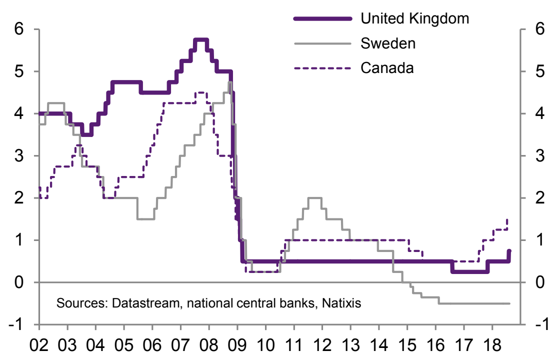


Chart 5B
Central banks' key interest rates (as %)



This behaviour may also trigger a financial crisis. The reason is that if interest rates remain very low, financial imbalances gather momentum:

- Increase in corporate debt in Sweden, and in household debt in Canada and Sweden **(Charts 6A** and **B).**

Chart 6A
Corporate debt (as % of nominal GDP)

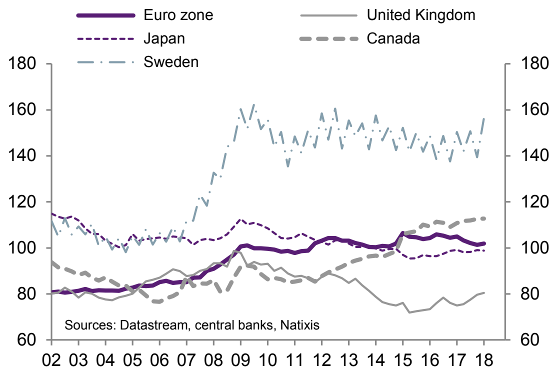
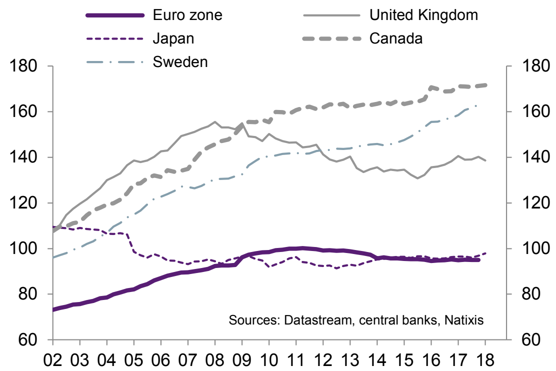


Chart 6B
Household debt (as % of household GDI)



- Rise in real estate prices **(Charts 7A** and **B)** in Canada, Sweden, the United Kingdom and Japan (residential real estate), and in the United Kingdom (commercial real estate).

Chart 7A
House prices (2002:1 = 100)

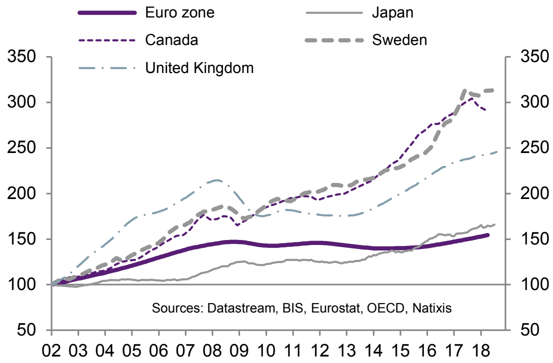
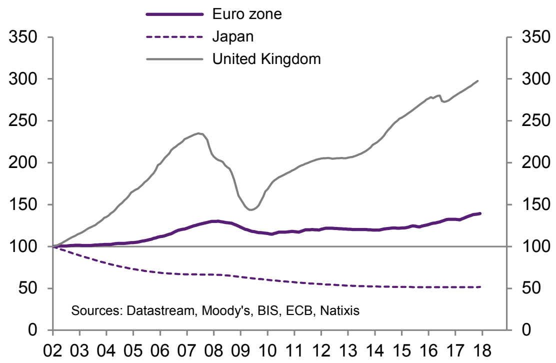


Chart 7B
Commercial real estate prices (2002:1 = 100)



Conclusion: The key question is whether it is too late to raise interest rates?

Could a financial crisis be triggered by the increase in interest rates in the United States or by the lack of rate hikes in other OECD countries (euro zone, United Kingdom, Canada, Sweden, Japan)?

The key question is therefore as follows: **is it too late to raise interest rates?**

If the answer is yes, i.e. that the financial imbalances (high debt and asset prices) are already too significant and that raising interest rates may trigger a crisis, it is then the Federal Reserve's policy that is dangerous.

If the answer is no, i.e. that it is still time to prevent financial imbalances from worsening, it is then the other central banks' policy that is dangerous.

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