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ECONOMICS

Unresolved financial problems exacerbate the next crisis

The next international financial crisis will be worse than the 2008 crisis. Sovereign debt threatens global economic stability and growth. National governments accumulated debt to prevent financial institutions collapsing. The dominance of financial institutions continues to threaten global economic stability. Increasing household debt threatens economic growth. Mittelstand corporations provide an example of corporate stability and managing corporate success. Engineering and science provides executives with the skills to manage a successful corporation. Business education does not prepare executives for corporate leadership.

Sovereign debt remains a significant problem for major economies. National governments in the developed world assumed the debt of financial institutions to protect their respective economies. The International Monetary Fund estimates global sovereign debt is US$59.7 trillion in 2015. The United States of America constitutes 29.1 percent of global sovereign debt. It is the largest government debt in the world. Japanese government debt constitutes 19.99 percent of the global total. Chinese sovereign debt consists of 6.18 percent of global sovereign debt. Government macroeconomic policies proved ineffective to resolve debt during the last seven years.

Increasing global debt is becoming unsustainable. McKinsey, a management consulting corporation examined the issue of global debt. It investigated increasing debt incurred by governments, corporations, households and financial institutions. Global debt was US$87 trillion at the end of 2000. It increased to US$142 trillion at the end of 2007. Global debt increased by US$57 trillion at the end of 2007 to US$199 trillion in the second quarter of 2014. Governments and corporations recorded significant increases in debt levels between the end of 2007 and the middle of 2014. Government debt increased from US$33 trillion to US$58 trillion during the period while corporate debt increased from US$33 trillion to US$56 trillion. Global debt compared to global gross domestic product was 286 percent in the middle of 2014 compared to 269 percent at the end of 2007.

Large financial institutions dominate finance. Financial institutions expanded their role beyond accepting deposits, providing corporate credit and basic investment products. Universal banks emerged in the 1970s. The institutions also provide clients investment banking services and commercial activities. Universal banks became large institutions managing the assets of numerous divisions. Deutsche Bank is a universal bank. The institution managed assets worth EUR 1.718 trillion on 31 December 2014 compared to 404 billion Deutsche Marks in 1990. Investment banks expanded during the late 1960s. Investment banks provide clients finance to underwrite equity issuance and advise corporate clients involved in mergers and acquisitions. Investment banks are an American phenomenon. Morgan Stanley managed assets worth US$802 billion on 31 December 2014. The organisations dominate American finance. The collapse of Lehman Brothers in 2008 almost destroyed the United States economy.

Financial institutions exert too much influence distorting the economy. Large profits and the extraordinary size of financial institutions contributed to the prestige and authority the financial sector enjoys. Prestige and authority changed the behaviour of institutions. It encouraged institutions to invest in risk and create riskier financial products. Remuneration is another factor demonstrating the influence of financial institutions. Finance executives enjoyed much higher remuneration compared to other industries. The large size of the financial industry restricted economic growth and increased inequality. Global financial institutions managed assets valued at US$146 trillion in 2013. Global gross domestic product was US$74 trillion.

Leverage increased the influence and risk of financial institutions. Leverage describes purchasing increasing quantities of an asset using credit. It is based on the assumption income from the asset and or appreciation of the asset will be greater than the cost of credit. Leverage magnifies gains and losses. Financial institutions used leverage to increase the value of assets under management. Excessive leverage contributed to the 2008 crisis. Securitisation through the accumulation of contractual debt and offering the asset to independent investors as securities flourished. Investors were able to gain finance with greater ease. Regulation encouraged financial institutions to deduct interest expenses from taxation liabilities.

Increasing household debt is a global phenomenon. Household debt refers to the debt private individuals owe financial institutions. The Bank for International Settlements (BIS) examined the ratio of household debt to gross domestic product at the end of 2014. Switzerland recorded the highest level of 120 percent followed by Australia's 119 percent and Canada achieved 93 percent. South Korea recorded a ratio of 84 percent. It is the highest among developing countries. The BIS stated the level of household debt increased significantly from the end of 2007. Household savings declined in most developed countries during the last three decades. Financial institutions reduced lending conditions to consumers due to deregulation and the desire of institutions to generate revenue and profit.

Financial innovation and complexity continue to pose a threat to stability. Financial innovation refers to creating new securities to exploit an opportunity to generate income without any productivity gains. The growth of derivatives contributed to the development of new financial assets. Interest rate swaps and credit default swaps are two prominent derivative products. Both contributed to greater volatility and risk. Mathematical research resulted in developments. The Black-Scholes model increased the popularity of options. The copula technique influenced the creation of the collateralised debt obligation. Technological improvements with developments in computer hardware and software and communication tend to reduce transaction costs. Demand for over the counter derivatives contracts flourished. The nominal value of over the counter derivatives was US$710 trillion at the end of 2013.

The expansion of wholesale finance threatens economic growth and stability. Wholesale finance refers to large financial institutions providing large quantities of financial services to other financial institutions. The secondary market refers to investors trading financial assets on an exchange. Financial institutions tend to trade with other financial institutions. The Boston Consulting Group forecast revenue from wholesale finance would increase from US$259 billion in 2013 to US$604 in 2023. Financial institutions preference for wholesale finance adversely affects their role as a financial intermediary. Retail banking and small businesses are considered less desirable and are neglected. It creates greater financial volatility.

Mittelstand corporations provide the foundation for stable economic growth. Mittelstand corporations provide the successful economic foundation for Austria, Germany and Switzerland. The corporations are privately owned by an entrepreneur or family. Management can focus on providing impeccable goods and services to clients. Executives are not distracted by short term demands from institutional investors. Executives are concerned with long term objectives of sustainable revenue and profitability. Zumtobel is an Austrian Mittelstand corporation. It is the global leader in supplying sophisticated lighting for indoor and outdoor applications. The corporation generated revenue of EUR 989.9 million in 2014/2015. The corporation managed 5,302 employees in 2014/2015 throughout Europe, North America, South America, Asia and Oceania.

Public corporations are fragile. Management is concerned with appeasing short term demands of institutional investors. Institutional investors are prominent stakeholders in large public corporations and exert tremendous influence on executives and corporate strategy. Managers tend to focus on short term revenue and profitability to ensure investors receive a dividend. Managers tend to neglect the important matter of providing customers desirable goods or services. Appeasing customer demands provides the foundation for long term revenue and profitability.

Engineering and science provide the impetus for Mittelstand corporations. Engineering and science graduates are celebrated in Austria, Switzerland and Germany. Engineering and science provides graduates with the important skills to solve complex engineering problems and imagine elegant approaches to the physical world. Austrian, German and Swiss universities and universities of applied sciences are renowned for fine scientific scholarship and research. The University of Innsbruck, University of Leoben, Graz University of Technology, University of Linz, Swiss Federal Institute of Technology and Munich University of Technology are excellent research universities. Scientists and engineers possess the skills and versatility to pursue an academic career, a professional career and establishing future Mittelstand corporations with the ambition to dominate international markets.

North America and the United Kingdom celebrate master of business administration graduates. Financial institutions are considered the epitome of corporate success and attract the intellectual and social elite. The master of business administration degree is a prerequisite for managing large financial institutions. The qualification provides a basic understanding of accounting and marketing. It does not provide graduates with the ability to manage employees or craft strategy to manage complex organisations and evolving corporate environments. North American and British managers lack problem solving skills. Richard Fuld was chairman and chief executive of Lehman Brothers when it collapsed in September 2008. He graduated from New York University with a master of business administration degree.

The global economy remains weak and susceptible to another crisis. Unsustainable sovereign debt continues to affect major developed economies and their capacity to implement effective macroeconomic policies. Financial institutions continue to dominate economies. The size, influence and behaviour of the institutions present a threat to economic stability. Increasing household debt is a factor influenced by the finance industry. Mittelstand corporations provide a more sustainable approach to economic growth. The corporations focus on astute management and engineering excellence. The master of business administration fails to provide the skills for managers to govern corporations.