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OPINIONISTA

Hier kom groot kak – the coming fall of today's Troy, the Western financial order



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Dr Michael Power recently retired from Ninety One where he was the Global Strategist for most of the past two decades. He remains a Consultant to Ninety One. Prior to Ninety One, he had worked in London, South Africa and Kenya for Anglo-American, Rothschild, HSBC Equator and Barings. He has a PhD from UCT, a master's from the Fletcher School at Tufts and a bachelor's from Oxford. His primary focus today is doing research into the emerging field of geo-economics focussing in particular on the global implications of the return of the economic centre of gravity to a China-centred Asia.

If I were presenting on the state of the global economy today, I would be calling for a four-alarm fire: I see a global crisis unfolding over the next few years, yes, financial in part, but this time around, so much more. A combination of long-simmering, long-ignored factors in a slew of mainly Western economies is coming to a head.



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The most common definition of a Cassandra is “a person who prophesies doom”. But the classical definition goes far deeper.

Cassandra, a Trojan princess, spurned the advances of the god, Apollo, who vengefully cursed King Priam’s daughter not only by giving her the gift of foresight but also – and here’s the rub – not having anyone believe her prophecies.

When Ninety One was still part of the Investec Group, I would regularly be invited to present to the Investec main board on the state of the global economy. Most memorably, in 2007, I detailed the perilous state of the US property market; how I foresaw its housing bubble bursting and how I predicted it would engulf not just the US financial

sector but spread worldwide.

I could have written the script given the events that subsequently unfolded: 2008's global financial crisis (GFC).

At that 2007 meeting, understandably, my forecast was neither welcomed nor, I suspect, believed. But I only learned this when, a couple of years later, one of Investec's directors informed me that my nickname was Cassandra. I like to think he meant it as a back-handed compliment.

Severe disruption

Were I presenting to the Investec board today, I would be calling for a four-alarm fire: I see a global crisis unfolding over the next few years, yes, financial in part, but this time around, so much more.

And, no, I would not be focusing on the end of the Nvidia-driven AI melt-up in the US stock market, even though that is a bubble ripe for bursting. Rather, my prophecy speaks to a far bigger series of events than a mere cyclical reckoning that periodically befalls a stock market which becomes overvalued.

A combination of factors in a slew of mainly Western economies – long-simmering, long-ignored by the ephemerality of market commentators – is coming to a head and will cause severe disruption, financial and otherwise. And this disruption will generate fallout globally. South Africa will be buffeted, though, as I explain below, perhaps not as dramatically as many economies.

It matters not which nation stumbles first. There is so much precariousness in the global financial system, that a tangential event could easily domino

into a global phenomenon, a so-called “polycrisis”.

Unfolding polycrisis

Adam Tooze, the economic historian, defines a polycrisis as a variety of unwelcome events – economic, political, geopolitical, environmental – that feed off each other, exacerbating unstable underlying circumstances. They need not be clearly linked, but when they happen simultaneously, they metastasise, cross-fertilise and spread, making the overall environment far worse.

Tellingly, Tooze traces the roots of today's unfolding polycrisis to the aforementioned GFC of 2008.

My view of what happened in 2008 is that it was largely cyclical. By contrast, the reckoning the world now faces will be far more structural in nature. And, after say two years of disruption, its net effect will be to reorient the world's financial order... and the nature of this reorientation will embrace both meanings of the word ‘Orient’.

The US is going to forfeit its undisputed position at the centre of world capital and a messy multipolar alternative – yes, one where the US will still be very influential but one which is equally centred upon Asia and not merely China – will replace it.

In this unfolding polycrisis, I do not rank financial aspects above the economic, political, geopolitical or environmental dimensions. To do so would be to misunderstand its essential nature: as it is, it will likely be triggered by the most peripheral of events.

Historians often trace the proximate cause of the Great Depression of the 1930s to the 1931 failure

of the Austrian bank, Creditanstalt. As the Chinese proverb says: “The flapping of the wings of a butterfly can be felt on the other side of the world.”

As I consider myself more qualified to detail the financial aspects of this polycrisis, that will be my focus.

Fault lines

There are many fault lines underlying today's world of finance but if I had to name one above all others, it would be the extraordinary amounts of debt that clog up the system. And that debt swamps both the West and East. In the West, the most debilitating variety is accumulated government debt; in China, it is property debt, though I see the latter as more cyclical and so more solvable.

Let me create a more historical context to explain how the world got into today's precarious predicament; a state where national debts for many countries are often greater than they were – as a percentage of GDP – in 1945, at the end of World War 2.

I consider myself to be a Keynesian, albeit a true Keynesian. This means I usually accept that there are occasions during the economic cycle – particularly in the depth of a recession – when government needs to be fiscally expansive; to spend money to jumpstart its economy. But following Keynes' original advice, I advocate that once an economy is back on track, borrowed money must be harvested and repaid.

This means I am not, in the definition used by Keynes' guardian angel, Joan Robinson, a typical American Keynesian. Especially during the 21st century, the recommendations of the latter group

have meant that borrowed money spent by governments in the bad times has not been routinely reclaimed in the good. Worse still, this profligacy now involves spending money and running up national debt in the good times as well.

Profligate behaviour

In 2023, when US GDP grew at 2.5% and unemployment was negligible, the US budget deficit was 6.3%. Result? The US now has gross federal debt detritus totalling 123% of GDP.

On 27 June 2024, the IMF's managing director, Kristalina Georgieva, made the Fund's most trenchant criticism yet of the profligate behaviour of the United States, its largest shareholder: "The fiscal deficit is too large, creating a sustained upward trajectory for the public debt-GDP ratio."

She added: "There is a temptation to postpone decisions related to debt and deficits for the future, rather than pay them when the sun is shining."

Let me be both clear and fair: once the mostly coastal ("saltwater") American economists mutated Keynesianism, much of the West followed suit – even Keynes' homeland, Britain.

Debt-to-GDP ratios have relentlessly edged higher ever since (IMF G7 2024 data for government debt to GDP: Japan 256%; Italy 139%; US 123%; France 112%; Canada 107%; UK 104%; Germany 64%).

Keynes famously said: "In the long run, we are all dead." So, it seems, is the all-important Keynesian multiplier which, historically, leveraged government spending into higher economic growth.

But there is so much debt choking today's G7

economies that – except perhaps for Germany – the Keynesian multiplier has ceased to work. In fact, it is worse than that: more government spending, far from adding to economic growth, now seems to detract from it.

The above debt-to-GDP numbers would be much lower – even in “*vorsichtig*” Germany – if true Keynesianism had been followed. The latter is like using a manual choke on an older vehicle: you pull it out to help start the car on a cold morning... but then push it back in again immediately after the car has started. Running the car with the choke out does permanent damage to the engine, as many debt-flooded nations are now finding out.

To repeat: more government spending in most of the G7 is now causing their economic growth engines to splutter and stall.

At the root

The root cause of what allowed the US to rip up the rules of prudence – for government to carry on spending even in good times – dates back to 1971 when Nixon suspended gold convertibility, releasing the US dollar from its golden fetters. This ushered in the age of fiat currencies – paper money.

What followed in the US was two decades of fiscal expansion, including under a Republican president, Ronald Reagan, and notably during the good GDP growth years of 1983 to 1989. In the aftermath of the US bond rout of 1994, there followed six years of relative prudence, perhaps surprisingly under a Democratic president, Bill Clinton. But post-2000 – when US debt to GDP was but 54% – things fell apart. Gross US debt to GDP has more than doubled to 123% in just 24

years.

Each nation following this spendthrift path has thus far found its own way to muddle through. Initially, Japan used its current account surpluses and high level of “ring-fenced” domestic savings to help fund its gargantuan budget deficits. More recently, with its debt-to-GDP ratio now 256%, Japan has opted for pure debt monetisation (money printing): through buying Japanese government bonds (JGB), the Bank of Japan now owns over 50% of all JGBs in issue.

Since 2000, the US has instead relied more and more on the reserve currency status of the US dollar: obliging foreigners have bought US Treasuries, helping to cover the funding shortfalls of ever-mounting US budget deficits.

This bail-out has been facilitated via the structural current account deficit the US started running in the 1990s, a shortfall that grew rapidly after 2001, not coincidentally the year China entered the World Trade Organisation. After 2006's low-point annual current account deficit of \$817-billion and 2008's GFC, a rough halving of the US deficit to around \$400-billion per annum followed. This “restraint” ended with Covid; 2024's current account deficit is forecast to be \$950-billion.

Funding the deficit

A broadly stable US dollar suggests these deficits have been financed by matching foreign capital inflows. Debt far more than equity has been favoured by foreigners: 2023's “debt-to-equity purchase ratio” was 92% to 8%. And about 85% of these debt-directed inflows bought US government securities, mostly Treasuries, with 15% going into corporate bonds. These bond purchases helped

fund the US' budget deficit.

Thus, the US' twin deficits – current account and budget – have been heavily reliant upon the kindness of foreign strangers for equalisation: in 2023, foreign savers redirected some 60% of the world's net mobile savings to the US to this end.

Today 23% of the US national debt is owned by foreigners, or 30% of that not owned by the Federal Reserve. As a result, the US' net international position – what the US owns abroad less what foreigners own in the US – went from broadly balanced in 1990 to a \$1.3-trillion deficit in 2000 to a \$21.3-trillion deficit in 2024.

Is this the Trojan Horse within America's gates?

All the while, since the 1990s, high-profile American economists have preached the “*spend, consume, spend, consume, spend, consume*” mantra so convincingly, that it is widely accepted as economic orthodoxy: permanent overspending and subsequent debt accumulation is now the new normal, and not just in the OECD.

So how on earth did this corruption of true Keynesianism spread? Joan Robinson again: “The bastard Keynesian doctrine, evolved in the United States, invaded the economic faculties of the world, floating on the wings of the Almighty Dollar.”

Cassandra prophecy

So here is my Cassandra prophecy: this incontinent use of debt by Western governments to fund current consumption will be challenged in the coming years. And when it is, the US-centric global financial structure – based on an unholy fusion between Federal debt and the US dollar –

will come apart at the seams.

The centricity of the US bond market and the US dollar in world finance will be challenged. And the walls of our modern-day Troy – the Western financial order – will be breached.

Yet the world's financial markets are only half-heartedly watching – mostly, it seems, pretending not to see – these Western nations as, year after year, they ratchet up their government debt loads, even as their demographics deteriorate. It is like witnessing the slow demise of that proverbial frog in a cauldron of water whose temperature is inexorably rising.

In the aftermath of what the French call *L'Affaire Truss* where UK prime minister Liz Truss tried to address Britain's debt issue almost overnight by going for tax-cut-driven GDP growth, it seems that Western capital markets will revolt at swallowing the debt-purging medicine (a combination of *higher* taxes – a no-no to the political Right – and *lower* spending – ditto for the political Left) that their nations ultimately need. And without this medicine, poor Kermit will likely be boiled alive.

I am reminded of Keynes' famous quote about bankers: "A 'sound' banker, alas, is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional and orthodox way along with his fellows, so that no one can really blame him."

So it is with today's "sound" nations – Western states with sovereign debts rated AA or better – pursuing the same profligate course, seemingly blind to the longer-term consequences of their overspending. And, like Keynes' bankers, they rely on that poisonous logic of: "Yes, everything must

be alright as we are all going deeper and deeper into debt together.”

Compounding the problem

The preference for political “sticking plaster” solutions not only fails to address avoiding the longer-term structural reckoning but likely compounds it. Indeed, it may even bring forward the date of that financial *Götterdämmerung*.

But with Western electoral cycles rarely more than five years long, which group of elected officials would dare to try to fix the underlying problem by forcing their electorates to take that bitter medicine?

When Margaret Thatcher pointed out to President François Mitterrand that the French pension system was unsustainable and must eventually collapse, he replied: “*Je connais, Marguerite... but not on my watch*”. Not on your watch perhaps, François, but Emmanuel’s... or perhaps Marie’s?

Whatever the rights and wrongs of the Liz Truss vision, at the time the ephemeral nature of here-and-now markets simply refused to listen to her. The market’s verdict? Prime minister and your entourage... begone! Her government was peremptorily dismissed, infamously lasting fewer days than the shelf-life of a lettuce.

My own view was that Truss highlighted uncomfortable but necessary truths that Britons needed to hear – a combination of low productivity growth and so low economic growth coupled with high debt – only her solutions were poorly thought out and badly executed.

Pessimistic commentators have suggested that Britain has already passed the point of no return:

whatever Truss did would have only compounded Britain's problems. In chess, they use the German term “*zugzwang*” (move compulsion) for the point in the game where whatever move a player makes, only makes his or her position worse.

Undemocratic outcome

Did this event highlight the fatal conceit that hides within modern-day democracy?

Current governments borrow from tomorrow's non-voting children so that their voting parents can consume today... only to leave their descendants an inheritance of a grossly indebted nation. If what results is an intergenerational tragedy which the non-voting will pay for, it is a profoundly undemocratic outcome.

How then does the G7 – with 63% of world bond markets, 26% of 2023's global GDP (PPP), 14% of global GDP growth (PPP) over the past decade and less than 10% of the world's population – look?

The US federal debt barrels towards \$50-trillion by 2034 (the CBO's latest estimate) as the American democratic mask slips and “that debate” reveals the US political elite to be little more than a plutocratic gerontocracy with a paralysed Congress and an ethically compromised Supreme Court.

Macron's France is gasping for breath under its heavy debt load, as his electoral challengers left and right promise to increase government spending even more. Meanwhile, Italy's debt to GDP exceeds that of France. France and Italy are especially exposed: in the former, government spending to GDP is now 59%; in Italy, 54%. And half of French government debt is owned by foreigners: in Italy, that ratio is 90%.

Japan – with by far the highest debt burden in the developed world and an economy that shrank 2.9% in the past year – watches helplessly as the yen falls to levels last seen in the mid-1980s.

In the British election campaign, no one dared address the issue of national debt directly: haunted by Truss' ghost, the rhetoric was all platitudes and promises. The Tories were electorally wiped out by the Left last week... even as Scholz's SPD in Germany and Trudeau's Liberals in Canada face similar drubbings, but from the Right in their general elections next year.

Unsustainable debt

The frog in the cauldron for most G7 countries is being willfully ignored “Left, Right and Centre” in nearly all the G7's political spectrums as they descend ever deeper into the hot water of government debt; debt soon to be revealed as unsustainable.

Even if the coming unravelling does not start in the US, where will this denouement have the greatest repercussions for the world's current financial order? The US, of course, even though only 4.2% of the world's population live there.

The US owns the world's reserve currency: the US dollar. It owns – and owes – 39% of the world's government debt. It “controls” the world's risk-free rate on capital: the yield on the US Treasury's 10-year bond. It generates over 40% of the world's budget deficits. It runs over 60% of the world's current account deficits.

This is surely evidence enough of a lopsided world financial order and an accident waiting to happen, following which a new order will emerge.

Written on the US dollar is the Latin phrase:
“*Novus ordo seclorum*”: a new order of the ages.
How portentous.

Meanwhile, the US expects foreigners to continue financing a considerable share of its annual shortfalls. But for how long? History tells us running budget deficits can happen for ages. France has not had a surplus for over 50 years, Italy for over 100. But – as Argentina has shown – bondholders do not have inexhaustible patience. Indeed, in 1994, the US bond vigilantes revolted too, and six years of relative austerity followed.

France last ran a surplus in 1974 when its debt-to-GDP ratio was 20%: today it is 112%. The US has gone from 65% in 1994 to 56% in 2000 to 123% today. Tick-tock!

Reorientation of global finance

Perhaps most tellingly, the US now consumes over 60% of the world's net mobile savings to help fund its twin deficits. This 60% ratio cannot rise forever, and, as economist Herb Stein has noted: “If something cannot go on forever, it will stop.”

And when the debt music of America does stop, I expect the resulting polycrisis to spread worldwide and the reorientation of global finance to begin in earnest.

National politics will be chaotic as bond markets revolt.

Geopolitical tensions will escalate as the full faith and credit of the United States will be – to use a biblical phrase – “weighed in the balance and found wanting”. Trade wars between the West and China will intensify.

And all this will happen when the heavily

populated Northern Hemisphere suffers intensifying fallout from climate change.

Question of SA

So, how might South Africa be partially insulated from this coming reorientation of the world's financial order? Because we are still a big miner of gold. Granted, we are not the giant we were two decades ago, but we are still a Top Ten producer.

And gold's recent price performance is surely trying to tell us something. As the *Daily Telegraph* wrote in April: "Gold is sniffing out monetary and geopolitical dystopia."

The *Financial Times* echoed this sentiment: "Gold is back – and it has a message for us. The precious metal's surge may herald a whole new world."

What then will happen in the next couple of years? At the centre of the financial dimension of the coming polycrisis will be a major dislocation in the US bond market. It will balk at having to absorb ever-increasing volumes of debt instruments being issued by the US Treasury: new debt plus old debt being rolled over.

Add to this, interest on US debt – now running at over \$1-trillion a year – will be "capitalised"... which means turned into yet more debt.

High-profile US financiers are bellowing, "Washington, we have a problem".

Inflection point

Jamie Dimon sees the rising debt mountain as the "most predictable crisis" the US economy faces.

Ray Dalio sees the US reaching that inflection point where, quite suddenly, the debt problem gets much worse. Paul Tudor Jones believes a "debt

bomb” is soon to go off. Even the ever-hyperbolic Elon Musk has tweeted: “We need to do something about our national debt or the dollar will be worth nothing.”

Bill Dudley, the former New York Fed president, recently noted the US deficit will top \$1.9-trillion in 2024; double the 2019 pre-Covid level of \$984-billion:

“The more (the US government) borrows, the greater the chance it’ll end up in a vicious cycle, in which government debt and interest rates drive one another inexorably upward. It’s impossible to know when investors will decide that such risks are too much to bear, as the bond vigilantes famously did in the 1990s. When it happens, it tends to be sudden and brutal.”

Even less partisan Congressmen are raising the alarm: in January 2024, cross-party senators Mitt Romney and Joe Manchin, and Representatives Bill Huizinga and Scott Peters, jointly wrote an opinion piece in *The Hill* titled: “National debt is the greatest threat to our country (<https://thehill.com/opinion/congress-blog/4415862-national-debt-is-the-greatest-threat-to-our-country-its-time-for-congress-to-act/>)”.

So what might the flapping butterfly wing be that could trigger this debt-driven tornado?

Saudi Arabia repricing oil sales in Saudi riyals, not US dollars? A long-overdue recession in the US? A crisis in French OAT bond markets... and so the Euro Zone? The US stock market bubble bursting? A falling yen triggering bank defaults in Japan?

Or a commercial real estate collapse hitting regional banks in the US? A climate-related

As they say in the banking halls of Jakkalsfontein:
“Hier kom groot kak...” **DM**