Brexit vote highlights deepening crisis in global economy

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While the immediate turbulence on financial markets following the Brexit referendum result has eased, at least for now, the longer-term implications of the British decision to quit the European Union are starting to emerge.

Equity markets have largely recovered the $3 trillion loss in value they sustained in the days following the vote, but on currency markets the British pound remains near the 31-year low it reached against the US dollar after sustaining its largest-ever two-day fall. And there are concerns that, just as there were miscalculations in financial markets over the possibility of a quit decision, which then led to a major sell-off, so the significance of what has taken place is being underestimated.

The senior currency strategist at the Dutch banking and financial services firm Rabobank, Jane Foley, told the *Financial Times* that market pricing reflected the belief that Brexit would not happen right up to last Thursday's referendum, and "investors are currently at risk of failing to face up to the severity of the political and economic issues that now confront the UK."

"The market is reassured by expectations of further easing from a spectrum of central banks. However, the perception that further central bank action is a 'cure all' is remarkably short-sighted," she said.

Similar views were expressed from across the Atlantic. As an article in the *New York Times* by Landon Thomas noted, investors were "again expecting central banks to ride to the rescue. And that may be the problem." This was because another round of central bank intervention would "compound the sense of alienation, frustration and anger at global elites that encouraged a majority of Britons to opt for leaving the European Union."

Similar sentiments were voiced in another *New York Times* article by Neil Irwin. "What makes Brexit so concerning," he wrote, "is that it accentuates and deepens global forces that have been building for years. So far, governments have been unable to limit any of it. And those forces have self-reinforcing, vicious-cycle dimensions that make it a particularly perilous time for the global economy."

The long-term trends go back more than a quarter of century. In the midst of the Wall Street crash of October 1987, newly-installed Federal Reserve chairman Alan Greenspan committed the central bank to open the financial spigots and flood markets with cheap cash. This became the standard response to the financial storms that developed thereafter, including the Asian financial crisis of 1997-98 and the collapse of the dot.com bubble of 2000-2001.

When the sub-prime mortgage bubble burst in 2008, setting off a global financial meltdown, central banks around the world pumped trillions of dollars into the financial system. However, almost eight years of such "quantitative easing" have not only failed to bring about any economic recovery but also created the conditions for a new financial crash.

At the same, the program of handing out trillions of dollars of cheap money to the banks and financial speculators, while driving down the social position of the working class in country after country, has led to a deepening hostility to the political establishment that has now received sharp expression in the Brexit vote.

In the euro zone, economic output is only barely back to the levels it was in 2007, while in Britain the inflation-adjusted wage is still £20 a week below where it was before the crisis. Housing costs have been driven up by financial speculation, while social services have been slashed.

One of the sharpest expressions of an emerging new financial crisis is the slump in European bank shares. Immediately after the vote, they plunged by 16 percent, bringing the losses so far this year to 33 percent. The largest German bank, Deutsche Bank, fell by more than 20 percent in the two days after the Brexit vote. Since the start of the year, its shares have lost almost two-thirds of their value.

It is estimated that the Italian banking system is operating with around €360 billion of non-performing loans, more than 18 percent of all loans. Italy's largest bank, Unicredit, saw its shares plunge by 16 percent after the vote, bringing its total losses for the year to more than 60 percent. Italian Prime Minister Matteo Renzi is seeking permission from EU authorities for an injection of €40 billion into the financial system. But given the extent of the bad loans, this is far from adequate.

The crisis in the European banking system flows from the response to the 2008 financial crisis. Rather than recognise losses and recapitalise, European banks covered over bad debt problems in the hope that economic growth would resolve them. They feared that if they incurred capital write-downs this would weaken their position relative to better capitalised American and British banks. But recovery did not take place—the Italian economy is stagnant, having experienced no productivity growth since 1999—and the bad debts have continued to mount.

Another sharp expression of the worsening financial disorder is in Japan, where the bond-buying program of the Bank of Japan (BoJ), launched in an effort to lift the economy out of deflation, has transformed the financial system.

According to data compiled by Bloomberg, the central bank now owns 34 percent of government bonds and is one of the top 10 shareholders in 90 percent of the companies listed on the stock exchange. Almost all new bond issues are bought up by the BoJ. In other words, in government bond markets, one arm of the state issues debt, which is then purchased by another arm.

The Brexit decision will exacerbate the tensions and contradictions in international currency markets. The immediate response to the fall in the British pound has been a rise in the value of the US dollar and the Japanese yen, as speculative investment flows seek supposed safe havens. The rise in the value of the yen has virtually wiped out all the BoJ's efforts to bring down its value and provide a boost to Japanese exporters.

This raises the prospect of a direct intervention by the Japanese government to try to push down the value of the yen, an action that would produce a hostile response from other countries.

Major problems also confront the US Federal Reserve. It would like to lift interest rates, in order to have some "ammunition" available to combat any slowdown in the US economy. But it fears that a move in this direction will boost the value of the dollar and impact on major US corporations as they compete in global markets. While exports comprise 13 percent of US gross domestic product, a relatively low figure internationally, it is estimated that nearly half the sales by S&P 500 companies are generated overseas.

On Tuesday, Jerome Powell, a member of Fed's board of governors, said while it was too early to jump to conclusions about the Brexit vote, the British decision had the potential to create new headwinds for the US and global economy. Before the vote there had been risks to the US economy from overseas factors, including low growth and inflation, and they had now "shifted even further to the downside."