

World faces wave of epic debt defaults, fears central bank veteran

Exclusive: Situation worse than it was in 2007, says chairman of the OECD's review committee



The next task awaiting the global authorities is how to manage debt write-offs without setting off a political storm Photo: Rex

By Ambrose Evans-Pritchard, in Davos

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The global financial system has become dangerously unstable and faces an avalanche of bankruptcies that will test social and political stability, a leading monetary theorist has warned.

"The situation is worse than it was in 2007. Our macroeconomic ammunition to fight downturns is essentially all used up," said William White, the Swiss-based chairman of the OECD's review committee and former chief economist of the Bank for International Settlements (BIS).

"Emerging markets were part of the solution after the Lehman crisis. Now they are part of the problem, too."

William White, OECD

"Debts have continued to build up over the last eight years and they have reached such levels in every part of the world that they have become a potent cause for mischief," he said.

"It will become obvious in the next recession that many of these debts will never be serviced or repaid, and this will be uncomfortable for a lot of people who think they own assets that are worth something," he told The Telegraph on the eve of the World Economic Forum in Davos.

"The only question is whether we are able to look reality in the eye and face what is coming in an orderly fashion, or whether it will be disorderly. Debt jubilees have been going on for 5,000 years, as far back as the Sumerians."

The next task awaiting the global authorities is how to manage debt write-offs - and therefore a massive reordering of winners and losers in society - without setting off a political storm.

Mr White said Europe's creditors are likely to face some of the biggest haircuts. European banks have already admitted to \$1 trillion of non-performing loans: they are heavily exposed to emerging markets and are almost certainly rolling over further bad debts that have never been disclosed.

The European banking system may have to be recapitalized on a scale yet unimagined, and new "bail-in" rules mean that any deposit holder above the guarantee of €100,000 will have to help pay for it.

The warnings have special resonance since Mr White was one of the very few voices in the central banking fraternity who stated loudly and clearly between 2005 and 2008 that Western finance was riding for a fall, and that the global economy was susceptible to a violent crisis.

Mr White said stimulus from quantitative easing and zero rates by the big central banks after the Lehman crisis leaked out across east Asia and emerging markets, stoking credit bubbles and a surge in dollar borrowing that was hard to control in a world of free capital flows.

The result is that these countries have now been drawn into the morass as well. Combined public and private debt has surged to all-time highs to 185pc of GDP in emerging markets and to 265pc of GDP in the OECD club, both up by 35 percentage points since the top of the last credit cycle in 2007.

"Emerging markets were part of the solution after the Lehman crisis. Now they are part of the problem too," Mr White said.

Mr White, who also chief author of G30's recent report on the post-crisis future of central banking, said it is impossible know what the trigger will be for the next crisis since the global system has lost its anchor and is inherently prone to breakdown.

A Chinese devaluation clearly has the potential to metastasize. "Every major country is engaged in currency wars even though they insist that QE has nothing to do with competitive depreciation. They have all been playing the game except for China - so far - and it is a zero-sum game. China could really up the ante."

Mr White said QE and easy money policies by the US Federal Reserve and its peers have had the effect of bringing spending forward from the future in what is known as "inter-temporal smoothing". It

becomes a toxic addiction over time and ultimately loses traction. In the end, the future catches up with you. "By definition, this means you cannot spend the money tomorrow," he said.

A reflex of "asymmetry" began when the Fed injected too much stimulus to prevent a purge after the 1987 crash. The authorities have since allowed each boom to run its course - thinking they could safely clean up later - while responding to each shock with alacrity. The BIS critique is that this has led to a perpetual easing bias, with interest rates falling ever further below their "Wicksellian natural rate" with each credit cycle.

"It was always dangerous to rely on central banks to sort out a solvency problem ... It is a recipe for disorder, and now we are hitting the limit."

William White, OECD

The error was compounded in the 1990s when China and eastern Europe suddenly joined the global economy, flooding the world with cheap exports in a "positive supply shock". Falling prices of manufactured goods masked the rampant asset inflation that was building up. "Policy makers were seduced into inaction by a set of comforting beliefs, all of which we now see were false. They believed that if inflation

was under control, all was well," he said.

In retrospect, central banks should have let the benign deflation of this (temporary) phase of globalisation run its course. By stoking debt bubbles, they have instead incubated what may prove to be a more malign variant, a classic 1930s-style "Fisherite" debt-deflation.

Mr White said the Fed is now in a horrible quandary as it tries to extract itself from QE and right the ship again. "It is a debt trap. Things are so bad that there is no right answer. If they raise rates it'll be nasty. If they don't raise rates, it just makes matters worse," he said.

There is no easy way out of this tangle. But Mr White said it would be a good start for governments to stop depending on central banks to do their dirty work. They should return to fiscal primacy - call it Keynesian, if you wish - and launch an investment blitz on infrastructure that pays for itself through higher growth.

"It was always dangerous to rely on central banks to sort out a solvency problem when all they can do is tackle liquidity problems. It is a recipe for disorder, and now we are hitting the limit," he said.

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WEF and Davos: A brief history



1971

Professor arranges first meeting

German-born Klaus Schwab (pictured above), then Professor of Business Policy at the University of Geneva, gathered European business leaders in Davos for a discussion on global management practices.

The concept was to bring together the key players in the worlds of business, academia, arts and politics to meet to discuss the main issues of the day.

Such was the popularity of this first conference that Professor Schwab decided to create the European Management Forum.

Initially, the meetings focused predominantly on how European firms could catch up with US management practices.

1973

Focus of the annual meeting expands

Events in 1973, namely the collapse of the Bretton Woods fixed exchange rate mechanism and the Arab-Israeli War, saw the Annual Meeting expand its focus from management to economic and social issues.

1974

Political leaders invited

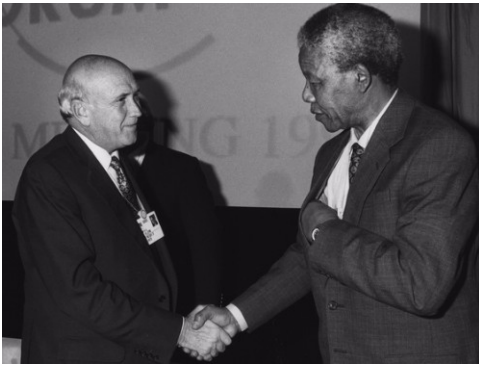
Political leaders were invited for the first time to Davos.

1987

Meeting becomes 'World Economic Forum'

1992

South Africa's tackles apartheid on WEF stage



South African president FW de Klerk, chief Mangosuthu Buthelezi and the recently liberated Nelson Mandela appeared on a podium together for the first time in what became a key date in the country's political transition away from apartheid.

2015

Rate rises, Greece and QE

WEF was dominated by talk of the first post-financial crisis interest rate rise in the developing world. In the end, the rate hike passed off with a whimper rather than a bang in financial markets.

Policymakers also gathered in the Swiss Alps days before Greece was due to hold elections which ultimately threw the eurozone into a new crisis for much of 2015. It also coincided with the ECB's historic decision to launch full-blown quantitative easing in the ailing single currency

Professor Schwab changed its name to the World Economic Forum

2002

Forum held in New York after 9/11

After the September 11 terrorist attacks in the US, the WEF decided to relocate its annual meeting from Davos to New York to show solidarity with both the city and the American public.

2010

Eurozone rescue plan revealed at WEF

Jose Manuel Barroso, president of the European Commission, unveiled the eurozone rescue plan at the WEF on Europe in Brussels. "We will do anything to defend the euro," he said.