

UN fears third leg of the global financial crisis - with prospect of epic debt defaults



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The third leg of the world's intractable depression is yet to come. If trade economists at the United Nations are right, the next traumatic episode may entail the greatest debt jubilee in history.

It may also prove to be the definitive crisis of globalized capitalism, the demise of the liberal free-market orthodoxies promoted for almost forty years by the Bretton Woods institutions, the OECD, and the Davos fraternity.

"Alarm bells have been ringing over the explosion of corporate debt levels in emerging economies, which now exceed \$25 trillion. Damaging deflationary spirals cannot be ruled out," said the annual report of the UN Conference on Trade and Development (UNCTAD).

We know already that the poisonous side-effect of zero rates and quantitative easing in the US, Europe, and Japan was to flood developing nations with cheap credit, upsetting their internal chemistry and drawing them into a snare. What is less understood is just how destructive this has been.

Much of the money was wasted, skewed towards "highly cyclical and rent-based sectors of limited strategic importance for catching up," it said.

Worse yet, these countries have imported the deformities of western finance before they are ready to cope with the consequences. This has undermined what UNCTAD calls the "profit-investment nexus" that ultimately drives growth and prosperity.



Is the world about to get another financial kicking? CREDIT: ALAMY

The extraordinary result is that some countries are slipping backwards, victims of "premature deindustrialisation". Many of them have fallen further behind the rich world than they were in 1980 despite opening up their economies and following the global policy script diligently.

The middle income trap closed in on Latin America and the non-oil states of the Middle East a long time ago, but now it is beginning to close in such countries as Malaysia and Thailand, and in some respects China. "The benefits of a rushed integration into international financial markets post-2008 are fast evaporating," it said.

Yet the suffocating liabilities built up over the QE years remain. UNCTAD says corporate debt in emerging markets has risen from 57pc to 104pc of GDP since the end of 2008, and much of this may have to be written off unless there is a world policy revolution.

"If the global economy were to slow down more sharply, a significant share of developing-country debt incurred since 2008 could become unpayable and exert considerable pressure on the financial system," it said.

"There remains a risk of deflationary spirals in which capital flight, currency devaluations and collapsing asset prices would stymie growth and shrink government revenues. As capital begins to flow out, there is now a real danger of entering a third phase of the financial crisis which began in the US housing market in late 2007 before spreading to the European bond market," it said.

These are deeply-disturbing assertions. The combined US subprime and 'Alt-A' property exposure before the Lehman crisis was just \$2 trillion, and Greece's debts were trivial. What UNCTAD is talking about is an order of magnitude larger.

Views differ on whether the emerging market bloc is really out of the woods. UNCTAD says capital outflows reached \$656bn last year after the US Federal Reserve turned off the liquidity spigot, and a further \$185bn left in the first quarter of this year.

While there has been a respite over recent months thanks to the Fed's retreat, UNCTAD fears that the underlying rot is pervasive.

We are left with a world in a state of leaderless policy inertia, unable to escape slow suffocation. Trade is stagnant. Deflation is still knocking at the door a full seven-and-a-half years into the economic cycle, even with the monetary pedal pushed to the floor. The next downturn will test this regime to destruction.

The UN's diagnosis is that "shareholder primacy" and the entire edifice of liberal market finance are among the key culprits, all made worse by stringent fiscal austerity that has starved the global economy of sufficient demand.

Its prescription is radical. The world must jettison neo-liberal ideology, and launch a "global new deal" with a blitz of investment on strategic sectors. It wants a return of the "developmental state", commanding a potent industrial policy, and backed by severe controls on capital flows.

"If policymakers fail to mitigate the negative impacts of unchecked global market forces, then a turn to protectionism could trigger a vicious downward spiral for everyone," it said.

The UNCTAD critique - controversial to be sure - is that activist funds have acquired a stranglehold over the corporate management, leading to a culture of share-buybacks and the relentless extraction of profit. "Corporations are not reinvesting their profits into production capacity, jobs, or self-sustaining growth," it says.

While the profit share of GDP has risen to an historic high of 36pc of GDP from 30pc in 1980, private investment has slumped to 17pc from 21pc. This accumulation of unused savings is itself a major cause of the deflationary malaise.

It also explains the conundrum of collapsing productivity. There is no need for the grim pessimism of Professor Robert Gordon, who [thinks](#) the great the spurt of human progress over the last 250 years is largely exhausted, supposedly because we have already made most of the great advances. Falling investment explains it well enough.

The UN's advice to the emerging nations is to retake control of their destiny and turn the tables on the financial elites. They should impose capital controls, preferential tax treatment for retained earnings, and force fund managers to hold assets for longer. They should allocate credit without apology, and learn a trick or two from the Korea's methods of "financial repression".

It is not to everybody's taste. UNCTAD's manifesto of Left-wing proposals clashes with almost every nostrum taught in universities and business schools for the last two generations. Yet its arguments cannot be dismissed lightly, and its dissenting voice deserves to be heard.

The report puts the advocates of globalisation (as practiced) in a quandary. They - or we, perhaps I should say - typically argue that it has vastly raised the living standards of hundreds of millions of people across Asia.

It allegedly "works" for emerging nations, and this is cited as the paramount moral justification even if free flows of capital have regrettably allowed multinationals to fatten on 'labour arbitrage' and play off western wages at against low-pay hubs abroad.

But what UNCTAD shows is that globalisation has not in fact worked for these countries, bar a few exceptions. One starts to suspect that it works for nobody except the owners of capital and their close allies.

Besides, I have a hunch that UNCTAD's moment may be coming. It was Britain's Margaret Thatcher who kicked off the neo-liberal age of tax cuts, privatisation, and unfettered supremacy of the markets.

With uncanny timing - fit from a Conservative Party that has outlived every other major party in the world from sheer instinct and [fingerspitzengefühl](#) - Theresa May may now start to close that era with her embrace of industrial strategy.

What is clear is that world will soon need a massive and coordinated spending push by governments to create demand and bring the broken global system back into equilibrium. UNCTAD is entirely right about that.

If this does not happen, it is *sauf qui peut*.

