World economy “defying gravity”

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So far, the global economy appears to have dodged a bullet. Predictions of a recession resulting from the interest hikes by the world’s major central banks have not materialised. But there are warnings that beneath the surface, and not far below it, there are mounting problems, and the present situation is not sustainable.

This was the theme of an editorial in the *Economist* magazine published over the weekend under the title: “The world economy is defying gravity. That cannot last.” In a reference to the road-runner cartoon character, some commentators have labelled it a Wile E. Coyote moment.

Even as wars rage and the geopolitical climate darkens, it began, “the world economy has been an irrepressible source of cheer.”

According to the magazine, America’s economy roared ahead in the fourth quarter at an annualised rate of 4.9 percent, inflation is coming down, the central banks may have stopped their rate tightening and China, because of a property crisis, appears to be about to benefit from a modest stimulus.

“Unfortunately, however,” it continued, “this good cheer cannot last. The foundations for today’s growth look unstable. Peer ahead, and threats abound.”

Pointing to the rapid rise in interest rates, one of the sharpest in decades, the editorial noted that the US government now had to pay 5 percent to borrow for 30 years, compared to just 1.2 percent during the COVID-19 pandemic recession. Not long ago, Germany’s borrowing costs were negative but were now nearly 3 percent and even the Bank of Japan had all but given up on its promise to keep borrowing costs at 1 percent.

The editorial directly took issue with recent comments by US Treasury Secretary Janet Yellen that the higher rates were a good thing because they reflected a healthy economy.

“In fact, they are a source of danger. Because higher rates are likely to persist, today’s economic policies will fail and so will the growth they have fostered.”

The *Economist* claimed, as others have, that one of the reasons the US economy has fared better than expected is because consumers have been spending money accumulated in the pandemic and there were still $1 trillion of “excess savings” left.

Once that ran out, interest rates would “start to bite” and trouble would emerge across the world economy as rates stayed higher for longer.

Business bankruptcies were starting to rise in the US and Europe, with companies that locked in low rates eventually facing the rising cost of finance. Higher mortgage costs would affect house prices. Banks holding long-term securities (the value of which has fallen) would have to take action to “plug the holes blown in their balance sheets by higher rates.”

The editorial saw rising government debt as a major problem, with US government deficit in the year to September about double what had been expected in mid-2022.

“At a time of low unemployment, such borrowing is jaw-droppingly reckless. All told, government debt in the rich world is now higher, as a share of GDP, than at any time since after the Napoleonic wars.”

The *Economist* is clearly of the view that the growth of debt is behind the selloff in the bond market and the rise in interest rates (bond prices and interest rates have an inverse relationship) because of the growing incapacity of financial markets to keep funding government debt.

The opposed position, advanced by Yellen and others, is that rising rates are an expression of economic strength.

Some important evidence on this issue came last week with the market reaction to the US Treasury’s decision to reduce the issuing of new debt below market expectations and to restructure debt issuance towards the shorter end of the market.

As the *Wall Street Journal* reported, the Treasury decision “handed investors a happy surprise.”

By the end of the week, the yield on the 10-year Treasury note had fallen to 4.557 percent, after briefly topping 5 percent on October 23. The S&P 500 stock market index climbed 5.9 percent for the week, “largely reflecting relief over the decline in yields, which are a critical driver of US borrowing costs.”

Under what were once “normal” conditions, the Treasury moves would have had next-to-no impact. That they were even undertaken and had the effect they produced, indicated growing problems of liquidity in the world’s most important financial market, resulting from its increasing difficulty in digesting rising government debt.

Following the Treasury move and the US Federal Reserve decision on the same day not to increase its interest rates, the *Wall Street Journal* (WSJ) said “relief was palpable across Wall Street.”

How long that lasts is another question. Sonal Desai, chief investment officer at Franklin Templeton Fixed Income, told the WSJ the rally was “overdone.”

There was an idea that “Treasury has the market’s back, [but] it can’t,” she said. “The size of the budget deficit means that there is an absolute limit to how much the Treasury can do.”

The growth of US debt amid tightening liquidity is by no means the only source of turbulence.

There is the ongoing issue of the so-called basis trade, in which investors use large amounts of borrowed money to sell bond futures and buy bonds to make money from the very small gap in their price—a practice which, according to research by the Federal Reserve, posed “financial stability vulnerability.”

Life insurance companies, once regarded as pillar of financial rectitude, are also getting caught up in the coils of the financial market.

Last week, the International Monetary Fund (IMF) urged financial regulators to take a close look at the activities of private equity funds such as Apollo, Blackstone Carlyle and others, warning of the possibility of “systemic risk” and the danger of “contagion” to other parts of the financial system.

The IMF move followed a warning last month by private equity investor J C Flowers that the increase in life insurance companies investing with private equity groups was posing a risk. There was the possibility of more than one firm getting “zapped.”

The role of insurance companies is decisive. It should be recalled that in 2008 financial authorities were prepared to let the investment bank Lehman Brothers go under but stepped in to bail out the system when the insurance giant AIG was threatened.

On top of the ever-present and deepening financial risks, there is the added threat of war and geo-political tensions to the stability of the global economy. Two major figures in the world of finance capital issued warnings to this effect over the weekend.

JP Morgan chairman Jamie Dimon said that, coming on top of the Ukraine war, the Israeli war on Hamas was “quite scary and unpredictable.”

In the US there was still a “strong” economy. “But these geopolitical matters are very serious—arguably the most serious since 1938.”

Larry Fink, the chief executive of BlackRock, the world’s biggest asset manager, said geopolitical risk was a major component in shaping lives amid growing fears.

Rising fear led to reduced spending and so “the probability of a European recession grows and the probability of a US recession grows.”

Fink said inflation would be higher for longer and this would require the Federal Reserve to lift rates further and “that will be ultimately the way we get into a recession.”