OECD report points to growing dangers for world economy

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The dangers posed to the global economy and the entire financial system by the growth of financial parasitism, in which investment in productive capacity is increasingly replaced by various forms of speculation, have been highlighted in a report issued by the Organisation for Economic Co-operation and Development.

The inaugural Business and Finance Outlook published on Wednesday involved a detailed study of some 10,000 companies whose output amounts to around 30 percent of global gross domestic product.

The report probed what has been called a "global investment puzzle," that is, why at a time of the lowest interest rates in history, there is so little investment by firms in productive capacity. Corporations are sitting on large amounts of cash, which are being employed in financial operations such as share buybacks.

The study also pointed to the dangers building up in the financial system because of the low-interest-rate regime created by the world's major central banks, leading investors to undertake ever riskier investments in order to obtain a sufficient return. The low return on assets such as government bonds meant that life insurance companies and pension funds are facing a funding gap or potential insolvency.

Launching the report, OECD secretary-general Angel Gurria pointed to the perverse situation in advanced economies where companies which carry out high capital expenditure (capex) are punished by stock markets while those that organise share buybacks and other such operations do much better.

"Over the 2009–2014 period buying shares in companies with low capex, while selling those with high capex, would have added 12 percent to the value of your portfolio in Japan, 21 percent in emerging countries, 47 percent in Europe and a whopping 50 percent in the United States," he said. "Clearly the incentives are badly skewed."

In an interview with the *Australian Financial Review* the principal author of the report Adrian Blundell-Wignall, the special financial adviser on financial markets to the OECD secretary-general, said that in the current environment any company wanting to invest over the next 15 years gets "relatively punished."

One of the key reasons, he said, was the development of global value chains which meant that investment was less likely to be carried out in the home country of many corporations but in emerging markets. However there was not enough demand being generated in these countries because governments were engaged in "financial repression" aimed at keeping their currencies at a low value in order to maintain export competitiveness.

This finding puts paid to the claim that despite the stagnation in advanced economies the emergence of a middle class in emerging economies would make up for the shortfall. The lack of a genuine middle class consumer group in many of these countries, Blundell-Wignall said, was hampering the search for a boost to global demand.

Another key finding of the report was that there are mounting dangers to the global financial system because traditional safe investments, including government bonds targeted by insurance companies and pension funds, are bringing such a low rate of return that they have to pursue riskier ventures.

"Increasingly pension funds and life insurers are feeling the pressure to chase yield themselves, and to pursue higher-risk investment strategies that could ultimately undermine their solvency. This not only poses financial sector risks, but potentially jeopardises the secure retirement of our citizens," Gurria said.

Over the next five years pension funds are expected to grow by 26 percent from an estimated $28.4 trillion in 2014 to $35.8 trillion in 2019, while insurance companies' assets will expand by 33 percent over the same period from $28.2 trillion to $37.7 trillion.

These funds face a growing problem as the higher-yielding bonds in which they have invested in the past come to maturity and are progressively replaced by low-yielding bonds in their portfolios. Pension funds generally have about 40 percent of their assets in fixed income securities, including government bonds, and so could face a funding shortfall and be unable to meet their commitments.

Blundell-Wignall warned that many long-term pension funds with defined benefit schemes, especially in Europe, were "coming up to an insolvency crisis of some form." This warning follows a similar assessment by the International Monetary Fund three months ago in which it said that European life insurance companies were facing "severe challenges."

He also noted that the expanding global market for high yield bonds had produced a dangerous surge of money flowing into risky alternative investments. He warned that this could lead to problems when interest rates started to normalise and rise from their present ultra-low levels.

"There's a big bubble in private equity, absolute return fund, synthetic exchange traded funds and hedge funds," he said.

The OECD report listed a potential series of triggers for another financial crisis, including a return of interest rates to more normal levels, a more than expected escalation in the value of the US dollar, a crisis in emerging markets, the failure of the quantitative easing program of the European Central Bank, a crisis sparked by a Greek exit from the euro zone and a further sudden plunge in oil prices.

Under conditions where financial markets increasingly operate outside of the control and regulation of any central bank or financial authority, and where such regulations as have been put in place have been countered by new mechanisms devised by speculators to evade their reach, the immediate cause of another crisis may well be "off the radar" at present. As the economist John Maynard Keynes once remarked, "the expected never happens: it is the unexpected always."

Whatever the immediate spark for another disaster, the objective conditions which will produce it are clearly in evidence. They are rooted in the contradiction between the real economy, where growth prospects are so poor that investment in productive capacity is considered too risky, and the financial markets, which act as if investment were riskless.

Gurria pointed to this yawning gap in his remarks on the report.

"Why do so many people managing listed companies that carry out a large portion of the world's capital formation see so much risk on the horizon, while so many players in financial markets apparently see so little risk?" he said. "Someone will inevitably be proved wrong. How do we avoid a crisis when this happens?"

His comment amounts to nothing less than a damning indictment of the entire political and financial establishment of the global capitalist system, of which the OECD itself is a part. Since 2008, the endless supply of cash to financial markets by the world's central banks in the name of promoting growth has only created the conditions for another catastrophe.