



Candidates for the next Financial Crisis

In this section we'll highlight some of the potential candidates for the next financial crisis. This is far from a prediction that they will occur but merely to show where some of the stresses are in the financial system and ones that could create global financial and economic problems. The list is also not exhaustive. Crises and shocks by their nature are unpredictable and while we might be right that the current system is crisis prone, we may be missing a brewing problem elsewhere under our noses! So we're more confident that crises can't be avoided in this global financial framework rather than confident of where they'll occur next. Nevertheless, there are places we can look to and the following section details where vigilance and prudence are required.

The Great Central Bank unwind

When looking for the next financial crisis, it's hard to escape from the fact that we're seemingly in the early stages of the 'great unwind' of global monetary stimulus at the same time as global debt remains at all-time highs following an increase over the past decade – at the government level at least – which has been unparalleled in peacetime history. Not only are interest rates starting to rise (e.g. US, Canada), but the Fed is about to start running down its balance sheet with the ECB likely to soon announce that the tapering of QE will continue in 2018.

Working in financial markets on a day to day basis it's easy to become blasé about the size of central bank balance sheets. You slowly become anchored to believe the current situation is normal as it's persisted for so long now. However it's anything but normal. Since the financial crisis, \$10 trillion plus has been added to the balance sheets of the four largest central banks with over \$14 trillion of assets now owned. Since a local trough in March 2015, the ECB alone has added around \$2.3 trillion to its balance sheet. To put these numbers into some perspective, the annual output of China - the world's 2nd largest economy and consisting of 1.4 billion people - is around \$11.2 trillion – not far off the balance sheet increases of the big four central banks since the GFC. Putting the ECB's increase over the last three years in some context, the French (6th largest in the world) and Indian (7th largest in the world) economies - consisting of 64.7 million and 1.3 billion people respectively – produce an annual output of \$2.5 trillion and \$2.3 trillion respectively. So in just over two years the ECB has printed the same amount of money that it's taken the whole 1.3bn Indian population to produce economically in a year. Mindboggling numbers.

Figure 32 shows the real adjusted balance sheet size of the largest four DM central banks through history. The Fed and BoE both have data starting from 1914, while the Bundesbank has data from 1957 to 1999 (scaled up to the ECB's balance sheet size as of Dec 1998) and the ECB then from 1999 and finally the BoJ from 1971 onwards. It clearly shows how unique this current situation is relative to history and it has to be the case that this makes the financial system more unstable as a result. We also show just the Fed and BoE data as these two have a series going back at least a century whereas the first chart has data patched in where appropriate. The Bundesbank data clearly starts after the Weimar Republic money printing experiment of the 1920s so the second chart is perhaps a more faithful account of how unusual the last decade has been.