Some revealing comments on the state of the global economy

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In their public presentations the leaders of the world's major financial organisations seek to project the image that they have somehow engineered a "soft landing"—that is, bringing down the highest level of inflation in four decades without inducing a recession.

They would have one believe that those who supposedly preside over the global economy have the situation under control.

Yet there is clearly a very different discussion going on behind the scenes that every so often comes into public view, at least partially.

One example was the speech delivered in Washington last week by European Central Bank President Christine Lagarde, a former head of the International Monetary Fund (IMF). In the 2024 Michel Camdessus lecture, inaugurated by Lagarde in honour of the ex-IMF chief, she likened the present period to the 1920s.

Lagarde pointed to two parallels between the "two twenties." Both were characterised by a fracturing of the world market amid significant technological change.

In the lead up to World War I, she noted that world trade as a percentage of gross domestic product (GDP) had risen from 10 percent in 1870 to 21 percent by 1913, but after the war "economic nationalism rose and a rapid unravelling of globalisation followed." World trade fell to 14 percent in 1929 and then to just 9 percent of GDP by 1938, as tariffs more than tripled in European countries and rose in the US.

Lagarde indicated that today the world economy was facing rifts comparable to those that led to the 1930s Great Depression and a collapse in world trade.

"We have faced the worst pandemic since the 1920s, the worst conflict in Europe since the 1940s and the worst energy shock since the 1970s," she said.

These developments had changed the structure of the economy and posed a challenge for monetary policy under conditions of an environment characterised by "more frequent global supply shocks" and a "fragmenting geopolitical landscape."

Lagarde concluded her speech with a show of bravado aimed at demonstrating that the guardians of the capitalist system, above all the heads of central banks, had things in hand.

She first cited the 1933 comments of the governor of the Bank of England, Montagu Norman, to his newly appointed economic advisor that "you are not here to tell us what to do, but to explain to us why we have done it."

Lagarde promised her audience this would not be the present approach and "we will draw on our best analysis, experience and knowledge, so that when change comes, we will be ready."

The attempt to inspire confidence, however, fell rather flat. The present head of the IMF, Kristalina Georgieva, asked in question time what she would have done in the 1920s to avert the disaster that followed. Lagarde was unable to give a coherent reply.

On the other side of the Atlantic, in a speech delivered in Ireland, the first deputy managing director of the IMF, Gita Gopinath, warned of the crisis building up in government finances as debts pile ever higher.

Gopinath said the focus of her lecture was to push for a "strategic pivot in global fiscal policy" to ensure that governments have the resources to "fight the next crisis."

"Such a pivot begins with the recognition of the true scale of the fiscal risks," she said. "It is worse than you think. This calls for further recognising that the economic consequences of high debt can no longer be dismissed in advanced economies."

Gopinath noted that when drawing attention to the fiscal risks a common reaction was: "So what? Many advanced economies have kept very high debt levels and nothing dramatic has happened. So why should we be concerned now?"

The concerns arose because of the slow growth in the world economy and the ending of large-scale purchases of government debt by central banks (so-called quantitative easing, QE) which drove yields (interest rates) on government bonds to record lows.

Loose fiscal policy meant there was now a premium on the yields needed to attract investors to government bonds, leading to increased borrowing costs in the broader economy. Gopinath did not go into detail, but this situation is particularly marked in the US where government debt is approaching $36 trillion and the interest on the debt is approaching $1 trillion a year.

In conclusion, she noted that "political and structural trends" were "increasing pressure on governments to spend more and borrow more."

"If history is any guide," she continued, "the trajectory of debt will be worse than any of us project today. This is not sustainable, and we need to strategically pivot."

The key issue is what is the content of this pivot? Employing the usual anodyne language of organisations such as the IMF to cover up the social implications of the policies they advocate, Gopinath said that in countries where growth was close to potential, such as in the US and most of Europe, there had to be a start on the path of "gradual fiscal consolidation."

Under conditions where growth is at low levels and military spending is on a rapid rise, this can only mean major cuts in spending on social services.

The mounting problems in government debt are taking place under conditions of ongoing turbulence in the global financial system.

Last week, the Bank for International Settlements (BIS) Quarterly Review examined the market turbulence at the beginning of August and the increasingly risky operations of life insurance companies.

The August market sell-off saw the VIX volatility index, sometimes referred to as Wall Street's "fear gauge," jump to levels around those experienced in the 2007-08 global financial crisis and a major fall of more than 12 percent on the Tokyo stock market.

The sell-off coincided with a worse than expected jobs report in the US, sparking fears of a possible recession. The BIS analysis insisted that the US news "by itself could not be taken as an unequivocal sign of a deteriorating outlook, let alone a looming global recession, and did not warrant such a market reaction."

The US news was a factor, but it was amplified by the conditions in financial markets produced by the Bank of Japan's decision to lift its interest rate into positive territory. This impacted the so-called carry trade, in which investors borrow Japanese yen at a low interest rate and use them to speculate in higher yielding US financial assets.

According to the analysis, the US hedge fund sector had become "increasingly exposed to markets that were at the epicentre of the August 5 turbulence."

With hedge funds using large amounts of debt and essentially employing the same strategies (often delivered by algorithms) for their speculation, this gave rise to "crowdedness," which amplified risks as "funds scramble to exist in similar positions at the same time."

The August events proved to be relatively short lived and no major losses have been reported, at least not so far. Nevertheless, this incident and a similar flare up of volatility at the beginning of this month, though on a smaller scale, underscored "just how hypersensitive markets have become" to new surprises and the changes in expectations as to the policies of central banks.

The BIS review also probed the other side of the low-interest rate regime of the central banks under QE, when they bought government debt. This benefited hedge funds and other speculators, providing them with essentially free money, but had an adverse impact on life insurance companies.

Life insurance, the BIS noted, plays a pivotal role in global finance. In 2022, these firms managed some $35 trillion in assets or around 8 percent of global financial assets. Their business model used to be conservative. They invested in government bonds and other low-risk assets to meet their obligations.

The low-interest rate regime meant this model was "severely challenged" and insurance companies have more closely involved themselves with hedge funds to try to boost their returns. This has raised concerns about their increased "risk of losses and vulnerability to sudden liquidity needs" as well as about the interconnectedness with other parts of the financial system.

These dangers were seen in the UK pension fund crisis of September-October 2022 when the Bank of England had to intervene in the bond market to staunch what could have been meltdown of the financial system. Clearly the UK crisis was the initial expression of broader conditions.