August 2016
Investment Publications Highlights

Risks Still in the Medium Range, But Pushed Higher by UK Referendum Result

US Treasury's Office of Financial Research, *Financial Stability Monitor*, July 2016

The US Treasury's Office of Financial Research (OFR) publishes a biannual report on US financial stability focused on five areas of risk: market, macroeconomic, credit, funding and liquidity, and contagion. The July 2016 report concludes that financial risks in the United States remain moderate, but investors should be aware of potential threats from a prolonged period of low interest rates and the United Kingdom's vote to leave the European Union (EU).

OFR believes risks to the US financial system have generally not changed since third quarter 2015, with the primary vulnerability remaining those risks connected to the market. Within the market category, asset valuations worsened and interest rates remained at the highest level of risk. US interest rates have declined to ultra-low levels, and many key foreign interest rates are negative. These low interest rates support excess risk taking, high equity prices, and high commercial real estate prices, leaving the US financial system at risk.

The Federal Reserve's 25 basis point target interest rate increase and the United Kingdom's vote to leave the EU have increased potential threats to financial stability in the United States. Although the UK referendum was too recent to be incorporated into OFR's rating system, instability in the United Kingdom or EU could impact the United States through trade, a hit to investor confidence, or financial exposure. According to OFR, 11.3% of US GDP is invested in the United Kingdom and 15.9% in the EU. Losses in either of these regions could hurt US investors.

While credit, funding and liquidity, and contagion risks remain in the low-to-medium range, they should not be ignored. Debt continues to outpace GDP and earnings growth. Credit is a $15 trillion sector, and a severe default cycle could lead to declines across risk assets. Looking at liquidity, current risks reside primarily in the potential for fire sales in repo markets or a run on prime money market funds, where the net asset value may appear stable, but is not protected by the government. And because contagion risks are activated by financial stress, they are difficult to predict.

Brexit and Euro-Area Banks: A Key Contagion Channel

Mark Wall, *Focus Europe*, Deutsche Bank Research, 8 July 2016, pp 3–11

In the short term, "Brexit" could lead to a sharp tightening of credit in an already fragile Eurozone banking system, jeopardizing economic conditions and political stability. Although government officials could take a number of measures to prevent financial instability, political and regulatory constraints likely stand in the way.

Eurozone banks' ability to accumulate capital and sustain lending growth has been hindered by depressed equity prices, both low and flat yield curves, and tight regulations. The uncertainty surrounding the fallout from Brexit will likely exacerbate these issues, potentially leading to a tightening of credit on par with the European sovereign debt crisis in 2012. In the short term, the focus should be on restoring confidence in the banking sector, especially in the more vulnerable Italian banking system, and restoring integrity in the EU.

In an ideal world, Eurozone officials could implement a number of measures to achieve these goals. For example, further capital tightening can be offset by reversing planned increases in banks' capital ratios, injecting Italian banks with cash by temporarily suspending state aid and bail-in regulations, or developing a Eurozone-wide deposit insurance plan. The implementation of any of these measures faces both political and legal constraints.

The proposition of Italy circumventing EU state aid and bail-in regulations would likely be met with the most resistance. Opponents of such action believe that making an exception for Italy will systematically weaken the rules. In addition, the perception that the rules are not being followed could boost support for populist parties in countries like Germany. Any credible plan must come to terms with the Eurozone's unique set of regulatory and political constraints. If a compromise is not reached quickly enough, Brexit could destabilize the Eurozone banking system, setting the European recovery back substantially and threatening the political sustainability of the EU.

The Financial Stability Risks of Ultra-Loose Monetary Policy

Grégory Claeys and Zsolt Darvas, *Bruegel Policy Contribution*, Issue 2015/03, March 2015

Ultra-loose monetary policies are intended to promote inflation and economic output, but they also pose risks to financial systems. The authors examine such policies in the United States, United Kingdom, and Japan to determine risks to financial stability in the Eurozone. Four specific policies to reduce financial-stability risks are proposed.

Financial stability can be defined as "a situation where the financial system can fulfill its main functions (of submitting payments, transforming saving into financing, and providing risk management) with sufficient resilience to disruptions that threaten these functions." Ultra-loose monetary policies—such as low or negative interest rates, quantitative easing, and forward guidance by central banks designed to increase inflation and boost output—may weaken financial stability. For example, in theory lower long-term real interest rates should lead to increased risk taking in the financial sector. These riskier corporate investments thus should increase financial-stability risk. In practice, the authors found the post-crisis low interest rates in the United Kingdom and United States did not lead to excessive risk taking by banks.

Other potential side effects of ultra-loose monetary policies include: increased use of leverage, increased asset prices leading to bubbles, insurance company asset deterioration, and volatile capital flows to and from emerging markets. However, the authors argue the empirical data show these potential negative side effects have had little impact on financial stability in the post-crisis environment. Further, some potential side effects are positive, such as an improved economic outlook, increased profitability for non-financial corporations, reduced unemployment, and reduced likelihood of a sovereign debt crisis. This does not mean unnecessary risk to financial stability has been optimally reduced.

The authors propose four types of policies to minimize financial-stability risks: (1) tightening regulation of financial institutions, (2) tightening regulation on system-wide borrowing and lending, (3) ensuring financial-stability regulators work alongside fiscal policy authorities, and (4) regulation of bubble-prone industries such as construction. Financial-stability risks may not be able to be eliminated altogether, but taking action to reduce these risks with these additional policy tools should help. ■

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