Bank report points to financial storms

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A reading of the latest annual report of the Bank for International Settlements (BIS) on the state of the global economy and the international financial system cannot fail to bring to mind a famous passage from the Communist Manifesto.

"Modern bourgeois society," Marx wrote, "with its relations of production, of exchange and of property, a society that has conjured up such gigantic means of production and of exchange, is like the sorcerer, who is no longer able to control the powers of the nether world whom he has called up by his spells."

After more than 140 pages of analysis of growth trends, the state of financial markets, the condition of so-called "emerging markets" and the financial relations between the major capitalist powers, the BIS, sometimes referred to as the central bankers' central bank admits that it has no idea where the next financial storm may erupt, much less how to do anything to prevent it.

"Financial failures in the 1930s," it notes in the conclusion to its report, "seriously aggravated the economic downturn in many industrial countries, and led to a sharp tightening of the regulations governing financial activity. The postwar period witnessed a progressive liberalisation as the memories of earlier difficulties faded and the potential benefits of freer financial markets became better recognised. However, recurring financial crises during the last three decades, in both industrial countries and emerging market economies, have focused renewed attention on three issues. How might future crises be avoided? How might they be better managed when they occur? And how might crises ultimately be resolved, including through debt reduction? With respect to each, the actual progress made has been substantial, but is dwarfed by what remains to be done. On some questions there is still no international consensus as to what constitutes sensible policies. And in virtually all cases, the practical challenges involved in actually implementing agreed proposals remain daunting."

And as if to sum up the general confusion in leading financial circles, the BIS proclaims: "There seems to be a widespread perception that the global economy now stands on the brink, but the brink of what remains the question."

While striking a generally optimistic note in the main body of the report—growth rates are increasing, there has been a recovery from the Asian crisis, the financial storms of the past two years have been weathered—the BIS warns that this optimism itself could be a source of problems.

"Ironically, as history has repeatedly shown," it notes in the introduction, "even well founded optimism has the insidious tendency to transform itself into excess. The probability of this happening seemed to increase during the period under review."

Significantly, the source of these dangers is not in the "emerging markets" but resides in the relations between the two largest economies, the United States and Japan.

According to the report a "disconcerting observation" is that various economic and financial forces seem to be "unusually interrelated." "For example, in the United States rising stock prices (especially in the high-tech sector) added to personal wealth and facilitated business financing, contributing in turn to stronger consumer spending and investment respectively. Higher demand and capital deepening raised measured productivity, which enhanced optimism about future profits, further supported stock prices, and so on. Clearly, mutually reinforcing processes of this sort can exaggerate both financial market and real fluctuations, particularly if accentuated by supportive exchange rate shifts.

"A further reason for tempering optimism is that many of the imbalances and structural deficiencies which had characterised the global economy in the previous few years came no closer to being redressed. Indeed, in some respects they worsened. Foremost among these imbalances was the unprecedented gap between the record high rate of private saving in Japan and the record low rate in the United States. While shifts in fiscal positions moderated the impact of these extremes, albeit at the cost of a steep deterioration in the public finances of Japan, large current account imbalances remained, carrying risks of exchange rate consequences."

The US and Japanese economies are in some ways mirror images of each other. In the US government debt has been run down, while private debt, of both consumers and corporations, has been increasing. The US balance of payments has reached a record high and international debt is now around $1.9 trillion, or 20 percent of gross domestic product.

By contrast, in Japan consumption demand has been falling, savings levels have increased and the country continues to run a balance of payments surplus. Government debt, however, has increased to record levels as a result of the continued, and failed, attempts to boost the economy.

Both of these tendencies—the slide of the US into indebtedness and increased Japanese government spending—are unsustainable in the long run. But the US and Japan are locked into a mutual dependence. The US requires the high level of savings in Japan (and consequent stagnation of the economy, requiring ever greater levels of government spending) in order to finance its widening balance of payments gap, while Japan requires high levels of US spending (and consequent growing indebtedness) to provide export markets.

This relationship has been the subject of increasing concern about the instability of the global financial system. As the billionaire international financier George Soros recently predicted, the next financial storm is likely to have its origins in the relationships between the major currencies.

And as Martin Wolf, the economics commentator of the *Financial Times* noted his column published on June 6: “The US and Japan have, in effect, become an odd couple, both dependent, in part, on the unsustainable behaviour of the other. The US needs excessive Japanese savings, just as Japan needs excess US demand. There are ways out of this mutual dependence on the excesses of the other. But if the US adjustment were mishandled or ran out of control, the path ahead could become very bumpy, for both. Soon people might conclude that the only thing worse than unsustainable growth in US demand and the external deficit that accompanies it would be their rapid disappearance.”

One of the scenarios presently being canvassed is the possibility of a rapid decline in the value of the US dollar. As the BIS notes in the conclusion to its report: “The US dollar ... appears to be stronger than is compatible with the stabilisation of longer-term external debt ratios”.

Given the extent to which rising stock markets have driven capital flows in recent period, “the possibility of a simultaneous adjustment in both markets would seem greater than historical correlations might indicate.” In other words, while the rising dollar and booming equity markets have combined to ensure an inflow of capital, this tendency could operate in reverse—a decline in the dollar leading to a fall in stock markets, resulting in an outflow of capital and a further drop in the dollar's value.

So far, despite the widening balance of payments gap, the value of the dollar has remained high. International investment funds have been attracted into the US by the booming stock market and the profit opportunities provided by investments in new technologies.

But the global nature of capital investment and competition could see the flow of investment funds change direction. This possibility was raised in a comment published in the *Financial Times* of June 5: “America's supremacy in the new economy has supported both the stock market and the dollar over the past five years as international money has poured into the US to finance an investment boom. This is about to change. The success of the US economy has not gone unnoticed and Europe and Japan are embarking on increasingly serious efforts to catch up.”

While the US will continue to retain its preeminent position, its relative supremacy over the rest of the world will tend to decline.

“This has two big, long-run implications for financial markets. The first is that most of the untapped investment potential lies outside the US. The second is dollar weakness. Despite a rising current account deficit, the greenback has been to date buoyed by massive foreign direct investment and portfolio inflows. As investors seek more profitable growth opportunities elsewhere, the dollar will enter a period of structural decline.”

Cognisant of the possibility of such shifts, and the devastating impact they could have on the US and other major economies, the BIS notes that in the future, “the biggest policy challenge could be coping with a sudden reversal in the fortunes of the dollar.”

But what program could be set in place? Here, the BIS, like Marx's over-powered sorcerer, admits that the financial authorities, supposedly in control of global markets, have none.

“As for contributions by market overseers to better market functioning,” the report states in its conclusion, “there is evidence that markets are becoming less atomistic, and potentially more subject to herding behaviour particularly at times of stress. Growing concentration among market participants, common risk management and regulatory schemes, increasing use of benchmarks and index tracking, and the exploitation of common and instantaneously available information may all be contributing to this. However, what supervisory authorities might do about these underlying structural trends is significantly less obvious. Finally, there is the most fundamental issue of all. Why do markets overshoot, in effect failing to discipline themselves? In an ideal world, those who pushed prices away from ‘equilibrium' levels would quickly lose money as prices reverted to the mean. However, in the real world, this often does not happen. ... it may be that market failures of this sort are simply one of the costs to be borne when reaping the overall benefits of a market-based economic system.”

Coming from one of the major institutions supposedly in control of the global capitalist economy, there could hardly be a clearer admission of the historical bankruptcy and utter irrationality of the profit system and its modus operandi, the “free market”.