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The Chances of a Global Meltdown

Investors have reasons to be fearful—but not terrified. Here’s what to expect in the rocky months ahead.

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Are we headed for another global financial crisis? The market convulsions of the past week reflected a continuation of a market selloff that began on the first trading day of 2016. Investors have reasons to be fearful—but not terrified.

This year is likely to be one of financial crises in industries and countries around the world. Whether those turn into a global financial crisis is an open question, and the answer will likely turn on the health of the U.S. financial industry and broader economy. No crisis is global if American financial markets hold up. The best I can foresee, at this moment, is that a true global financial crisis is not likely.

Pundits are focused on collapsing oil prices, which reflect the technological revolution in production among nimble private producers, combined with weakening global demand for their product. The result has been layoffs in the energy industry, and there will be more. Weak and highly leveraged energy firms have gone bankrupt and more will. But bankruptcy doesn’t necessarily mean that production will decline.

Creditors who lent to these energy producers will suffer losses on their loans, and they too might become financially impaired. If past is prologue, those lenders will be reluctant to fully realize their losses, and they will continue to view future energy prices through too-rosy glasses. Banks will be reluctant to mark down the value of nonperforming loans and book losses, or even set aside sufficient loan loss reserves. They will instead “extend and pretend”—i.e., extend maturities and pretend they expect the loans to be paid back. Will federal and state banking regulators aid and abet the process? They have in the past, and rumor is that they are already doing so today.

The problem with extend and pretend is that it allows losses to accumulate. When they finally must be realized, they are larger than they would have been, and some financial firms will collapse. This happened in the Texas banking crisis of the 1980s and the nationwide savings-and-loan crisis of the 1980s and ’90s. I am not predicting another banking crisis—but pointing to the folly of extend and pretend.

Regulators need to apply prompt corrective action to overextended lenders. New capital must be injected by investors into solvent banks, but those that are insolvent or too weak to survive must be closed.

In addition to the world-wide oil glut, which will continue in 2016, another important factor in the story is the strong U.S. dollar. The dollar is at a near-term high against an index of other currencies. This reflects, at least in part, trends in monetary policy. The U.S. Federal Reserve implemented a long-expected, modest increase in short-term interest rates in December, while other major central banks, like the European Central Bank and the Bank of Japan,are easing their monetary policies. The Fed's action is seen as a prelude to a series of interest-rate increases. That would further strengthen the dollar.
However, oil is priced globally in dollars. When the dollar is getting stronger, oil becomes more expensive for other countries, who have to sell more of their own currencies to afford it—and this dampens their demand, putting further downward pressure on oil and other commodity prices. In addition, a stronger U.S. dollar makes it more expensive for other countries to buy U.S. goods, lowering U.S. exports.

A strong dollar also means that those who borrowed in U.S. dollars but earn income in other currencies are stressed to pay back their dollar-denominated debts. Emerging-market countries (governments and private borrowers) were heavy borrowers in dollars and are at risk of default on these debts.

In their 2009 book on financial crises, "This Time Is Different," Carmen Reinhart andKenneth Rogoff observed that countries are more prone to default on foreign-held debt than debt held by their own citizens. Especially at risk are energy-producing, emerging-market countries as they have been hit by a double whammy: steep drops in the price of their leading export and rising debt-servicing costs in dollars.

I am not going to predict which specific countries are likely to default because there are many variables, including the varying political situations. Default is as much a political decision as an economic necessity. But one country illustrates the ramifications for the U.S. of a default. Brazil is a large, emerging-market debtor. U.S. banks had $89 billion worth of loan exposure to Brazil as of the middle of last year. That debt was likely concentrated in a few large institutions.

The Fed's monetary policy of extraordinarily low interest rates helped create the asset bubbles in stock and commodity prices that are now bursting. Low rates also distorted investment decisions. I have argued for the Fed's increasing interest rates much sooner. Now the Fed has made a tentative step forward on rates. It has done so, however, with incredibly bad timing—with the dollar already getting stronger and the global economy weakening. The Fed is worried about energy-industry loans. But how can oil prices recover with a rising U.S. dollar?

In retrospect, the Fed's rate hike last month will likely be viewed as monetary malpractice. The next hike is on hold, and there is already talk of another round of quantitative easing. None of this is likely to forestall turmoil in credit markets. Investors are wise to be worried, but it's likely that 2016 won't be a replay of 2008.

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