# Bankers' bank sounds some warnings

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Central bankers generally try to put an optimistic gloss on their reports on the state of the economy and the financial system lest any critical comments undermine the confidence that is so crucial to the maintenance of stability. So it is not surprising that the Swiss-based Bank for International Settlements (BIS), sometimes known as the central bankers' bank, published in July its annual report containing a generally upbeat assessment of the state of the world economy.

Listing the most serious financial events of the past 12 months—the stock market downturn, the terrorist attacks of September 11, the collapse of Enron, the Argentine default (the largest in history) and the continuing conflict in the Middle East—the report notes that their impact "could have been far more serious" and that "compared with what might have been expected, it is remarkable how well the system has coped."

However the report went on to say that it would be "premature to conclude that all must now be well". "Some of the concerns may yet be realised and a number of last year's shocks may prove to have long lasting implications."

According to BIS, the collapse of Enron, while less dramatic than the events of September 11, was "perhaps more damaging to market confidence in that it called into question the quality of market information about individual corporations."

The most damage was caused not so much by the collapse of Enron itself but the false accounting methods stretching across the corporate world which its demise began to reveal.

"Significantly," the report notes, "the equity markets' reaction to the firm's bankruptcy in early December was not nearly as severe as the reaction in late January to the news that Enron's auditing firm [Arthur Andersen] had shredded documents, or the response in early February to a report detailing Enron's use of partnerships and special purpose vehicles to inflate earnings and hide losses. As a consequence, stock prices started to incorporate a discount for accounting risks, and the market punished specifically the stocks of large firms with relatively opaque financial reports."

The BIS report repeats the familiar refrain that in the case of Enron the cause of the crisis was the failure of ethical standards and regulators and offers the reassurance that the lessons have been positive, leading to renewed vigilance and regulation to avoid similar events.

But the presence of systematic fraud cannot be so easily dismissed. It is an organic product of deep-rooted tendencies within the global capitalist economy. In particular, downward pressure on profit rates has meant that corporations have increasingly been forced to turn to activities in financial markets in order to try to increase or maintain their return on shareholders' funds. Those that fail to meet "market expectations" find it more difficult to raise additional capital, and become the takeover targets of other corporations. Hence the need for fraudulent accounting methods.

The BIS report itself refers in part to this process: "The technology led bull market of the late 1990s distorted the incentive to produce reliable information. Newly listed technology firms followed a business model in which they spent heavily on research and development, gleaned little current profit from operations and relied heavily on equity issuance to raise cash, compensate management and employees and acquire other companies. For some of these firms, a high stock price was so critical to survival that the incentive to manage information for this purpose overrode the importance of future reputation. For many other firms, paying compensation in the form of stock options lent a similar make or break character to stock prices and led management to place undue emphasis on supporting these prices in the short run."

In recent weeks there have been warnings in the financial press, most notably the *Wall Street Journal* and the *Financial Times*, of the possibility of a financial crisis resulting from the heavy involvement of major banks in derivatives markets. In the last period of major financial turmoil in August-September 1998, the collapse of the New York firm Long Term Capital Management (LTCM)

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threatened to precipitate a global financial crisis. The US Federal Reserve came to the rescue by organising a $3 billion bailout.

In the four years since the demise of LTCM, the risks of systemic failure have not lessened. Indeed, they may have increased because of the high degree of concentration in financial markets. According to BIS, London and New York account for 47 percent of global trading in foreign exchange markets and 49 percent of global trading in over-the-counter derivatives. "The high degree of concentration in some market segments," it notes, "exposes the financial system to a greater risk of systemic failure."

In foreign exchange markets three quarters of all foreign currency transactions in London and New York were conducted by only 30 dealers in 2001 compared to 40 in 1995. In the US, the share of the top three banks in the credit derivatives market rose from 79 percent in 1998 to 94 per cent in 2001.

According to BIS, one of the main reasons for this high degree of concentration is the large number of mergers and acquisitions over the past decade.

Another area of concern is the rising level of corporate and household debt in the major industrialised countries, particularly the United States, and the size of the US trade deficit and external debt.

The downturn in the major industrialised countries has been limited due to high levels of consumer spending fueled by rising asset prices, in particular for housing, low interest rates and increased debt. If job losses increase and interest rates rise consumption spending could be reduced significantly. Japan already suffers from stagnant or falling consumption spending.

Both household and corporate debt ratios have increased in the advanced industrial countries since the mid-1990s and are "now higher than is usual at the beginning of an upturn. Outstanding liabilities represent more than 100 percent of household disposable income in the G-7 countries, an increase of more than 10 percentage points since the previous economic downturn." The ratio of non-financial corporate debt to gross domestic product (GDP) has reached almost 90 percent in the G-7 countries compared to 80 percent 10 years ago.

Turning to the US economy, BIS says that one of the "more worrying features" is the failure of US savings to increase during the investment boom of the late 1990s. "In fact, the ratio of national saving to GDP fell by nearly 3 percentage points from 1998 to 2001, as a steep decline in household saving more than offset the improvement in government saving."

Increased spending in the US and relatively weak investment in other regions led to a widening of the US trade deficit. This growing gap, now running at more than 4 percent of GDP, would not present a great problem were it not the for the fact that the income on the US net investment account has fallen as profits from US-owned foreign companies have declined.

"In the past," BIS notes, "net foreign direct investment income has provided a positive contribution to the US current account balance. However, a continuation of this trend looks uncertain."

Moreover, the outlook for net interest payments is "equally worrying" because the continued rise in net foreign liabilities has meant that the United States is "increasingly exposed to changes in global interest rates and financial market sentiment."

The latest figures bear this out. They show that America's net external debt to the rest of the world is running at $2.3 trillion or almost 23 percent of GDP. Even more significant than the absolute size of this debt is its rate of increase. Twenty years ago, the US was the world's biggest creditor. It moved into debt by the mid-1980s with external debt rising to around $260 billion by the end of the decade. After averaging around $268 billion in the period 1990-96 it has exploded to its current level over the past five years.

Japan has financed much of this debt but this process may be about to end. According to the BIS, while Japan has been the major source of financing for the US deficit, the Japanese economy is at a "relatively advanced stage in the global aging process" and may "gradually become less attractive as a location for production and thus will be more reliant on repatriated income from Japanese-owned foreign enterprises and foreign financial assets held by Japanese institutions."

Under conditions where Japanese companies and financial institutions have more than $1 trillion worth of investments in the US, a significant repatriation of these funds would have a devastating impact on the US and the world economy.

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