Downturn to continue for a generation, Bank of England governor warns

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The governor of the Bank of England, Sir Mervyn King, has given his clearest warning yet that the impact of the global financial crisis is going to continue for decades. More than four years on from the collapse of Lehman Brothers, the financial and economic outlook is steadily worsening around the world.

In a speech delivered in Cardiff, Wales, on Tuesday evening, King said that after a period of "lopsided" expansion marked by growing trade deficits, increased debt levels and a collapse of their banking systems, "advanced economies across the world are facing a huge adjustment." The scale of the shift meant that the generation coming into the workforce "may live under its shadow for a long time to come."

King warned that over the past year "the economic sky has darkened." The clouds coming from the euro area had not lifted and new ones had developed with China, Brazil and India, the three largest "emerging market economies", all slowing. According to the latest International Monetary Fund projections, output will fall in no less than 10 European economies this year.

Despite the fact that it had control of monetary policy and its own currency, Britain was not exempt from the processes taking place in Europe. Gross Domestic Product was barely higher than two years ago and was 15 percent below where it would have been had the pre-2007 trends continued.

Like other central banks around the world, the Bank of England has engaged in its own version of "quantitative easing", cutting the bank rate to its lowest level ever and purchasing £350 million of financial assets in order to inject money into the economy. But while this policy could ease the pace of "adjustment", it would not continue indefinitely and there were "limits to its ability to stimulate private sector spending," King insisted.

"In the long run, we will need to rebalance our economy away from domestic spending and towards exports, to reduce our trade deficit, to repay our debts, and to raise the rate of national saving and investment," he said. King did not spell out the implications of this "adjustment" but it means a further significant lowering of living standards in order to make British capitalism more internationally competitive.

The "paradox" of the present policy, he warned, was that in seeking to bring forward expenditure from tomorrow to today an even larger stimulus was needed to further stimulate the economy in the future. "When the factors leading to a downturn are long-lasting, only continual injections of stimulus will suffice to sustain the level of real activity. Obviously this cannot continue indefinitely."

Investments made before the crisis had now been rendered unprofitable. He noted that "almost 1,000 high street chain stores had closed in the first half of the year" with lower asset values leaving debt levels looking too high.

The overhang of debt was particularly prevalent in the banking sector where debt reduction, or "deleveraging," was holding back the flow of new lending. Banks were overflowing with liquid assets but had insufficient capital. "Just as in 2008, there is deep reluctance to admit the extent of the undercapitalisation of the banking system in many parts of the world," he said.

There was a danger that the "mistakes" of the 1930s could be repeated when the pretence that debts could be repaid was maintained for far too long. Creditors had to acknowledge "further likely losses, a significant writing down of assets values and recapitalisation of their financial systems."

King's warnings are the latest in a series which point

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to the fact that “quantitative easing” is doing little or nothing to provide a boost to the global economy and may in fact be creating the conditions for a new financial crisis, even bigger than that of 2008.

A comment by *Financial Times* journalist Henny Sender last Friday noted that while US Federal Reserve chief Ben Bernanke and other officials had been trumpeting the success of their “quantitative easing” program, there was “little hard evidence of either a recovery in the broad economy” or a connection between it and “any hopeful signs of improvement in the economy.”

The economic activity that was supposed to have been sparked by the third round of “quantitative easing” had “yet to materialise” and there were signs that it impact was “already fading”.

“A drop in third-quarter capital expenditure suggests the Fed policy hasn’t been the catalyst for corporate investment at all,” she noted.

There are also fears that the Fed policy may have severely adverse consequences in the longer term. The governor of the Bank of Japan, Masaaki Shirakawa, warned earlier this month that “the global easing bias may have parallels with the environment that gave rise to the great credit bubble of the 2000s.”

In the US, Sender explained, the junk bond market had returned to the conditions of 2007 with a stark contrast between “frothy debt markets and a listless economy.” Data for the first two weeks in October shows record refinancing in both high-yield and leveraged loan markets organised in the main by investment firms. “That data underscores the extent to which the biggest beneficiaries of the Fed policy have been private equity firms, rather than households (especially savers) or companies.”

Other critics of “quantitative easing” point out that one of its effects is to push up the prices of basic commodities, impacting most heavily on the poor, while benefiting the wealthy who are able to capitalise on rising asset prices.

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