IMF points to dangers of stagnation and financial turbulence

Nick Beams
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The International Monetary Fund has added its voice to those of other major economic organisations warning of lower world economic growth and the dangers of another financial crisis, possibly sparked by a flood of capital out of emerging markets once interest rates in the US start to rise.

In a note prepared for finance ministers and central bankers meeting in Cairns this weekend prior to the G20 summit in November, the IMF said global growth was weaker than its forecast last April. It cited a "surprisingly soft first quarter in the United States," in which the American economy experienced a contraction, weak performance in Latin America, contraction in the second quarter in Japan and "downward surprises" in Europe where "activity stagnated in the second quarter."

In the medium term it pointed to the possibility of broad "growth stagnation," low inflation and even deflation in some advanced economies.

In a crucial observation, it noted that lower growth was the outcome of "investment weakness at the global level in the first half of the year." This signifies that, despite the lowering of interest rates to zero in most advanced economies, investment, the key driving force of the capitalist economy, is not being undertaken.

It said the risk of "secular stagnation"—a long period of very low growth and weak demand—in major advanced economies, particularly Europe and Japan, could not be ruled out. Growth momentum had not resumed in Europe despite very low interest rates.

While failing to boost activity in the real economy, low interest rates, coupled with the injection of ultra-cheap cash as a result of the various "quantitative easing" programs of the US Fed and other central banks, have boosted financial markets.

However, this has only increased the danger of another financial crisis. Increased risk taking, because of low rates of return on government bonds and other financial assets regarded as secure, coupled with "financial optimism," due to the continued supply of money from central banks, could "eventually trigger abrupt corrections." There were also what it called "heightened geo-political risks," a reference to the conflicts with Russia over Ukraine and the expanding US-led war in the Middle East.

Other risks were associated with the "normalisation" of interest rate policies in the US and the UK, it said. This refers to the danger that as American and British interest rates increase, even if only by a small amount, volatile finance placed in "emerging markets" by asset management organisations will suddenly exit. Because the size of these investments is large compared to the GDP and the financial markets of these countries, any sudden exit could have a major impact and trigger a financial crisis. A warning of such an event was provided in the middle of last year and again at the beginning of this year when there was an outflow of funds in response to expectations of increased interest rates in the US.

The dangers are not confined to emerging markets. The IMF said there was evidence of "excessive risk taking" in US corporate credit and insurance markets as well as "housing price booms" in a number of smaller advanced economies.

On the day the IMF assessment was issued, further signs of global economic instability emerged, this time from China. Following a decision on Wednesday to inject $80 billion into the banking system, the country's central bank yesterday cut a major official interest rate by 0.2 percent as new data showed further falls in property markets across the country. Real estate and construction form a major component of the

Chinese economy—as much as 20 percent according to some estimates—and is dependent on the supply of cheap credit.

The gloomy IMF outlook follows a broadly similar assessment of the state of the world economy prepared for the G20 meeting by the Organisation for Economic Co-operation and Development released earlier this week.

One of the key items on the agenda for the summit meeting will be to review progress on a G20 commitment to lift global growth rates by 2 percentage points over the IMF's baseline rate of just under 3 percent set on October 2013. There seems to be no prospect of reaching this target.

In a television interview on Wednesday, Australian treasurer Joe Hockey, who, as the leading official of the summit's host nation has responsibility for the proposal, admitted that the target was "ambitious." He said without a focus on jobs and growth there would be a rise in international unemployment and poverty levels and "we'll end up in a spiral that fails to deliver what our communities expect."

But the proposal, even if carried out, would not mean a return to conditions that prevailed before the onset of the global financial crisis in 2008. Hockey said there was agreement that growth had to be promoted through "structural reforms" rather than reliance on reduced interest rates or increased government expenditure.

"Structural reforms" is a code phrase for reductions in corporate taxes and other concessions to big business, coupled with the dismantling of what remains of labour market regulations to promote greater "flexibility" through lower wages and less secure employment conditions.

The IMF and other organisations are pointing to immediate problems in the financial system, involving the failure to sufficiently take account of risk factors and the prospect of a sudden exit from emerging markets. But a recent extensive report by Deutsche Bank strategist Jim Reid has directed attention to longer term developments.

Over the last two decades, he wrote, the global economy had "rolled from one bubble to another" with excesses never being allowed to fully unravel. "Instead aggressive policy responses have encouraged them to roll into new bubbles" in a process which "arguably has kept the modern financial system going."

"Clearly there have always been bubbles formed through history but has there been a period like the last 20 years where the bursting of one bubble has directly led to the formation of the next?"

The latest bubble is in government bonds, a product of crisis management over the two decades, and now a major necessary condition for maintaining the debt-laden financial system.

However, according to Reid, "the worry is that there is nowhere left for this bubble to go given that it is now in the hands of the lenders of last resort," governments and central banks.

In other words, the conditions for a new financial crisis are in the making in which central banks and governments will not be able to play the role in stabilising financial markets they have in the past because they are so deeply embroiled in the creation of the bubble itself.

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