Bank for International Settlements annual report

World economy may be at “tipping point”

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The world economy is already experiencing the worst financial market turbulence in the postwar period and could be on the edge of something much worse. That is the analysis made in the annual report of the Bank for International Settlements, published yesterday.

The BIS, often known as the central bankers’ bank, has been warning of the dangers contained in the build-up of credit and the development of new and highly complex financial instruments over the past decade. Now it says “the unsustainable has run its course.”

The report insisted that the subprime crisis in the United States was only the trigger for the financial crisis, not its ultimate cause. It also took issue with the “what is different” school of thought, which has sought an explanation for the crisis in the extension of the originate-to-distribute model of banking—in which debts are bundled and then sold off—to the housing market. While such an analysis contained some important insights, it was also important to focus on “what is the same”. Adherents of this school would note the parallels between the current period of economic turmoil and earlier ones.

“Historians would recall the long recession beginning in 1873, the global downturn that began in the late 1920s, and the Japanese and Asian crises of the early and late 1990s, respectively. In each episode, a long period of strong credit growth coincided with an increasingly euphoric upturn in both the real economy and financial markets, followed by an unexpected crisis and extended downturn. In virtually every instance, some form of new economic discovery or new financial development provided a further ‘new era’ justification for rapid credit expansion, and predictably became a focus for blame in the downturn.”

The report pointed out that while over the past two decades “much seems to have gone right in the global economy,” there has been an increase in both the frequency and magnitude of financial shocks. The crisis which followed the collapse of the hedge fund Long Term Capital Management in 1998 raised the question as to whether the centre of the global financial system might eventually prove as vulnerable as the periphery. The events of the past year revealed that these causes for concern were not misplaced.

“The current market turmoil in the world’s financial centres is without precedent in the postwar period. With a significant risk of recession in the United States, compounded by sharply rising inflation in many countries, fears are building that the global economy might be at some kind of tipping point. These fears are not groundless.”

The report noted how previous optimistic predictions about the course of the crisis had proven to be unrealistic. When disturbances began in the subprime section of the American financial market it was thought they could be contained and that consumer spending and the general economy would not be greatly affected. Both those assessments were wrong, with the US housing sector suffering under the impact of falling house prices and a massive build-up of unsold homes.

Then it was suggested, towards the end of last year, that as domestic demand continued to hold up in “emerging market economies” they might be able to “decouple” from the United States, and even act as a “safe haven” from the financial turmoil unfolding elsewhere. This led to capital flows to these economies, providing support for asset prices, even as they fell in other parts of the world. This was no longer the situation.

“As concerns mounted about the possible scale of the US downturn, however, the mood began to change. Indeed, upon closer scrutiny, doubts about the longer-term health of the emerging markets began to surface. In China, the extraordinarily rapid pace of fixed capital investment, much of it recently in heavy industry, fuelled worries about misallocations as well as the broader effects on both global commodity prices and the environment.” In the Middle East there are fears that similar development plans will eventually result in problems of excess capacity and in central and eastern Europe a number of countries are experiencing rising current account deficits, which will prove unsustainable.

On the specific role of financial innovations in preparing the crisis, the report noted that while they were thought to produce a welcome spreading of risk, in fact the way they were introduced “reduced the quality of credit assessments in many markets and also led to a marked increase in opacity.”

“The result was the eventual generation of enormous uncertainty about the size of losses and their distribution. In effect, through innovative repackaging and redistribution, risks were transformed into high-cost but, for a while at least, lower-probability events. In practice, this meant that the risks inherent in new loans seemed effectively to disappear, buoying ratings as well, until they suddenly reappeared in response to the trigger of some realised loss that was wholly unexpected.”

Those charged with oversight of the financial system should have voiced their concerns, but “perhaps... no one saw any pressing need to ask hard questions about the sources of profits when things were going so well.”

While financial innovations played a role, the report found that the “fundamental cause of today’s emerging problems was excessive and imprudent credit growth over a long period. This always threatened two unwelcome outcomes, although it was never clear which would emerge first. One possibility was a rise in inflation as the world economy gradually approached its near-term production potential; the second was an accumulation of debt-related imbalances in the financial and real economy which would at some point prove unsustainable and lead to a significant economic slowdown. In the event, the global economy now seems to be experiencing both unwelcome phenomena at the same time, albeit with different countries often having significantly different degrees of exposure to these common threats.”

The report pointed out that there was considerable uncertainty about the future prospects for the global economy and the impact on growth of a number of interactive processes. It placed considerable emphasis on the “spectre of deleveraging.” That is, after many years of debt accumulation, attempts to reduce debt holdings could lead to banks cutting back on the provision of credit to borrowers and tightening margin requirements. This could result in borrowers, unable to meet the more onerous credit conditions, being forced to undertake a “fire sale” of assets.

It also noted the problem of the “fallacy of composition” that arises as “individual economic actors” trying to deal sensibly with their own problems only succeed in making everyone else’s worse.

The growth of debt, it noted, pointed to the need for higher savings. But not everyone can save simultaneously, and one person’s spending is another person’s income. Consequently, the end result of a process in which saving was increased all round would be lower economic activity, not only in the countries carrying out the saving but in those countries exporting to them. Higher investment would not compensate for a reduction in US consumer spending because corporations would judge that demand was unlikely to recover for some time and hold back spending while cutting costs.

The BIS warned that easing monetary policy, the method employed over the recent period by the US Federal Reserve and other central banks to try to stimulate growth, may not have the desired effect and may only result in higher prices.

As far as policy is concerned, the BIS came down in favour of reining in credit coupled with the use of fiscal measures—increased government spending—to provide a growth stimulus. But it was far from confident in the outcome. A fiscal stimulus could lift inflation, while countries with large external deficits may not be able to implement it because of the effect on their exchange rates.

It was also necessary to recognise that in the US and “prospectively in a number of other countries, there has been a build up of debts that cannot be serviced on the originally agreed terms.”

In conclusion, the report noted that there were “many practical impediments” to the development of a common global approach to the crisis. There were differences over whether excess credit was to blame in the first place and “not everyone” was in agreement that it “might prove difficult to clean up the mess” after periods of excessive credit growth. And then, in a pointed comment directed to its opponents, the reported noted: “While hopefully it will not come to that, if the costs of the current turmoil continue to mount and policy measures prove largely ineffective, such beliefs are more likely to be re-evaluated.”

Even if the measures it advocates were adopted, the BIS insisted that “to be realistic” no one should think that “financial crises with significant economic costs” can ever be eliminated.

In other words, as the global economy stands on the edge of what the BIS, as well as other leading economic and financial authorities, acknowledges is a crisis with the potential for destruction at least as great as during the Great Depression, the world’s people should simply peacefully submit to having their lives violently torn apart.

There could hardly be a clearer demonstration to the international working class of the need to develop a political struggle for an international socialist program to lead mankind out of the economic madhouse into which it has been driven by global capitalism.