

DIMITRIS N. CHORAFAS

FINANCIAL CYCLES

Sovereigns, Bankers,
and Stress Tests

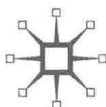


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Stress Tests**

Dimitris N. Chorafas

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First published in 2015 by

PALGRAVE MACMILLAN®

in the United States—a division of St. Martin's Press LLC,
175 Fifth Avenue, New York, NY 10010.

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ISBN: 978–1–137–49797–0

Library of Congress Cataloging-in-Publication Data

Chorafas, Dimitris N.

Financial cycles : sovereigns, bankers and stress tests /

Dimitris N. Chorafas.

pages cm

Includes bibliographical references and index.

ISBN 978–1–137–49797–0 (hardback : alk. paper)

1. Business cycles. 2. Financial crises. 3. Finance. 4. Monetary policy. I. Title.

HB3722.C463 2014

338.5'42—dc23

2014037907

A catalogue record of the book is available from the British Library.

Design by Newgen Knowledge Works (P) Ltd., Chennai, India.

First edition: March 2015

10 9 8 7 6 5 4 3 2 1

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Preface

As financial positions expanded, economies became more vulnerable to adverse and unexpected developments, many of which took place outside the usually six to seven years of a business cycle. Nikolai Kondratieff, a Russian economist, developed the theory of long waves of up to 50 years, incorporating in it an extended cycle of innovation and upward thrust, despite the setback of recessions, followed by a longer era of decline that business cycles classically admit.

In the background of the *financial cycle* lies the fact that, in this longer run the trend of growth would eventually exhaust itself while recovery requires a consolidating period which, compared to the good years, represents depression and retrenchment. This pause is necessary before the economy can regain self-confidence; hence, vigor and growth. This is the concept underpinning the Kondratieff cycle. Other economists, like Arthur Burns, the former chairman of the Federal Reserve, identified the long swings of up to 25 years, when economic growth and capital formation:

- First reaches a peak, and
- Then retreats to an era of slower expansion, and eventually deleveraging.

Neither should the role played by human capital be underestimated. According to Paul Volcker, the former chairman of the Federal Reserve, as the long financial cycle is unfolding, its duration is crucially influenced by what is inside people's minds: the psychology of investors, consumers, businessmen, and government executives. Peoples' reactions vary:

- They could be disappointed and try to preserve the status quo by aggravating the crisis,
- Or, they may adjust to the inevitable and accept the more modest prospects imposed by the new economic conditions characterizing the lower part of the cycle.

It should not escape attention that in the 50-year cycle are included two successive generations of economists and market players, with plenty of psychological effects coming into the picture. The third generation that follows the 50 years of a financial cycle has practically forgotten the lessons of the past and is more likely to repeat the same wrong-way moves and mistakes. This is also happening, though at lower intensity, with the 25-year cycle.

If economists, market players, politicians, and bureaucrats fail to honor the limits to growth, *then* the economy is destined to suffer turmoil and a greater crisis. Essentially, the statements of Volcker, Burns, and Kondratieff have been articulating a classic perspective of central bankers that dictates the choice of order and financial stability, hence moderation of aspirations aimed at rebuilding the economic infrastructure.

Written for an academic readership and addressing itself to the new generation of economists, this book concentrates on three areas that have not yet entered the mainstream of economic thinking, but are not far from doing so. The one is the impact of the longer-term financial cycle; the second is the beginning of de-globalization as the world enters an era of iron-clad economic blocks; the third is the new structure of analysis that, to a significant measure, involves stress testing the financial staying power of credit institutions.

As far as de-globalization is concerned, after nearly seven decades of an effort directed toward globalization, the trend has changed as the financial and political world started to split into economic blocs. This emerging policy of de-globalization is not a faraway future. It is a reality imposed by political authorities that are changing the rules.

It is too early to say how far it will go, or whether it will reverse itself. At the beginning of World War I the German kaiser queried what a quarter of a million-strong Swiss Army would do if faced with an invasion by half a million Germans. A Swiss militiaman replied, "Shoot twice."¹ De-globalization is that second shooting. We shall see the results.

The study of an increasingly complex economic and financial environment also requires a new structure of analysis. This is still in the making. It is provided by asset quality reviews of the banking industry made by central banks and supervisory authorities, and most particularly by way of stress tests. The need for a rigorous financial analysis is most widespread because, like the mountains of debt, uncontrollable risks have become a most corroding malady of our generation.

* * *

Chapter 1 explains the concept underpinning financial cycles, bringing to attention the fact that many of the notions behind it are subject to an

ongoing evolution. The interest in financial cycles comes from the fact that, by being longer term, they incorporate economic forces at work that are poorly accounted for in classical business cycles. The text outlines the reasons why financial cycles are vital particularly in connection with the study of a sophisticated economy, and it provides a snapshot of the most important methods and tools for their analysis.

One of the basic reasons for the examination of the background and foreground forces affecting a financial cycle is to promote financial stability. This is the theme of chapter 2, which outlines current efforts to ensure financial stability, like the institution of a Financial Stability Board, and demonstrates that nineteenth-century economic theories applied by socialist regimes are unfit for today's problems and are counterproductive. One of the focal points brought to the reader's attention is the connection between financial stability and sovereign budgets.

The seven decades that have elapsed since the end of World War II have been characterized by economic globalization. This process is now being reversed as *de-globalization* forces gain the upper ground. Practically all major industrial economies try to change the rules of the game to their advantage. Chapter 3 starts with a historical review of reserve currencies, which have provided globalization's common ground; brings attention to socioeconomic problems characterized by unfunded liabilities; explains why globalization is undermined by parochial agreements like the TTIP; and discusses the likely future of the New Development Bank of BRICS—a competitor to the IMF.

Antiglobalization is boosted by the rapid rise of novel economic and financial forces like shadow banking, the uncertain trumpet of cross-border macro-prudential supervision, and the development of regional resolution regimes. Chapter 4 examines the impact of such ongoing developments, in parallel with unorthodox policies by central banks that fill their vaults with the toxic waste of profligate government bonds. It also brings in perspective the renewed risk from questionable securitizations that, a short seven years ago, pushed the Western economies to the precipice.

Chapter 5 concentrates on the economic aftereffects of the rising mountains of public debt. It discusses why this practice is undemocratic and unwarranted. Eventually all citizens, and most particularly a country's economically weakest members, are going to pay for it. "We must tax the poor, they are the most numerous," said André Tardieu, a former French socialist prime minister.

Returning to the theme of financial stability, discussed in chapter 2, chapter 5 demonstrates that a policy of steady budget deficits is wrong. Its existence is a clear sign of a democracy in terminal decline. The infective virus of exploding public debt has infiltrated all Western sovereigns. Italy

and France are basket cases, Greece went bankrupt, and the United States is confronted by a guesstimated \$300 trillion of unfunded liabilities (*How* and *why* are explained in the chapter).

Goldman Sachs said that Italy's slam amplifies its public debt woes. The installation and steady expansion of modern welfare systems have failed to account for their longer-term affordability. A way of life built around endowments has required high and expanding levels of income, as well as a significant degree of confidence about the future. But this is exactly what is collapsing, taking along with it the personal freedoms that, after World War II, characterized Western society.

While engaged in accumulating debt, sovereigns have failed to consider whether or not they are able to serve it, and which ways and means they have available to confront their obligations. The theme of chapter 6 is debt sustainability, starting with the fact that, whether they know it or not, overindebted countries are abandoning their economic sovereignty. Public debt affordability is a complex notion that combines "easy solutions" with the absence of prudence in managing the country's wealth. Venezuela is taken as a case study of the new financial cycle, with emphasis on both borrowers' and lenders' vulnerabilities.

The close connection characterizing many of the activities of sovereigns and of big banks mandates the need for a close look at the status of the banking industry. Chapter 7 explains what is special with banks, the problems they encounter with past-due loans, the different questionable policies that make a mockery of banking as social service, and the new income sovereigns derive by prosecuting the banks—a practice that started in America and has now spread to Europe.

The fact that the banking industry is not out of the long, dark tunnel it entered in 2008, mandates a close look at its financial health. Risk analysis can be promoted by stress testing, provided that such tests are both pragmatic and honest. As chapter 8 brings to the reader's attention, this is not always the case. There are prerequisites to stress testing that are not necessarily observed. The results of testing for exposure to default are often bent to hide a bad situation. Belatedly, both the Federal Reserve and the European Central Bank warn of tougher stress tests. We shall see the outcome.

Chapter 9 is a continuation of chapter 8 and provides the reader with case studies. One of the case studies concentrates on what happens, and what could happen, with loans to governments. Another revolves around the interpretation and manipulation of risk-weighted assets. A third looks into the reasons for the recent virtual bankruptcy of Banco Espírito Santo, Portugal's biggest bank by assets. A fourth examines the likelihood of interbank contagion. The common ground of these case studies is the

search for rigorous accounting standards that can contribute to transparency and an effective risk control.

Banks can fail and the bankruptcy of a big and complex financial group may create havoc in the economy. It could even unravel the common currency shared by a number of sovereign states and their banks. In recognition of this fact and in order to avoid its aftereffects, Euroland has worked on systems and procedures of a banking union, the subject of chapter 10. This European endeavor is far from being perfect, as the harder-working sovereigns seek to protect themselves from undue exploitation by the profligates. There is as well the question of whether or not a single supervisory mechanism is the solution for repairing damaged balance sheets and for implementing structural reforms.

The message to retain from this book is that to overcome the more narrow limits of the business cycle, we need to go beyond its traditional six to seven years focus and address the longer term. This includes the analysis of economic risks characterizing the *financial cycle*, as well as the appreciation of forces underwriting both the cycle's growth and its decay. An ever-increasing public debt and the behavior of the banking industry are two principal reasons why the structure of analysis that served the previous financial cycle is no more adequate for present-day realities. A new methodology is starting to take shape, even if it still has to acquire political legitimacy.

* * *

I am indebted to a long list of knowledgeable people and organizations for their contribution to the research that made this book feasible. I am also grateful to several experts for constructive criticism during the preparation of the manuscript. Dr. Heinrich Steinmann and Eva Maria Binder have, as always, made significant contributions.

Let me take this opportunity to thank Leila Campoli for suggesting this project, Erin Ivy for seeing it all the way to publication, and Bhavana Nair for the editing work.

September 2014

DIMITRIS N. CHORAFAS
Valmer and Entlebuch

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Financial Cycles

1. The Difference between a Financial Cycle and a Business Cycle

Ancient Egyptian mythology spoke of seven fat cows followed by seven lean ones. Unlike other accounts based on hearsay and traditions, this one had an evidence. The fat cows represented the good years when the assets of the king and the citizens increased; the lean cows reflected the misery associated with bad harvest, floods, and the destruction of wealth.

The Bible, too, speaks of cycles of decay and renewal, without making it explicit that they are integral parts of economic life. They have been so since the beginning of civilization, predating commerce, banking, and the early financial transactions. The invention of money and the structure of institutions specializing in creating and holding virtual assets, gave a new meaning to these cycles of decay and renewal.

Over the centuries economic life acquired its own momentum and the creation of excess reserves saw to it that those possessing significant wealth could not remain indifferent to the demand for loans. Economic historians developed the theory that this was for the better, because the existence of a capital base could act as lifesaver in lean times. Without it, something in the normal regenerative process would have been missing. The absence of a force promoting recovery from the business cycle's bottom would have deprived the economy of an upside.

The theory of the business cycle established itself on these premises that reflected the switches in the tempo and mood of business activity over a period of six to seven years. Typically, though not always, those swings between rich and lean years were influenced by a variety of more or less objective events that repeated themselves, but there have been as well less-tangible psychological factors.

Also, typically, the high time in the business cycle's pattern has been a period of prosperity that bred confidence and led to revised standards of what is prudent and what is risky. Good years led to risk-on policies, while

risk-off policies characterized the lean years. In the case of both renewal and decay, the underlying process was self-reinforcing but also contained some seeds of its own demise as:

- Natural limits to the trend supporting prosperity were reached,
- Excesses and extremes multiplied, battering the economy, and
- The prevailing risk-taking could not be sustained for much longer.

As financial positions expanded, economies became more vulnerable to adverse and unexpected developments, many of which went beyond the usual six to seven years boundary of a business cycle. In the early 1920s, Nikolai Kondratieff, a Russian economist, developed the theory of *long waves* of 50 years or so, incorporating in it an extended cycle of innovation and upward thrust, despite the setback of recessions, and followed by a longer era of decline than business cycles classically admit.

Economic historians suggest that in his theory Kondratieff was influenced by the record-breaking global boom from about 1850 to the early 1870s, followed by a couple of decades of lean years and of economic uncertainties. Though neither he nor other economists could give a satisfactory explanation of this long wave, he did point out that social and economic forces were propping it up.¹

Proposed for equities, Elliot's Grand Super Cycle theory is close to Kondratieff's long leg cyclical analysis. Elliot used statistics from financial assets prices. Some economic history books suggest that in an effort parallel to that of Elliot, the Russian economist had also looked into crucial fluctuations in commodities in terms of patterns characterizing financial instruments and their behavior.

In the background of these studies, and of theories based on them, lies the fact that the longer cycle of growth eventually exhausts itself followed by a chute. Recovery requires a period of consolidation, which, compared to the good years, represents depression and retrenchment before the economy can regain self-confidence; hence, vigor and growth. The long wave is the concept underpinning the "Kondratieff cycle." Other economists, like Arthur Burns, the former chairman of the Federal Reserve, too identified long swings of up to 25 years, when economic growth and capital formation:

- First reaches a peak, and
- Then retreats to an era of slower expansion, or deleveraging.

Neither should the role played by human capital be underestimated. Kondratieff's 50-year cycle represents two successive generations of

economists and market players with plenty of psychological effects coming into the picture. The third generation that follows the 50 years of a financial cycle has practically forgotten the decay earlier on in that period and therefore is more likely to repeat the same wrong-way moves and mistakes. This also happens, though at a lower intensity, with the 25-year cycle.

According to Paul Volcker, the former chairman of the Federal Reserve, as the long financial cycle is unfolding, its duration is crucially influenced by what is inside people's minds: the psychology of investors, consumers, businessmen, and government executives. Peoples' reactions vary:

- They could be disappointed and try to preserve the status quo by aggravating the crisis,
- Or, they may adjust to the inevitable and accept the more modest prospects imposed by the new economic conditions characterizing the lower part of the cycle.²

If economists, market players, politicians, and bureaucrats fail to honor the limits to growth, *then* the economy is destined to suffer turmoil and a greater crisis. Essentially, the statements of Volcker, Burns, and Kondratieff have been articulating the classic perspective of central bankers that dictates the choice of order and financial stability, hence moderation of aspirations aimed at rebuilding the economic infrastructure.

Volcker, Burns, and Kondratieff have seen the reasons why attention should be paid to the long wave. So did other economists, but the majority kept on working on the shorter-term, hence more limited, business cycle. This is attested by statistics.

It needs no explaining that to overcome the more narrow limits of the business cycle, we have to go beyond its traditional six to seven years focus and address the longer term, including the building-up and running-off of economic risks characterizing the long wave of the *financial cycle*. The impact exercised by the longer term underlying economic forces is much greater than it might seem at first sight, because it means shifting away from debt as the main engine of growth and targeting policies such as:

- Repairing balance sheets, and
- Implementing structural reforms.

Indeed, economies that escaped the worst effects of the most recent economic and financial crisis have more or less followed assets-based policies, with an eye on dampening the extremes by way of prudential monetary and fiscal frameworks. Ducking away from reform, the way