More warnings on the state of the US and global financial system

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As Wall Street powers ahead and major banks go all out promoting the initial public offering (IPO) of the Elon Musk-owned SpaceX and those to come of the AI companies Anthropic and Open AI, collecting fat fees running into hundreds of millions of dollars, warning bells on the state of the US economy and the global financial system are growing louder.

There is increasing focus on the narrowness of the stock market boom, which is concentrated in the handful of AI companies amid a slowing of the rest of the economy. Profits as a proportion of GDP are rising, but rather than leading to a "trickle down" effect in which workers receive higher wages, real wages are falling, and the most profitable companies are those which shed the most labor as they seek to cut costs, increasingly through the use of AI.

The overall data show that consumption spending in the US is holding up in the aggregate, but an increasing proportion of this is coming from higher income groups while millions of families are struggling to make ends meet as inflation, above all in necessities, surges.

And there is growing concern about the way in which the economy and the financial system are resting on the growth of debt.

This was the subject of a major article in the *Financial Times* (FT) this week entitled "Trump's empire of debt," which drew attention to the role of military spending in sending government debt to record levels.

It cited research from Brown University that the estimated cost of the wars launched since 9/11 was about $8 trillion. The actual figure is higher even than that because it did not include the interest costs on the debt to finance wars, which is now running at around $1 trillion a year. According to the FT report, the interest bill of the US Treasury has increased from 1.5 percent of GDP in 2021 to more than 3 percent today.

The US has been able to finance its debt because of the dollar's pre-eminent role as the global currency, enabling it to raise money from international capital markets. But there is a shift underway as investors are coming to regard the US as "overstretched."

The article noted that "foreign investors are moving out of Treasuries because of the debt problem, threats to the independence of the US Federal Reserve, the weaponization of the dollar through financial sanctions and the erosion of political checks and balances under Trump."

It pointed to the recent report by the European Central Bank that the proportion of US Treasuries held as reserves by the world's central banks had fallen from 25 percent to 22 percent in the past year, while the proportion of gold had risen from 20 percent to 27 percent.

The holding of US Treasuries, as well as the debt of other governments, by central banks has played a crucial role in the global financial system following the global financial crash. In the period 2008 to 2021, central banks bought up 63 percent of the debt issued by the major powers in the G7. In other words, one arm of the capitalist state issued large amounts of debt, the majority of which was then bought by another arm.

That figure was taken from a study published in April by the Group of Thirty financial think tank drawn up by Augustin Carstens, Klaas Knot, and Stijn Claessens, respectively the former head of the Bank for International Settlements, the former chief of the Netherlands central banks, and a former IMF official.

Their report focused on the increased role of nonbank financial intermediation (NBFI) in the global financial system and the rising dangers it poses.

It began by noting the growth of this area of the financial system since the global financial crisis of 2008. By the end of 2024, NBFI assets reached $260 trillion globally and accounted for more than half of total financial intermediation through the activity of private funds as they function as the middlemen between those seeking money and those seeking to invest it.

It said that while many NBFI entities posed limited systemic risks to global finance, there were "several NBFI types" which exhibited structural vulnerabilities because they combined illiquid assets with "runnable liabilities, resulting in significant mismatches." In other words, in terms that were used in the past, they borrow short and lend long. But the system has grown to such an extent that it dwarfs the conditions that led to the bank runs of an earlier era.

According to the report: "For money market and other investment funds, large-scale redemptions during periods of stress can quickly generate liquidity shortfalls."

And this can transmit a crisis to the heart of the financial system because "in core bond markets, hedge funds and other globally active firms dominate trading, often holding large, highly leveraged, and short-term funded positions that can unwind abruptly following shocks."

It cited some examples of this process, including the run on money market funds during the global financial crisis, the bond market turmoil of March 2020, and the "stress" in the UK bond market in October 2022—the "Liz Truss" moment when the Tory government tried to finance tax cuts with debt—and which required a rescue operation by the Bank of England.

The report said the risks of such a "systemic" event as a result of the activities of NBFI activities appeared to be increasing. The infamous refrain "until the music stops, we keep dancing" was "current" today, and expansionary fiscal and monetary policies in advanced economies had "encouraged excessive risk taking."

These factors made "vulnerability and global financial market stress more likely," but this stress was "more difficult to manage given stretched public balance sheets [a reference to the growth of deficits and rise of debt] and limited international policy coordination" [a result of the breakdown of the international trading and financial order triggered by the Trump administration].

"While views may differ on the urgency, there is little doubt that adverse shocks could trigger a crisis on a scale not seen since the GFC."

The body of the report contained numerous scenarios as to how such a crisis may be set off, and it emphasized a point made in many other places that the opacity of the NBFI system, due to "limited, poor quality and unevenly available information," hampered timely risk assessments, complicated "the identification of critical vulnerabilities" and rendered "stress episodes harder to contain."

It also cast a revealing light on the incapacity of financial authorities to control the beast that is finance capital, ever seeking and finding ways around any restrictions imposed on it. One such attempted reform was the regulations on the banks introduced after the GFC. But the connections between NBFIs, banks, and core markets remained substantial.

The rapid expansion of the private credit "relies heavily" on financing and support from banks, and these links "undermine one theme of the post-GFC reforms—the transfer of risk away from banks—since, while credit risk has partly migrated to NBFIs, much of the associated liquidity risk remains concentrated in the banking system." An attempt to throw risk out the front door saw it come in with greater force via the back.

As for future measures to try to contain problems in the NBFI system, it noted that measures intended to give it support would only lead to more risk taking because in ruling out the worst possible losses it would encourage "hedge funds and others in NBFI to take on even more leverage."

Summing up the situation, the report said: "The risk of systemic events related to nonbank financial intermediaries (NBFIs) is increasing as several structural developments combine with rapidly growing vulnerabilities of NBFI. A 'perfect storm' may be brewing."