

Mounting signs of global economic stagnation

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More than six years after the global financial meltdown erupted in September 2008, the world economy is increasingly coming to resemble a minefield with any number of potential flashpoints that could set off another crisis.

The central cause of instability is the lack of any return to growth patterns once considered to be the norm and the consequent growth of financial parasitism.

Summarising the overall situation, the latest report of the Organisation for Economic Co-operation and Development, released earlier this month, noted that “a return to the pre-crisis growth path remains elusive for the majority of OECD countries. In most advanced economies, potential growth has been revised down and, in some cases, there are growing concerns that persistently weak demand is pulling down potential growth further, resulting in a protracted period of stagnation.”

It warned of the development of a vicious cycle “whereby weak demand undermines potential growth, the prospects of which in turn further depress demand, as both investors and consumers become risk averse and prefer to save.”

The report said immediate policy challenges include persistently high unemployment, high public sector budget deficits and debt and as well “remaining fragilities in the financial sector.” The crisis had increased social stress, hitting low-income households hard, with young people “suffering the most severe income losses and facing increasing poverty risk.”

The main prescription advanced by the OECD is for so-called structural reforms aimed at increasing labour productivity. But, as it acknowledges, one of the main effects of such measures, which are aimed at boosting profit rates, has been an increase in social inequality. It notes that in some of the countries hardest hit by the crisis where “substantial labour market reforms” have been carried out, the result has been “severe job and income losses, hurting young people the most” and that more broadly “vulnerable households have been losing ground

since the crisis across a majority of OECD countries.”

In the midst of ongoing stagnation, the other main feature of the global economy is what can only be described as an explosion of financial parasitism.

Profits are increasingly being accumulated not through investment and increased production, but by various forms of speculation fuelled by ultra-cheap money supplied by the world’s central banks via various forms of quantitative easing. The three-fold increase in the US S&P 500 index over the past six years since its low point in 2009 is only one indication of this trend.

In an overview of the situation, the consultancy firm McKinsey &Co recently reported that the world is now awash with more debt than before the global financial crisis.

Global debt has increased by \$57 trillion since 2007 to almost \$200 trillion, far outpacing real economic growth, with the share of debt rising from 270 percent to 286 percent of global gross domestic product. “Overall debt relative to gross domestic product is now higher in most nations than it was before the crisis” with higher levels of debt posing “questions about financial stability,” the report noted.

One of the most significant expressions of the increasing instability in financial markets is the emergence of the phenomenon of negative yields on both government and now corporate bonds.

Demand for bonds is so high in a world awash with cash that the yield is pushed down so low—the price of a bond and its yield bear an inverse relationship to each other—that the holder would suffer an overall loss by retaining the bond to the time of redemption when its face value is paid out.

The explanation for this seeming insanity lies in the fact that the bond purchaser calculates that before that time arrives the continued flood of cash will push the purchase price even higher and hence there is a profit to be made by selling the bond before the date of redemption.

In a comment published today on Australia’s *Business Spectator* web site, columnist Alan Kohler noted:

“Investing in negative-yield bonds is based on a tried and tested ‘bigger fool’ formula that became so prevalent in the stock market during the 1990s internet bubble. That is, you might be a fool for buying a bond at minus 0.5 percent yield ... but a bigger fool will buy it off you for minus 0.6 percent.”

The whole system is able to function because central banks are prepared to intervene and buy bonds at any price. As Kohler explained, what is in operation is a kind of government buyback scheme, guaranteeing profits through speculation and hence where “what would otherwise be described as irrational pessimism is actually a kind of rational exuberance.”

The sums of money involved are huge. According to JP Morgan, some \$2 trillion of European government bonds of more than one year’s maturity now have negative yields.

Concerns are now being raised about what the impact of negative yields will be on financial markets. Speaking at a *Financial Times* conference in London earlier this month, the head of global strategy at Standard Life Investments Andrew Milligan said it could be the start of a “completely new environment for global bond markets” with significant consequences if it became permanent.

Another speaker warned that negative yields had a huge impact on pension funds and insurance companies, placing them under a lot of pressure and forcing them to take a lot more risk.

One area of risk is the rapidly expanding market in corporate bonds in emerging economies issued in so-called hard currencies such as the US dollar. A decade ago this market hardly existed. According to estimates by BNP Paribas, the value of these bonds has gone from \$107 billion in 1994 to more than \$2 trillion today. Sudden movements in currency values, or a major default, could see a rush for the exits precipitating a financial crisis, involving major institutional investors which have been searching for higher yield because safe investments in government bonds no longer bring a sufficient rate of return.

If a corporate bond price falls, then investors, particularly hedge funds which have borrowed money to buy it, may be forced to sell other assets to cover their losses, leading to a wave of selling, not only of bonds but of other financial assets, setting off a much bigger crisis.

Another potential flashpoint is the rise of the US dollar. With the US Federal Reserve moving to increase interest rates, even if only very slowly, and the European Central Bank and the Bank of Japan continuing quantitative

easing as other central banks cut interest rates, the value of the US dollar is rising against other currencies.

Writing in the *Financial Times* this week, financial analyst Felix Martin warned of the potential consequences of this incipient currency war.

“History teaches that a reinvigorated US dollar exposes those whose balance sheets were built on the belief that cheap money would last forever. It acts like a depth charge, exploding below the surface of the ocean. First the minnows float the surface; then the bigger fish; and, then, finally, one or two real whales.”

One or two minnows had already surfaced when emerging market equities, bonds and currencies were “quick to crack” in 2013, after the Fed indicated it was moving to end quantitative easing.

Potential whales, Martin noted, included the Asian dollar bloc where currencies closely track the US currency. This policy made sense in the past, but if the dollar continued to strengthen then the rationale for devaluation would become irresistible with profound consequences, particularly if China decided on a policy-driven devaluation. There could also be a devaluation of sterling in conditions where the UK current account deficit is now 6 percent of gross domestic product, having grown to “alarming proportions.”

But the biggest whale of all was potentially the United States, Martin wrote. The current assumption is that present economic growth in the US will translate into higher interest rates and a strong dollar. But there was “another possibility: that the US itself is not ready for more expensive money”—an outcome which was “more than idle speculation.”



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