

Bank sounds warning on global stability

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After passing through the equivalent of a “near death experience,” the heads of the major banks and global financial institutions have heaved a sigh of relief.

But while last year's rapid lowering of interest rates by the US Federal Reserve seems to have alleviated the threat of a global financial meltdown and promoted a further boost in US and international stock market values, there is a recognition that none of the problems revealed by the so-called Asian financial crisis have been overcome. Further threats to the stability of the world financial system could be looming.

The Bank for International Settlements—sometimes referred to as the central bankers' bank—is one of those institutions to sound a note of warning.

Delivering the BIS annual report on June 7, bank chairman Urban Backstrom noted that while there was a “much greater spirit of optimism about world economic prospects than was the case only a few months ago” and economic growth appeared to be increasing, “these favourable developments should not lead us to conclude that the danger has passed.” There remained some “evident threats” to international financial and economic stability and “perhaps even more importantly, there may well be vulnerabilities that are not so evident”.

Backstrom reminded his audience that the forecasting record of the major financial institutions was far from perfect.

“Recall that the scale of the Mexican crisis in 1994 was foreseen by very few. In South-East Asia the onset, duration and scope of the recession were all missed by the forecasting community. At this meeting last year, no one had anticipated the extent of the turmoil in financial markets that would be generated by the Russian devaluation and moratorium... Let us be honest with ourselves: the track record shows that there are many things that we do not understand and cannot predict. It would be highly imprudent to assume that all will be well.”

The BIS report itself drew attention to a number of features of the world capitalist economy that point to the emergence of deep-seated contradictions within the profit system itself.

When the “Asian miracle” collapsed in 1997, academic economists and media pundits alike claimed that the financial crisis was a result of lax lending policies, insufficient supervision of banking and the inflated expectations arising from speculation. Such explanations, however, explained nothing—they were merely a description of phenomena that have marked every financial crisis in the history of capitalism.

The speculative activities in financial markets were not themselves the cause of the crisis but were the expression of more fundamental processes, in particular the over-expansion of capital and overproduction in a range of industries, arising from the emergence of falling profit rates.

Nearly two years after the financial crisis broke, the BIS report points to some of these underlying tendencies. The process of

disinflation and falling commodity prices, which accelerated last year was due, at least in part, to “substantial excess capacity in many industries” not only in Japan and Asia but also in the United States where “measured levels of capacity utilisation fell, contrary to what might have been expected”.

The emergence of excess capacity, on the one hand, combined with violent movements of financial capital on the other, is a sure indication that a general fall in the rate of profit across the economy as a whole is beginning to make itself felt. This tendency is always accompanied by increased financial speculation as capital, unable to secure normal rates of return, seeks to accumulate profits through riskier financial ventures.

The BIS report noted that since the early 1990s there had been a “more rapid rate of credit expansion and a related tendency to lower credit standards and increase risk-taking more generally”. Two examples were the large inflows into Asia in the early 1990s and the “virtual explosion in the issue of sub-investment-grade bonds in the United States and unprecedented levels of consumer debt and personal bankruptcies”. The effect of such credit expansion was to “push up the price of financial assets to unrealistic levels, even as increases in productive capacity push down the rates of return on the underlying real assets”.

While the BIS report did not make the point directly, the process it describes is applicable both to the boom in asset prices in Asia, which led to large-scale real estate speculation during the early 1990s, and the boom in financial assets, especially the stock market surge in the United States.

An examination of the role of credit and speculation points to the increasingly shaky foundations on which world economic growth has rested since the early 1990s. Following the recession at the beginning of the decade, more than half the increase in world economic output originated in East Asia, a result of the surging capital inflows into that region.

Today, with Japan and much of East Asia still in recession and Europe recording growth rates of between 1 and 2 percent, more than one-third of the increase in global economic demand since 1996 has come from the United States.

But this growth is even less securely based than that which resulted from the Asian boom. Following the crisis in global markets, finance capital has shifted back to the United States, pushing up share market values, leading to the creation of a “wealth effect” which has boosted consumption spending.

As the BIS report notes: “In the United States, both households and businesses have increasingly relied on credit markets to support the current elevated levels of spending, raising concerns about their sustainability. Household indebtedness increased to an all-time peak and corporate indebtedness to its highest level since 1990.”

This means that the whole economy is extremely susceptible to even

a small upward movement in interest rates, which could bring a cut in spending and induce a recession, which, given the crucial role of the United States, would rapidly spread worldwide.

The BIS opened its report with an introduction entitled “The dark side of the market,” reviewing the turmoil of the past two years. The conclusion, which the bank described as more forward looking, was headlined “Finding light among the shadows”. But even as it issued an obligatory reference to the “overwhelming merits” of the market, the BIS found little basis for optimism. Rather its predictions amounted to a series of warnings.

It began by pointing out that what happened in financial markets between August and October last year involved “interactions between various forms of risk, previously assumed to be separable” leading to “massive price movements which threatened the health of financial institutions and even the functioning of markets themselves.”

Furthermore, as events had demonstrated, macroeconomic variables, that is, employment and economic growth, were subject to “extreme outcomes” from which the advanced industrial countries were not immune.

“While many forecasters expect continued and indeed accelerating growth, there are many specific uncertainties which imply that current forecasts must have a wide margin of error. What will be the effects on consumer confidence in Japan when corporate restructuring really gathers pace? What will be the effects of the introduction of the euro on competition and prices in Europe, and on the financial structure through which monetary policy works? Will the spread of new technology lower unemployment by opening up new production possibilities or will it raise unemployment by displacing labour? Will Asian bank restructuring proceed rapidly or hardly at all? To these questions many more might be added, and the answers and policy implications are not obvious.”

The BIS notes that the “overhang of productive capacity in traded goods worldwide” has a number of implications. Not the least of these is the intensification of price competition and the vulnerability of firms to any significant increase in costs.

“Should profits come under further pressure in the United States, the effect on equity prices could be significant and this would in turn be expected to have an impact on consumption. Finally, record trade imbalances must at some point imply a lower dollar and an appreciation of the yen and the euro. Should this happen before the economies of Japan and continental Europe are growing healthily again, the potential downside for the global economy is obvious.”

The excess of industrial capacity “in many countries and sectors” also continues to be a “serious threat of financial stability”.

“Without an orderly reduction or take-up of this excess capacity, rates of return on capital will continue to disappoint, with potentially debilitating and long-lasting effects on confidence and investment spending. Moreover, the solvency of the institutions that financed this capital expansion will become increasingly questionable, potentially leading to credit rationing and strong headwinds affecting the economy as a whole.”

The first response to the Asian crisis was to denounce “crony capitalism” and the bad banking practices in the region. Then attention turned to the activities of the financial institutions and banks that had provided the speculative capital. But the activities of the banks cannot be separated from the underlying objective processes in the world economy as a whole, in particular the tendency of the average rate of profit to fall and the industrial overcapacity to which it gives rise.

As the BIS report puts it: “Imprudent lending has been motivated by both shrinking returns on traditional business at home and the belief that various forms of safety net would protect creditors should risks actually materialise. The former problem is likely to worsen as global competition in the provision of financial services increases and managements pay more attention to shareholder value. While it is possible that banks will respond by pricing risk more carefully, it is also possible that they will continue to be drawn into still riskier ventures.”

A further factor leading to instability is the closer involvement of the banks themselves in the securities market. In the past, banks performed a smoothing function by lending money when these markets became constricted. But the increasing dependence of the banks on such markets means that they may be increasingly unable to play this role.

In fact, the BIS report raises doubts about the capacity of central banks to control market fluctuations. Under conditions where in many countries central banks have been stripped of responsibility for bank supervision, whether they will be able “to obtain the information they require, when they need it, to use their emergency liquidity support powers wisely and effectively in a market-driven world remains a very open question”.

The underlying cause of the global financial turmoil of the past two years has been the over-accumulation of capital relative to the mass of profit extracted from the working class on a global scale. Capital has only one response to such a crisis: the implementation of measures aimed at increasing profits on the one hand, and the elimination of less profitable sections of capital on the other in order to expand the profits of those that remain.

These imperatives are reflected in the main policies advocated by the BIS. It calls for urgent “structural reforms” in many advanced industrialised countries. According to BIS general manager Andrew Crockett: “The use of monetary and fiscal policy, while it cannot be excluded, will probably have to take second place to a much more broad-based attack on structural rigidities.”

In the view of the BIS while the lowering of interest rates last year managed to avert an immediate financial crisis, the underlying processes, associated with overcapacity and falling profit rates, have not gone away and may even have worsened.

The type of “structural reform” being demanded is becoming ever more familiar in every part of the globe. It includes the closure and downsizing of major industries, job destruction through mergers and takeovers, the shutting down of banks and the constriction of credit, further “deregulation” of the labour market to eliminate conditions won in the past, and reduction of business taxes (paid for by reduced social services) to enhance profitability.



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