

Threat of a Complete Financial Meltdown: IMF Report Points to Growing Instability

By [Nick Beams](#)

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Four years after the collapse of Lehman Brothers, the latest Global Financial Stability Report published by the International Monetary Fund (IMF) makes clear that the threat of a complete meltdown of the international financial system remains. And the dangers of such an event are increasing.

The report, issued earlier this week, began by noting that risks to financial instability had increased since the previous report last April and that “confidence in the global financial system has become very fragile.”

The main risk to financial stability was a further deterioration in the euro area crisis, but “rising imbalances elsewhere are also a cause for concern.”

The report pointed to the increasing fragmentation of the euro zone, which could set off a massive withdrawal of capital from the weaker economies, as well as from central and eastern Europe. Such a withdrawal would push record unemployment levels even higher. There was now a “wedge” between the euro zone periphery and the core.

The crisis arises from the imbalances that were built into the euro zone from the outset. For the so-called periphery economies, adopting the euro as the common currency meant that they could no longer rely on a fall in the value of their national currencies to maintain their export markets. Hence, they increasingly suffered from a balance of payments deficit.

However, this was covered by an influx of capital from the stronger economies, in particular Germany. The inflow of capital boosted demand and provided valuable markets for German exports, setting up a virtuous circle. Now a vicious circle has replaced it, as capital flows in the other direction. “Liquidity in the core economy banks,” the report noted, “is not being recycled to the periphery but is instead being deposited at core central banks or in relatively safe government bonds.”

Bank bailouts have been accompanied by the imposition of austerity programs and recession, leading to a further withdrawal of funds.

The IMF report also warned that the corporate sector could become “an additional force in this pernicious feedback loop” as sovereign downgrades pulled investment grade corporate debt toward junk status.

The report’s forecasts were made on the basis of what the authors called a baseline scenario. This assumed that European policymakers would move to closer economic and

political integration, establish a single supervisory mechanism for the financial system and take action to close the gap between the high interest rates in the periphery and the very low rates in core countries, such as Germany.

Unless these measures were carried out—and that is far from likely, given the growing conflicts among the European powers—then the eurozone would slide into a “weak policies scenario”.

That scenario would bring a rapid worsening of the financial crisis. The forces of fragmentation would become “entrenched” and the capital problems of banks would increase, posing a “far-reaching threat to the global financial system and the global economic outlook.”

So far as policy prescriptions were concerned, the IMF demanded an intensification of the attacks on the working class. One of the key elements of any recovery program had to be the implementation of “growth-friendly fiscal consolidation”.

Such a thing does not exist. “Fiscal consolidation” is a euphemism for budget cuts, the impact of which is to reduce demand—either through cuts in social services or by the cutting of public sector jobs—leading to a further economic contraction, followed by demands for more cuts.

At the same time, finance capital demands that real wages be reduced and the exploitation of workers intensified. Accordingly, the IMF called for “wide-ranging ... structural and institutional reforms” in order to “strengthen competitiveness and narrow external imbalance.”

What this means is that, given that the countries running a balance of payments deficit cannot devalue their currency, they must carry out what is termed an “internal devaluation” in order to lower their costs, above all wages, and thereby become competitive on international markets.

The history of such “internal devaluation” was the subject of a comment by *Financial Times* columnist Martin Wolf, published on Wednesday. He pointed out that when the UK carried out such a regime between the wars, economic output in 1938 was barely above what it had been in 1918. “High unemployment,” he noted, “was the mechanism for driving nominal and real wages down.”

This is the program to be now applied across Europe.

While focusing attention on Europe, the IMF report also commented on the worsening situation in both Japan and the United States, two of the major pillars of the world economy.

Sovereign credit risk was an important “challenge” to stability in the US, with an already weak economy facing slow growth and inadequate demand. In addition, a “fiscal cliff” posed “near-term risks.” That is, the series of tax increases and spending cuts due to come into effect at the end of the year could, if implemented, cut US economic growth by as much as 2 percentage points.

The report warned that the present problems in the euro region were a “cautionary tale” for Japan, given its high public debt and the heavy investment by banks in government bonds.

The crisis has had contradictory effects. On the one hand, Japan has become a beneficiary of “safe-haven” inflows as a result of the crisis in Europe. These inflows have pushed the yields on government bonds to near-record lows, facilitating easy financing of the national public debt.

On the other hand, the foreign capital inflow has pushed up the value of the yen, thereby weakening Japanese exports and impacting on domestic production.

The increasing investment by domestic Japanese banks in government bonds could be sowing the seeds for future problems. If, for any reason, the yields on Japanese bonds started to rise (that is, there was a fall in bond prices) then the banks would incur a capital loss on their assets. And as the experience of Europe has shown, this can rapidly lead to the onset of a full-blown financial crisis.

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