The global economy is at the point of maximum danger

By Ambrose Evans- Pritchard
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It feels like the summer of 1931. The world's two biggest financial institutions have had a heart attack. The global currency system is breaking down. The policy doctrines that got us into this mess are bankrupt. No world leader seems able to discern the problem, let alone forge a solution.

The International Monetary Fund has abdicated into schizophrenia. It has upgraded its 2008 world forecast from 3.7pc to 4.1pc growth, whilst warning of a "chance of a global recession". Plainly, the IMF cannot or will not offer any useful insights.

Its "mean-reversion" model misses the entire point of this crisis, which is that central banks have pushed debt to fatal levels by holding interest too low for a generation, and now the chickens have come home to roost. True "mean-reversion" would imply debt deflation on such a scale that would, if abrupt, threaten democracy.

The risk is that these same central banks will commit a fresh error, this time overreacting to the oil spike. The European Central Bank has raised rates, warning of a 1970s wage-price spiral. Fixated on the rear-view mirror, it is not looking through the windscreen.

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The eurozone is falling into recession before the US itself. Its level of credit stress is worse, if measured by Euribor or the iTraxx bond indexes. Core inflation has fallen over the last year from 1.9pc to 1.8pc.

The US may soon tip into a second leg of this crisis as the fiscal package runs out and Americans lose jobs in earnest. US bank credit has contracted for three months. Real US wages fell at almost 10pc (annualised) over May and June. This is a ferocious squeeze for an economy already in the grip of the property and debt crunch.

No doubt the rescue of Fannie Mae and Freddie Mac - $5.3 trillion pillars of America's mortgage market - stinks of moral hazard. The Treasury is to buy shares: the Fed has opened its window yet wider. Risks have been socialised. Any rewards will go to capitalists.

Alas, no Scandinavian discipline for Wall Street. When Norway's banks fell below critical capital levels in the early 1990s, the Storting authorised seizure. Shareholders were stiffed.

But Nordic purism in the vast universe of US credit would court fate. The Californian lender IndyMac was indeed seized after depositors panicked on the streets of Encino. The police had to restore order. This was America's Northern Rock moment.

IndyMac will deplete a tenth of the $53bn reserve of the Federal Deposit Insurance Corporation. The FDIC has some 90 "troubled" lenders on watch. IndyMac was not one of them.

The awful reality is that Washington has its back to the wall. Fed chief Ben Bernanke thought the US could always get out of trouble by monetary stimulus "à l'outrance", and letting the dollar slide. He has learned that the world is a more complicated place.

Oil has queered the pitch. So has America's fatal reliance on foreign debt. The Fannie/Freddie rescue, incidentally, has just lifted the US national debt from German 'AAA' levels to Italian 'AA-' levels.

China, Russia, petro-powers and other foreign states own $985bn of US agency debt, besides holdings of US Treasuries. Purchases of Fannie/Freddie debt covered a third of the US current account deficit of $700bn over the last year. Alex Patelis from Merrill Lynch says America faces the risk of a "financing crisis" within months. Foreigners have a veto over US policy.

Japan did not have this problem during its Lost Decade. As the world's supplier of credit, it could let the yen slide. It also had a savings rate of 15pc. Albert Edwards from Société Générale says this has fallen to 3pc today. It has cushioned the slump. Americans are under water before they start.

My view is that a dollar crash will be averted as it becomes clearer that contagion has spread worldwide. But we are now at the point of maximum danger. Britain, Japan, and the Antipodes are stalling. Denmark is in recession. Germany contracted in the second quarter. May industrial output fell 6pc in Holland and 5.5pc in Sweden.

The coalitions in Belgium and Austria have just collapsed. Germany's left-right team is fraying. One German banker told me that the doctrines of "left Nazism" (Otto Strasser's group, purged by Hitler) had captured the rising Die Linke party. The Social Democrats are picking up its themes to protect their flank.

This is the healthy part of Europe. Further south, we are not far away from civic protest. BNP Paribas has just issued a hurricane alert for Spain.

Finance minister Pedro Solbes said Spain is facing the "most complex" economic crisis in its history. Actually, it is very simple. The country was lulled into a trap by giveaway interest rates of 2pc under EMU, leading to a current account deficit of 10pc of GDP.

A manic property bubble was funded by foreigners buying covered bonds and securities. This market has dried up. Monetary policy is now being tightened into the crunch by the ECB, hence the bankruptcy last week of Martinsa-Fadesa (€5.1bn). With Franco-era labour markets (70pc of wages are inflation-linked), the adjustment will occur through closure of the job marts.

China, India, East Europe and emerging Asia have all stolen growth from the future by condoning credit excess. To varying degrees, they are now being forced to pay back their own "inter-temporal overdrafts".

If we are lucky, America will start to stabilise before Asia goes down. Should our leaders mismanage affairs, almost every part of the global system will go down together. Then we are in trouble.

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