"Poisonous" Economic Combinations Preparing New International Crisis

By Nick Beams
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Since the global financial crisis in 2008 and the ensuing Great Recession, innumerable reports on the world economy have appeared from official bodies such as the International Monetary Fund (IMF), the World Bank and the OECD, as well as academic institutions, seeking to ascertain when a "recovery" might begin.

Released this week, the 16th annual Geneva Report, commissioned by the International Centre for Monetary and Banking Studies, and written by prominent economists, differs in one major respect.

Earlier studies, while pointing to the ongoing problems of the world capitalist economy, have tried to find at least one "bright spot." This report finds none. In fact, its basic theme is that any number of economic scenarios in one or other region of the world could set off another financial disaster.

The report's main focus is what the authors call "debt dynamics." Contrary to the widely-held belief that debt has come down since the global financial crisis, they point out that the overall world debt (public and private) ratio to gross domestic product (GDP) is still growing and has reached new highs. Excluding financial sector debt, it has risen by 38 percentage points since 2008 and now stands at 212 percent of GDP.

The authors point to a "poisonous combination" of lower world growth and lower inflation. When inflation is relatively high, debt burdens are easier to pay off because the real value of money is lower. In today's world of lower inflation and even outright deflation, however, deleveraging becomes much more difficult. At the same time, debt reduction lowers growth, setting in motion a "vicious loop."

The report also notes that the events of 2008 impacted on longer-term processes. Potential output growth in the developed economies had been on the decline already since the 1980s. The financial crisis "has caused a further, permanent, decline in both the level and growth rate of output."

A measure of the decline is seen in the growth projections contained in the IMF's annual World Economic Outlook reports. "Each successive IMF forecast was marked lower … for developed economies and for emerging economies." Consequently, "the furthest-ahead forecast for the level of real GDP made in 2008, which was for 2012, is currently not expected to be achieved until 2015."

The report casts a critical eye over the US economy. "[C]ontrary to the widespread perception and self-congratulations of public officials," it remains heavily indebted as a consequence of the near 38 percentage point increase in federal debt relative to GDP. Much of the increase in public debt resulted from financial bailouts.

The most striking result of state intervention to prop up the US financial system is the expansion of the balance sheet of the Federal Reserve. Its holdings of financial assets have gone from less than 6 percent of GDP in 2007 to 25 percent today.

The Fed's increase in asset purchases, known as quantitative easing, coupled with its low-interest rate regime, has encouraged the non-financial corporate sector to take on more debt. This borrowing has not been used for real investment and increased production but to build up cash buffers, lift dividends and buy back stock to boost share values.

Keeping interest rates low made investors "stretch for yield," the report states. "In effect, the Fed has been 'recruiting' investors to purchase risky assets. The problem is that not all investors may appreciate the extent of the risk they acquire in the bargain."

In other words, in a bid to counter the effects of the last crisis, the Fed, which has overall responsibility for the financial system's stability, is acting as a kind of master procurer for the next one.

Surveying the European economy, the report says that on the "current projection for inflation and potential output growth, the eurozone finds itself in a situation of great fragility." While the European Central Bank's policies prevented a collapse of the banking system, "they were neither adequate to deal with the solvency problems of the banks, nor sufficient to avoid a fully-fledged credit crunch."

In particular, high levels of debt in the so-called euro periphery made this group of countries "vulnerable to the normalisation of global long-term interest rates"—that is, to a return to supposedly better economic conditions. At the same time, they were "exposed in the event of a future disruption in international financial markets." This means, in effect, that these countries, including Spain, Greece and Portugal, have no way out.

With its focus on debt, the report notes that while China and so-called emerging economies were less vulnerable than the developed economies to the 2008 crisis, they may be the source of the next one.

A number of emerging economies, most notably China, reacted to the 2008 breakdown by switching from export-led growth to domestic growth, promoted by a large expansion of credit. Across all emerging markets, the result has been an increase in the ratio of total debt, excluding financial firms, to GDP by a "staggering" 36 percent since 2008.

China is "one of the candidates for the next episode of the debt crises that have plagued the world since the early 1990s." Since 2008, Chinese total debt, excluding the financial sector, has increased "by a stunning 72 percent of GDP," equivalent to 14 percent per year. This was double the rate experienced in the US and the UK in the years preceding 2008.

Before the global financial crisis, investment in China was concentrated in the manufacturing and export sectors. Since then, as a result of the credit boom, the chief boost to the economy has come from investments in housing and infrastructure. This has led to overcapacity in some sectors of the economy and downward pressure on prices.

“As a consequence, China is facing a poisonous combination of high, fast-growing leverage and slowing nominal GDP. This, in turn, suggests growing difficulties in servicing and repaying debt in a number of sectors in the future are likely.”

Summing up the present situation, the report says the legacy of the crisis was a major issue for a number of developed countries, while there were “early signs already visible” in China and some emerging markets of “the next financial crisis.”

The path for “successful” debt reduction “looks quite narrow” and “there is a high likelihood of either a prolonged policy of very low growth or even another global crisis.”

Of course, the authors of this report, and others like it, remain staunch defenders of the capitalist system, presenting it as the only possible form of socio-economic organisation. The facts and figures they produce, however, provide an overwhelming case for the socialist reconstruction of the entire world economy.