A warning to the G-8 from the bankers' bank

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On the eve of the G-8 meeting this week, the major capitalist powers have been given a warning that despite the appearance of healthy growth, the problems of the global economy are increasing. The warning comes in the 75th annual report of the Bank for International Settlements (BIS) issued last week. According to the BIS, known as the central bankers' bank, growing international debt and imbalances in the world economy have created the conditions for economic and financial crises.

Describing the growth of almost 5 percent in the world economy in 2004, the best in nearly three decades, as "so far, so good," the BIS welcomed the less volatile inflation and output growth of the recent period. "Less welcome," it continued, "are growing external and internal imbalances, the latter leading to more frequent periods of financial stress often associated with rapid increases in credit, asset prices and investment."

The report pointed to a "massive expansion of global liquidity," resulting from the efforts by many countries to ease their monetary policies and to accumulate currency reserves, in order to resist appreciation of their currencies against the US dollar.

While it would be difficult to get agreement on the proposition that the global economy has "problems", the report contented, there was more of a consensus that it has certain "exposures". "One simply cannot ignore the number of indicators that are now simultaneously exhibiting marked deviations from historical norms."

Among the internal imbalances that "compel attention" are:

* The decline in real policy interest rates (the base set by the central bank) in many industrial countries and in "emerging Asia" to close to zero.

* The remarkably low nominal rate on long-term bonds, as well as the narrowing of credit spreads—the difference in interest rates on low and high-risk assets.

* The downward trend in household savings in many industrial countries and the increase in debt levels to record highs.

* The increase in house prices in many countries.

At the same time, external imbalances, resulting from the balance of payments deficit of the US, "have never been larger in the postwar period."

Choosing its words carefully—it is not the job of a central bank to create disturbances—the BIS said that any one of the financial phenomena it cited "might well revert to the mean". "Such an unwinding might be gradual, and possibly benign, but it could also be rapid and destructive. In large part, what happens will be determined by real-financial interactions that we should not pretend to fully understand."

The report said the widening US balance of payments deficit was a "serious longer-term problem". "That is, it could eventually lead to a disorderly decline of the dollar, associated turmoil in other financial markets, and even recession." More immediately, it could bring a "resurgence of protectionist pressure."

According to the BIS, the unprecedented size of the deficit (now at more than 6 percent of US GDP), the speed with which external debts are growing, the dependence of the US on other central banks for external financing, and the fact that much US borrowing has been used to finance consumption rather than investment, suggest an eventual problem.

"Moreover, given the interdependency of modern financial markets, it is likely that problems would not be confined to the dollar alone. A higher risk premium on US dollar-denominated assets could raise long rates and spreads, with implications for asset prices of all kinds."

In other words, a rapid decline in the value of the US dollar would lead to a sharp rise in interest rates, which could then spread around the world, deflating the housing bubbles that have emerged in a number of countries. An increase in US rates could also impinge severely on the so-called "carry trades", where financial institutions have borrowed at low rates in the US to invest in longer-term and riskier assets at higher rates.

While pointing to the dangers of the US balance of payments deficit, the BIS did not hold out the prospect that it could start to come down in the near future through an increase in exports.

"Rejuvenating the manufacturing sector will not be easy, given that it has shrunk to only 10 percent of GDP, and that profits in manufacturing remain lacklustre. The fact that the traded goods sector has, so far, hardly shared in the recent upturn of investment in the United States is also a discouraging sign." With competition from China, India and other low-cost economies intensifying, it was "not a propitious moment to be seeking to regain international market share."

The BIS warned that not enough attention was being paid to the systemic issues thrown up by the financial imbalances nor was there "adequate recognition that acting in self-interest may be far from optimal." "What is needed now is real dialogue among all those affected by these external imbalances. Everyone needs to commit to some unpleasant compromises now, in order to avoid even more unpleasant alternatives in the future."

In a lengthy chapter on financial markets, the BIS report pointed to potential problems arising from the credit derivatives market. While the market had come through the downgrading of General Motors and Ford debt relatively well, this may "not be a true indication of how these markets would function under stress." This is because the downgrading of the carmakers' debt had been flagged well in advance. A surprise event could cause much more damage.

The sums involved are truly staggering; and growing. The credit default swap (CDS) market, which enables investors to hedge the risk of default by individual borrowers, is increasing exponentially. The BIS calculated that the amount outstanding on CDA contracts reached $4.5 trillion at the end of June 2004, up six-fold from the level three years earlier.

If there was a central policy theme to the report, it was that economic and financial problems could be expected to worsen in the coming period, with internal and external imbalances, rooted in major structural changes in the global economy, having the potential to unwind with "disruptive impact". The danger in such a situation was that "what might seem evident policy solutions for each country considered alone often stand in mutual contradiction." In other words, problems arising from the global nature of the capitalist economy come into conflict with the system of nation-states.

Accordingly, the BIS wants to see cooperative solutions and the establishment an international macrofinancial stabilisation framework. But it acknowledged that "given the reality of vested sovereign interests" such an international framework would be hard to implement.