The next crisis

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> "You have a dog, and I have a cat. We agree that they are each worth a billion dollars. You sell me the dog for a billion, and I sell you the cat for a billion. Now we are no longer pet owners, but Icelandic banks, with a billion dollars in new assets." *The Emperor Has No Clothes,* David Lizoain, Social Europe Journal, 16 April, 2013.[1]

Is there going to be another crisis? Of course there is. The liberalised global financial system remains intact and unregulated, if a little battered. "The crisis has proved itself as a way to solidify the existing economic order" – as Professor Joseph Vogl noted in his paper (Sovereignty effects) to the 2012 INET Conference in Berlin.

Neoliberal economic policies still prevail in all western Treasuries and in major university economics departments, informed by Samuelson's barter-based theory of money and credit:

> "Even in the most advanced industrial economies, if we strip exchange down to its barest essentials and peel off *the obscuring layer of money,* we find that trade between individuals or nations largely boils down to barter (my emphasis)."[2]

With money and money-creation helpfully obscured, and regulation trained on meaningless capital adequacy targets, business-is-better-than-usual for credit-creating commercial bankers, even while their balance sheets effectively remain under water. Central banks provide liquidity for speculation; taxpayers guarantee their risk-taking, and in a strange reversal of the purpose of banking, bankers no longer lend into the economy. Instead depositors and savers lend to bankers – expecting no return. In the meantime the discipline of the invisible hand is relegated to ancient textbooks.

Central banks, by their own admission, have used money market operations – "easy, cheap money" – to "buy time" and inflate asset bubbles, enriching the asset-rich, while austerity has impoverished the wage- and income-dependent.

Western politicians remain obeisant to Big Money, and on behalf of finance capital ruthlessly extract fictitious wealth created during the credit boom from their citizens, using austerity and "re-balancing" as the cover.

Finance capital reigns supreme in political centres of power. The revolving door between the world's biggest banks – Goldman Sachs, JP Morgan Chase and Citigroup – and finance ministries, central banks and political institutions – keeps revolving and by that means maintains the status quo.

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[1] See http://www.social-europe.eu/2013/04/the-emperor-has-no-clothes/?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+social-europe%2FwmyH+%28Social+Europe+Journal%29

[2] P. Samuelson, 1973, Economics, 9th Ed., New York: McGraw-Hill, quoted in G. INgham, *The Nature of Money*, Polity Press, 2004.

The most egregious recent example is that of Mario Draghi, now governor of the European Central Bank, but in the 1990s director-general of the Italian Treasury. There, according to an investigation by the *Financial Times*[3], he worked with private investment banks to arrange derivative contracts designed to disguise the scale of Italy's debt from EU authorities - to ease Italy's entry into the Eurozone. Draghi moved from the Italian Treasury to Goldman Sachs in 2002 - 2005, and from there it was one easy step to the governorship of the Bank of Italy in 2006. There he supervised and allowed Banca Monte dei Paschi di Siena SpA to mask losses 367 million-euros, which later required a taxpayer-funded bailout.[4] This experience qualified him for the role of governor of the European Central Bank in 2011.

Back in 2006 I wrote a modest little book which the publisher insisted on entitling "*The coming first world debt crisis*" – a title I believed would be out of date by the time of publication in September that year. I was wrong. The world's vast credit bubble had another year to expand before the "debtonation" of 9th August, 2007, when inter-bank lending froze. Even then the public remained ignorant of the full extent of the crisis until the bankruptcy of Lehman's bank in September, 2008.

I was wrong about another thing: that the "debtonation" would lead to a bursting of the global credit bubble; to a sustained period of global bank bankruptcies, debt write-offs and de-leveraging. Not so. Some big banks failed, many small US banks failed; but the overwhelming majority are still upright, thanks to extraordinary support and '"accommodation" by taxpayer-backed central banks. While 11.2 million American property owners have been foreclosed upon, and the US appears to be the only western economy to have begun the process of reducing the ratio of debt to GDP by 14%, debt-deleveraging – according to McKinsey and Co – has barely begun in the ten largest developed economies.[5]

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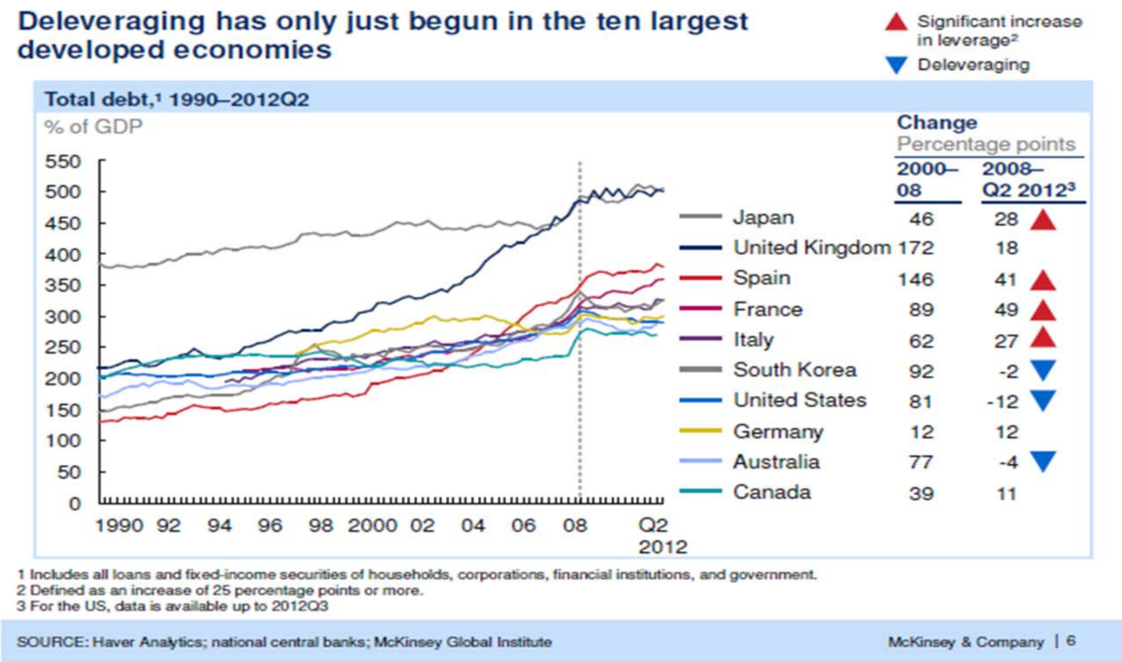
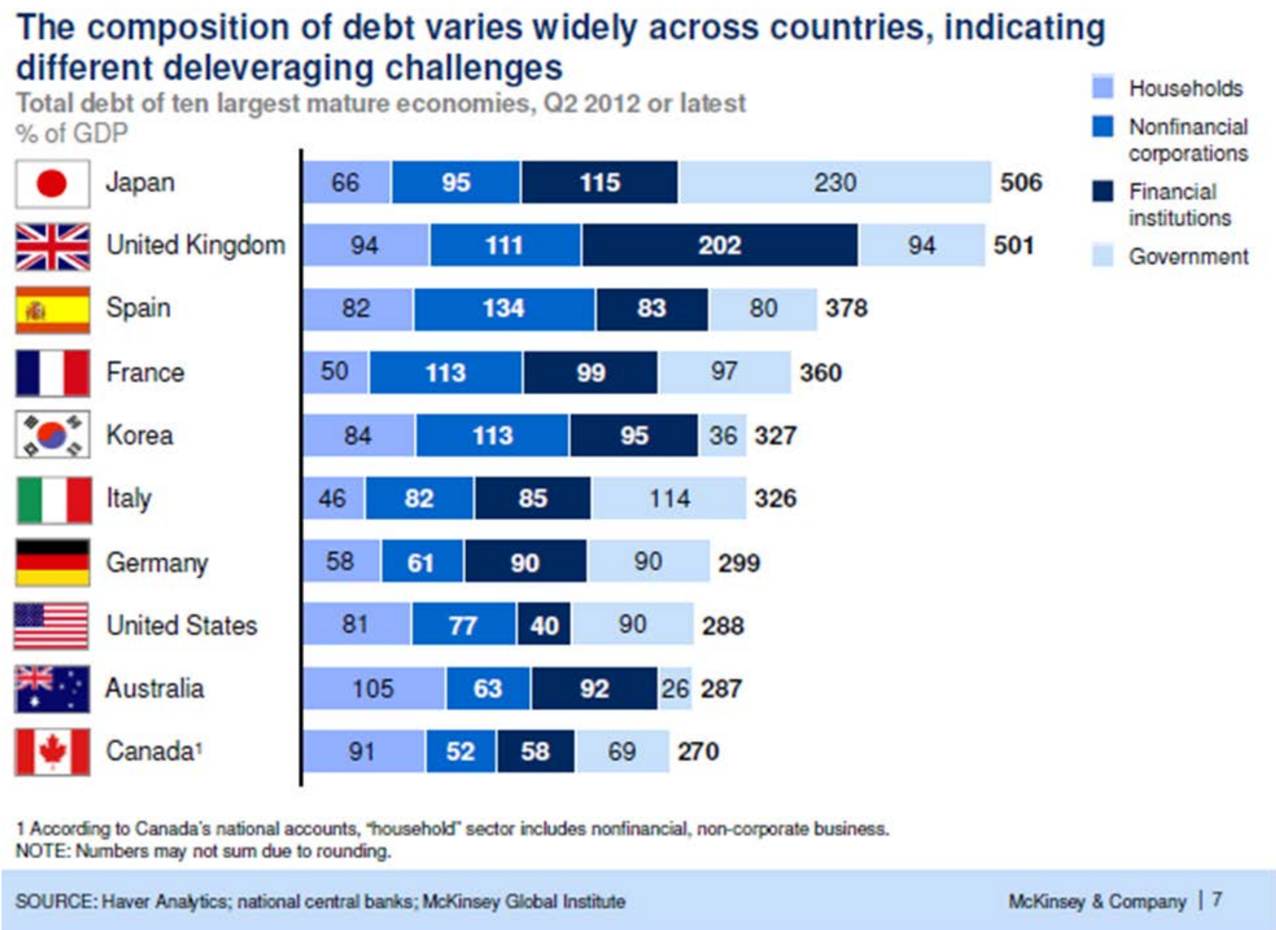
[3] *Financial Times* June 26, 2013. Italy faces restructured derivatives hit
By Guy Dinmore in Rome.
http://www.ft.com/cms/s/0/440007a8-dd9a-11e2-a756-00144feab7de.html#axzz2XK1eXV3H

[4] *Draghi Bank of Italy Knew of Monte Paschi Missteps in '10* By Elisa Martinuzzi, Sonia Sirletti & Lorenzo Totaro - Jan 30, 2013. http://www.bloomberg.com/news/2013-01-30/draghi-s-bank-of-italy-knew-of-monte-paschi-missteps-in-2010.html

[5] Debt and Deleveraging: Uneven progress on the path to growth. January, 2012.
http://www.mckinsey.com/insights/global_capital_markets/uneven_progress_on_the_path_to_growth


Deleveraging has only just begun in the ten largest developed economies
Significant increase in leverage²
Deleveraging
Total debt,¹ 1990–2012Q2
% of GDP
550
500
450
400
350
300
250
200
150
100
50
0
1990 92 94 96 98 2000 02 04 06 08 Q2 2012
Change
Percentage points
2000–08
2008–Q2 2012³
Japan 46 28
United Kingdom 172 18
Spain 146 41
France 89 49
Italy 62 27
South Korea 92 -2
United States 81 -12
Germany 12 12
Australia 77 -4
Canada 39 11
1 Includes all loans and fixed-income securities of households, corporations, financial institutions, and government.
2 Defined as an increase of 25 percentage points or more.
3 For the US, data is available up to 2012Q3
SOURCE: Haver Analytics; national central banks; McKinsey Global Institute
McKinsey & Company | 6


The composition of debt varies widely across countries, indicating different deleveraging challenges
Total debt of ten largest mature economies, Q2 2012 or latest
% of GDP
Households
Nonfinancial corporations
Financial institutions
Government
Japan 66 95 115 230 506
United Kingdom 94 111 202 94 501
Spain 82 134 83 80 378
France 50 113 99 97 360
Korea 84 113 95 36 327
Italy 46 82 85 114 326
Germany 58 61 90 90 299
United States 81 77 40 90 288
Australia 105 63 92 26 287
Canada¹ 91 52 58 69 270
1 According to Canada's national accounts, "household" sector includes nonfinancial, non-corporate business.
NOTE: Numbers may not sum due to rounding.
SOURCE: Haver Analytics; national central banks; McKinsey Global Institute
McKinsey & Company | 7

Banks, firms and households in western economies are still burdened by debts that will never be repaid. Much of that debt is phantom wealth, created out of thin air during the boom years. Behind the smokescreen of 'austerity' governments are colluding with finance capital to confiscate that wealth, and use it to shore up the private banking sector: "converting fictitious claims into more tangible gains" to quote David Lizoian.[6] Bankers (and their friends in political and regulatory institutions) lie about their balance sheets, fleece taxpayers, laugh about taking taxpayers to the cleaners (see the scandal of the Allied Irish Bank tapes) and simply 'extend and pretend' that assets on their balance sheets will be repaid. Furthermore, globalised banks have not been re-structured, thanks to effective lobbying of spineless politicians. They remain far too interconnected and will therefore once again transmit failure across the globe at the speed of lightning.

The question therefore becomes one of timing: when will the next crash happen? To that I offer the tentative answer: it may be imminent.

The Federal Reserve's recent, sudden change of direction has rattled bond markets and caused yields to rise. Only yesterday it seems, the Fed was offering long-term calendar guidance (through to 2015) on the direction of interest rates. Now that guidance, and date, has been dropped in favour of new, less predictable economic data: the 6.5% unemployment threshold.

The Fed it seems is (rightly) worried about deflation which in the words of Governor Bernanke "raises real interest rates… (and) means that debt deleveraging takes place more slowly". Furthermore, it seems the Fed is beginning to regret that its punchbowl of QE I, II and III, has so enriched the already-rich including speculators and those engaged in the carry trade ("big money does organise itself somewhat like feral hogs"[7] said the President of the Dallas Federal Reserve recently) – while having little impact on unemployment, which remains stubbornly high. This led Chairman Bernanke to comment to Congress on 22 May, 2013 that:

> "High rates of unemployment and underemployment are extraordinarily costly: Not only do they impose hardships on the affected individuals and their families, they also damage the productive potential of the economy as a whole by eroding workers' skills and – particularly relevant during this commencement season – by preventing many young people from gaining workplace skills and experience in the first place. The loss of output and earnings associated with high unemployment also reduces government revenues and increases spending on income-support programs, thereby leading to larger budget deficits and higher levels of public debt than would otherwise occur." [8]

We (Professor Victoria Chick and myself) argued as much back in 2010, when we published data from 100 years of national accounts in "*The Economic Consequences of Mr Osborne*" –

[6] The Emperor Has No Clothes, David Lizoain, Social Europe Journal, 16 April, 2013. http://www.social-europe.eu/2013/04/the-emperor-has-no-clothes/

[7] June 24, 2013. *Fed fights back against 'feral hogs'.* By Claire Jones and Robin Wigglesworth in London and James Politi in Washington http://www.ft.com/cms/s/0/9d8fa63e-dce6-11e2-b52b-00144feab7de.html#axzz2XK1eXV3H

[8] Chairman Ben S. Bernanke, *The Economic Outlook. Before* the Joint Economic Committee, U.S. Congress, Washington, D.C. May 22, 2013 http://www.federalreserve.gov/newsevents/testimony/bernanke20130522a.htm

and showed that in a slump "fiscal consolidation does not 'slash' the debt, but contributes to it". [9]

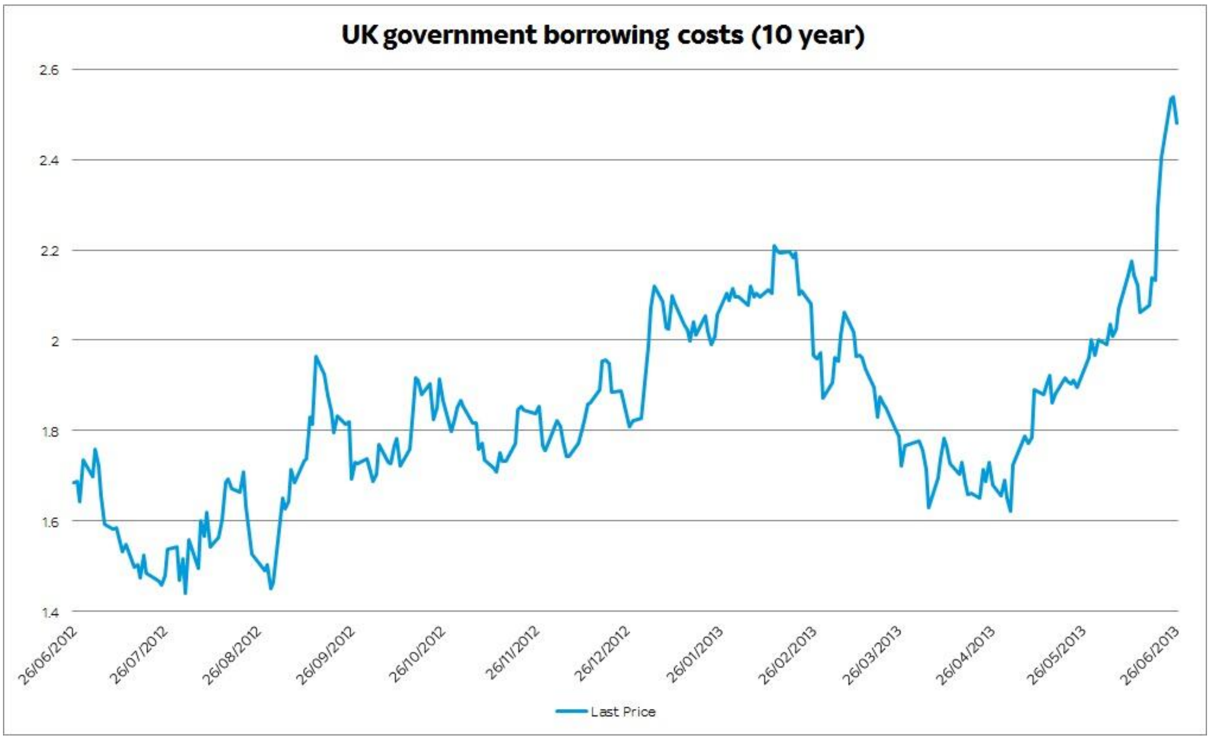
Federal Reserve 'Monetary activism' has hit the brick wall of Congressional "fiscal conservatism". Cuts in public spending in the US are expected to take out 1.0 – 1.5% GDP growth in 2013, Bernanke said. In the face of these "fiscal headwinds" Mr Bernanke has thrown in the towel:

> "In present circumstances" he said, "with short-term interest rates already close to zero, monetary policy does not have the capacity to fully offset an economic headwind of this magnitude." [10]

Markets have taken fright at the Fed's new emphasis on the unemployment threshold, and bond yields have risen. US Treasury Bond prices fell on 19 June, and the benchmark ten-year yield rose to its (current) 2.51%.

The following day the UK Gilt market, which has been falling since May, also fell, leading to major losses for bond investors, when the ten-year government bond yield rose to current 2.5%. These falls are already placing upward pressure on UK fixed-rate mortgages, and will ultimately pile pressure on indebted Britons whose incomes are falling in real terms.

And rising yields will increase UK government borrowing costs.



Courtesy Ed Conway (@EdConwaySky) of Sky News. Via twitter.

[9] PRIME: *The Economic Consequences of Mr. Osborne* by Professor Victoria Chick and Ann Pettifor. First published in July, 2010. http://www.primeeconomics.org/?page_id=51
[10] Chairman Ben S. Bernanke, *The Economic Outlook.* Before the Joint Economic Committee, U.S. Congress, Washington, D.C. May 22, 2013
http://www.federalreserve.gov/newsevents/testimony/bernanke20130522a.htm

To add to its debt burden, the UK Debt Management Office unwisely sold its £5 billion Gilt on 25 June, 2013 – a day of bond price volatility – at a rate committing the UK taxpayer to paying 3.65% for the next 55 years.

So debt burdens remain high, and interest rates look to be tightening, just as central bankers become impatient at the failure of politicians and bankers to make structural fixes. The question then becomes: when do spikes in interest rates become daggers aimed at bursting today's huge government bond/debt bubble?

Soon, in my humble opinion.

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