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Special Report: Surviving the Next Crisis

- Since the financial crash in 2008, the world been almost in constant anticipation of the next crisis, but what would this crisis look like?
- In this special report, we analyze what forms could next crisis take and what developments could ignite it. For example, exit of Britain from the EU, *Brexit*, could be a trigger for a renewed crisis, but only if it leads to wider speculation about the future of the European project.
- We also draw attention to the measures investors and individuals could do to shield their assets in the case of crisis.
- We forecast that the economy of Finland and that of the Eurozone will grow 1.9 and 1.3 percent this year. The US economy is forecasted to grow by 2 percent.

Recovery of the world economy seems to be gaining momentum. In Table 1, we present the *nowcasts* and the growth forecasts for the real GDP of the Eurozone, Finland, and the United States under a consensus scenario.

Table 1. *Nowcasts* (nc) and forecasts for the growth rate of real GDP in the US, Eurozone and Finland. Source: OECD, Bureau of Statistics and GnS Economics.

Quarter	Finland	Eurozone	USA
2016:1	0.6	0.55	0.21
2016:2 (nc)	0.34	0.17	0.64
2016:3	0.50	0.27	0.55
2016:4	0.49	0.32	0.58
2016	1.9	1.3	2.0
2017	1.8	1.2	2.3

These forecast show that the recovery accelerates, especially in Finland, whose economy is expected to grow by almost 2 percent this year. This is a big increase from our previous forecast (Q-review 1/2016) where we forecasted the Finnish economy to grow by only 1 percent in the current year. We also forecast that the recovery in the Eurozone will gain some more momentum with the expected real GDP per capita growth of 1.3 percent for this year. The US economy is expected to grow by 2 percent.

Despite of the improving economic climate, uncertainty about the future of world economy is increasing. Within the last two months, there has been increasing demand for so called safe assets, like the bonds of the US and German governments and gold. Referendum on euro-exit in Britain has also increased uncertainty in the markets. Thus, the risks of a crisis seem to be increasing, but what kind of crisis would it be?

Economic crises are as old as human civilizations. The earliest known crises date of the Bronze Age and were usually caused by some dramatic *exogenous* events, like droughts or wars. The earliest known sovereign debt crisis was the default of thirteen city-states of Greece concerning their debt to the Temple of Delos (with 80% loss of the principal) in 377 B.C. The first known financial crisis was the crash of banks owned by the families Peruzzi and the Bardi in 1345.

Forecasting the future is always extremely difficult (nearly impossible) task, especially what comes to the onset of crises. Something of their nature can, however, be encapsulated from the past developments. Extreme income inequality has, for example, often been the main culprit behind political and economic chaos. In addition to the *exogenous* events mentioned above, fraudulent behavior, indebtedness, persistent macroeconomic imbalances, and major mispricing of risks are usually present before major financial disruptions.

Currently, governments, banks, corporations and households are highly indebted and income inequality is high. According to some reports, fraudulent behavior is increasing and the world has witnessed some severe macroeconomic imbalances during the early part of the new millennium. Above all are the extreme measures of central banks that have altered prices and therefore risks of the majority of financial assets currently traded in the world market. Thus, based on academic research and historical developments preceding earlier crises, we are living in world with high or at least increasing likelihood of a crisis.

The onset of an economic crisis usually requires a *trigger*, that is, an event that suddenly and abruptly changes the expectations of individuals and market participants for the worse. After the "trigger has been pulled", leverage will be dismantled, consumption will fall, pushing economy to a recession. If imbalance is large enough and risk mispriced to a great extend (compare the crash of 2007-2008), a financial crisis will ensue.

Currently, and alarmingly, world is full of potential triggers. Unconventional means of the central banks have pushed the risks of several asset classes to the far ends of probability distribution, indicating that the risks of these assets have become, in practice, invisible. Asset prices have been known to over-shoot in booms-and-busts, but this time central banks, not markets, are under-pricing the risks. This makes the situation considerably more worrisome than before, because the decisios of central banks are hard to predict and they are subject to political pressure. Chinese economy is in a state of disarray and it is highly uncertain how it can cope, both economically and politically. Misplaced investments may lead to full blown crisis, which would have repercussions in the vulnerable world economy. European banking sector is still in dire straits and its situation has been made worse by the zero or below zero interest rate policies of the ECB. In some countries of the Eurozone, non-performing loans are astronomically high. Balance sheets of major banks include unknown amount of failed or "junk" assets, which are not yet been written down. Thus, the crisis could start from a sudden collapse of one, two or more major European banks.
Geopolitical tensions have risen in many parts of the world. Escalating conflict in the Middle-East, Asia or, in the unlikeliest but the most dangerous case, in Europe could easily trigger a "run for the door" reaction in the markets. Britain leaving the EU, *Brexit*, could be a potential trigger as its ramifications are completely unknown.There is no plausible way to estimate the economic effects of Brexit, because they are determined by political decisions made after the fact. If it would bring down the common currency or the EU, global financial order would be shaken to the core. In the markets, there is, however, very little indication of such panic. Brexit can also lead to a tighter union, which can be good for the markets, although it could lead to undermining national sovereignty and democracy.

How would a crisis evolve? This crucially depends on the onset of the crisis. Probably the most likely scenario would be the collapse of a major bank leading to a "Lehman-style" panic in the markets. Central banks would act to minimize the costs and government would make efforts to wind the troubled banks down in a controlled manner. However, this could have already ignited a run in commercial paper and/or other financial markets, where banks and financial institutions obtain funding. Interbank markets would freeze and restriction first on cash withdrawals and then maybe even on deposits would follow. After this, crisis could take one or more forms. In the best case, winding down of troubled banks would succeed, credit would become restricted and real economy would stumble, but there would not be signs of systemic breaking of the financial structure. Crisis can also mutate so that the only way to save the banks will be through extended bank holidays or even through confiscation of some proportion of deposits of ordinary people. Collapse of the global financial system could lead to food shortages as cargo would stay on ports, because customers could not pay and/or cover shipments of their goods, which are often done using different financial instruments, like *forward freight agreements*. Transferring cargo would be impossible without a functional financial system. Lack of food and cash would lead to riots and to onset of martial law. Some civil rights could be suspended to stem the rise of social unrest and anarchy. In the worst case, a full police state would be implemented. Because central banks have only limited means to stimulate the economy and the means they still possess, including the *helicopter drops* of money, could do more harm than good (see Q-review 1/2016), world economy could face several years or even decades of zero or negative economic growth.

How likely are these developments? We estimate that the likelihood of an onset of a global financial crisis within the next 12 months is 55 %. However, going from a global financial crash to systemic crisis, with a fall of political order and on the edge of anarchy requires several bad decisions from all the major industrialized societies. For example, the idea that banks should be saved at any cost, is futile. They can be winded down or even let to crash as long as governments are willing to bailout most of the depositors and setup a required number of new banks and the financial structure. Iceland showed that this can be done within a single country and their recipe can be extended to multitude of countries although the task will get more burdensome with the number of major global banks failing.

If global economy would face a crash threating systemic stability, there are also several measures that could be taken to limit its effects. First of all, countries should never (ever) cease to issue and use cash. It is the only publicly accepted and safe mean of payment and in a systemic crisis it will become the only mean of payment. Countries without cash will be hit hardest. Although commercial banks are responsible for the creation of money in modern economies, governments can always start to issue cash and even provide banking services. Every country should also hold self-sufficiency in transportation, food and power generation. Citizens should not rely only on bank accounts and cards, but to keep a sufficient amount of cash at hand for extended periods of bank holidays. This became self-explicatory evident during the Greek crisis in the summer of 2015. Just within a period of two days, modern financial system ceased to exist in Greece and counry reverted to a pure cash economy. As long as people and businesses have access to cash, economy will find its way. Shortages of food, gasoline, etc., may arise, but if social cohesion is prevailed, the effects of all these can be mitigated. If systemic crisis erupts, basically the only safe asset is land (assuming that private property rights are maintained and enforced). Like the common wisdom goes, it cannot be produced and it provides the crucial building blocks of human civilizations, including food and raw materials. Owning physical gold is an extreme safe asset during a systemic crisis, although its usefulness as a mean of payment is questionable.

Fundamentally, the severity of the next crisis will be dictated by people. People, not governments or banks, run societies and they can always decide the form it takes. When the financial system of former Soviet Union countries collapsed, people resorted to alternative means of payments, including clothes, food and *i-owe-you*'s, and prevailed. At the end, like during all major crisis in human history, endeavor and perseverance have decided the faith of societies. There is doubt that they will do so also in the future.

Appendix: Growth forecasts under a crisis scenario

Table 2 presents the *nowcasts* and the growth forecasts for the real GDP of the Eurozone, Finland, and the United States under a crisis scenario, where the crisis erupts early next year.

Table 2. *Nowcasts* (nc) and forecasts for the growth rate of real GDP in the US, Eurozone and Finland in a crisis scenario. Source: OECD, Bureau of Statistics and GnS Economics.

Quarter	Finland	Eurozone	USA
2016:1	0.6	0.55	0.21
2016:2 (nc)	0.34	0.17	0.64
2016:3	0.43	0.22	0.49
2016:4	0.16	0.08	0.27
2016	1.5	1.0	1.6
2017	-5.4	-3.0	-1.6

Process descriptions

The forecasts reported in this Q-review are based on the statistical modeling methods from the most recent academic research on predicting business cycle fluctuations. Nowcasts refer to the forecasts of the growth rates of the real Gross Domestic Product (GDP) for the current quarter. Nowcasts are needed because the standard measures for the GDP are published after a considerable lag and are typically subject to subsequent revisions, indicating that the coincident state of the economy is always uncertain. Our nowcasts for the current quarter are based on statistical models where all relevant information available at the time of nowcasting is utilized.

The GDP forecasts for longer horizons (over the current quarter) are based on the dynamic forecasting models where forecasts are constructed iteratively. This means, for example, that the three-quarter forecast is essentially based on the two-quarter forecasts and so on. Forecasts are constructed for all three economic areas (eurozone, Finland and the US) indicating that they depend on each other. Finally, note that the forecast scenarios considered in this Q-review are based on the expert view of GnS Economics.

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