

Bankers' bank puzzles over state of world economy

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30 June 2006

Recently in an email to the WSWS a reader drew a contrast between what she called the “explosive situation” in China—an “unregulated economy within a dictatorship”—and the United States where the economy is “regulated, open and handled by the best business-brains available.”

While not often stated so baldly, the views expressed here are quite widely held; that while there may be problems in what could be called the extremities of the world economy, the heart is basically sound and functions under the watchful eye of central bankers and financial regulators ready to intervene if necessary.

Anyone who subscribes to such a view would do well to examine the annual report of the Bank for International Settlements (BIS) published this week. Set up in the late 1920s to organise World War I reparations payments from Germany, the BIS is a unique body in the world of finance. Not tied to any particular national banking authority and functioning as a kind of “central bankers’ bank”, it often provides analyses of the world economy not found elsewhere.

The main press commentary on this year’s BIS report has focused on remarks by general manager Malcolm Knight that interest rates will have to be further tightened. “It would be imprudent,” he said, “to count on the happy combination of strong growth and low inflation lasting indefinitely. At some point, central banks may have to act more forcefully on policy rates than they have in the past few years.”

One of the report’s central themes was that while the recent period of low inflation resulting from globalisation has been beneficial, the low interest rate regime that has followed may have created other problems in the form of asset price inflation and global trade imbalances.

These problems are dealt with in some detail in the

conclusion to the report. It makes clear that far from financial markets operating under the regulation of the “best brains”, they are wracked by a series of contradictions which central bankers do not really understand, much less know how to control.

For example, the report notes that the compression of interest rates between more secure and riskier assets “remains a puzzle”, the surge in equity and housing prices globally “seems hard to reconcile with wide differences in domestic growth prospects” and that the “explosion in merger and acquisition activity, particularly in Europe, also seems difficult to rationalise.”

Like many other financial institutions, the BIS insists that the present global imbalances, above all the growing US current account deficit and the continued accumulation of foreign currency reserves by China and the East Asian economies, are not sustainable in the long run. However, “given the complexity of the situation and the limits of our knowledge, it is extremely difficult to predict how all this might unfold.”

One scenario is a “bang” of market turbulence. Another is the “whimper” of a long period of slow growth.

There are a number of possible triggers for a market “bang”, including: the tightening of interest rates, protectionist legislation relating to China or Middle East oil exporters, or the sudden failure of a large firm with major financial interests. But it could be something else entirely, for, as the report points out, “the triggers for most of the financial crises observed over the last few decades were almost entirely unexpected.”

One of the major problems confronting would-be regulators is the exponential expansion of financial

markets in recent years, especially because of the operations of hedge funds and the ever-more widespread use of derivatives. These are contracts which by their nature involve speculation about the movement of interest rates, currency rates, share prices, debt ratings among other indices. Accordingly, there are “several market-specific reasons” for concern. “In the main industrial countries, there are many new participants in financial markets and many new financial products, of increasing complexity and opacity. Market liquidity in this new environment has yet to be put to the test.”

In other words, while the use of complex derivatives is supposed to lessen financial turbulence through the spreading of risk, no one knows whether this is really the case. In fact, complex global financial connections mean that problems in one area may become amplified, rather than dampened, as trades unwind across the world. Accordingly, “there is a reasonable likelihood that if one market were to come under significant stress, it would spill over to others.”

Turning specifically to China, the BIS notes that “the principal concern must be that misallocated capital will eventually manifest itself in falling profits, and that this will feed back on the banking system, the fiscal authorities and the prospects for growth more generally. After a long period of credit-fuelled expansion, this would be the classic denouement.”

Such an outcome, it continued, “might have even more severe effects on the industrial countries than is currently thought” and could present a “great challenge for both the public and private sectors.”

The BIS concludes that the world economy not only faces “normal uncertainties” associated with the response to inflationary pressures, but also problems arising from the circumstances of the past decade. The increases in global supply (expanded output in China and the integration of former “closed economies” into the world market), coupled with lagging demand in all large economies, except the United States, have led to an over-reliance on easy money policies to try to close this gap.

Furthermore any threat to global growth rates over this period has been countered by lower interest rates. This has led to a progressive build-up of both corporate and household debt meaning that the tightening of interest rates is now more risky, while any easing is less

likely to work.

The BIS calls for a “more cooperative spirit” among the major economic players in the world economy, which, “with a little luck, might suffice to guide us around the pitfalls which still lie ahead”.

However, while there is recognition of the need for increased cooperation, putting it in place is another matter. The problems may be global in scope, but the conflicting national interests of the major capitalist powers are still decisive.

“National legislation which impedes international sharing of time-critical information remains an important obstacle to crisis management. And perhaps even more important, there is no agreement about international burden-sharing in the event of trouble. Whether it be deposit insurance, emergency liquidity facilities or the restructuring of an internationally-active bank, the ultimate costs could be substantial. Without prior agreement about the allocation of such costs, effective crisis management could easily be hampered by national authorities acting in response to what they see as their own national interests.”

In other words, far from the “best brains” working together to guide the world economy to calmer waters, a global economic crisis could see the breakdown of collaboration and a conflict of each against all.



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