Deep-seated fears send US dollar tumbling

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The world economic and financial crisis has well and truly come home to the United States. That is the significance of the violent movements in the US dollar-yen rate this week which saw the US currency lose 20 yen in the space of just 48 hours.

The initial movement appears to have been triggered by reports that agreement had been reached in Japan on a bailout for the banks--tending to increase the value of the yen--and a speech by US Federal Reserve chairman Alan Greenspan warning of dangerous conditions in US financial markets--tending to push down the dollar's value.

But it was then greatly magnified by the activities of hedge funds that had borrowed in Japanese yen to purchase US bonds bearing higher interest rates. The unexpected fall in the dollar forced them to change their bets, leading to a purchase of yen, thereby exacerbating the initial decline.

The dollar-yen turmoil--one of the most rapid currency realignments in history--added to the sense of bewilderment and fear that had dominated this week's joint meeting of the International Monetary Fund and World Bank in Washington.

US President Clinton said that if the strengthening of the yen had come about because of a belief that Japan was serious about economic reform then it was a 'good thing' and would lead to a 'balancing of forces in the world economy.' On the other hand, 'if it's a temporary phenomenon that evidences some sort of instability, then that's something we just have to try to sort out. But I don't think we can know for sure yet.'

A shocked governor of the Bank of Japan, Masaru Hayami, said the rise of the yen had been 'too rapid'.

Commenting on the latest financial gyrations, the *Financial Times* said they were 'symptomatic of the scale on which financial market contagion is now spreading into the developed world.'

'The accepted wisdom until recently was that the crisis would affect the developed world via trade flows. The collapse of Long-Term Capital Management [the US hedge fund] quickly changed that view. Now, western central bankers are becoming increasingly concerned about how their own financial institutions are coping. Highly-leveraged institutions are proving vulnerable to the unprecedented movements in the financial markets. The collapse of LTCM is having a widespread effect. It would not be surprising if this latest turbulence claimed another victim.'

The real story behind the downfall of LTCM is not the common explanation that the financial models devised by its management failed to anticipate the market shifts following the Russian default in mid-August. It is the extent to which major banks and financial institutions had lent LTCM hundreds of millions of dollars to finance its activities.

And LTCM is only one of several thousand funds. The most recent estimate is that the total equity raised by hedge funds is in the vicinity of $100 billion. This has been leveraged by about ten times, with the funds borrowing some $1 trillion--a considerable proportion of this from the banks. These funds have been used to finance speculative activities a further ten times that level--that is, $10 trillion. The total exposure to hedge fund activity is around one third of the total gross domestic production of the global economy.

Predictions of US recession

Whatever the immediate outcome of the latest turbulence, the plunge in the dollar indicates that the time has passed when the US currency could be regarded as a 'safe haven' in the global financial turmoil.

The rapid turnaround in the US economic position was the subject of a speech by Greenspan to the

National Association for Business Economics last Wednesday. He began by pointing out that the 'outlook for the US economy has weakened measurably in the aftermath of the Russian devaluation and debt moratorium'.

There had been a 'very dramatic change' in the risk profile in world financial markets 'for which the Russian episode was essentially the triggering mechanism'.

Greenspan told his audience that following the Russian crisis there was not just a movement to less risky bonds--a policy of risk aversion--but a shift by financial investors towards liquid assets--liquidity protection--and that in his nearly 50 years of observing the American economy he had 'never seen anything like this.'

Risk aversion, he said, arose from a calculated adjustment to perceived changes in the market, but liquidity protection 'results not from a judgment, some conceptual insight, but rather a loss of knowledge' and the destruction of perception.

'As a consequence, what is occurring is a broad area of uncertainty or fear. And when human beings are confronted with uncertainty, meaning they do not understand the rules or the terms of particular types of engagement they're having in the real world, they disengage.

'When you're crossing the street and you're uncertain as to whether a car is coming, you stop. You disengage from that particular process. And when you are uncertain about commitments in the market place, you disengage.'

Greenspan said that while risk aversion may be extremely difficult, it was still a market-calculated process. However 'a major shift towards liquidity protection is not really a market phenomenon' but a 'fear-induced, psychological response' which created an environment in which 'markets cannot effectively function in an efficient manner.'

While Greenspan sought to maintain his 'balanced' assessment, insisting that the United States was short of anything resembling a 'credit crunch,' he warned that there were 'all sorts of difficulties' for a lot of people in borrowing.

He estimated that so far the wealth loss resulting from the decline in the US stock market was around $1.5 trillion. This would have an impact on personal consumption spending and housing and consequently 'one can be inclined to say that there's a major contraction in the process'.

Only hours after Greenspan spoke, economists at JP Morgan forecast a recession in the United States next year--an eventuality which almost certainly would result in a global economic contraction.

The forecast said there would be no growth in the first quarter of 1999, a decline of 2 percent in the second quarter and 1 percent in the third quarter, followed by a rise of 1.5 per cent in the fourth quarter.

Morgan economist James F. O'Sullivan said the 'extra weakness' in the economy leading to the recession prediction had been 'triggered by the further deterioration in financial markets in recent weeks'.

'Although a downturn could still be avoided, it would likely take a prompt reversal of recent financial deterioration, or particularly quick and aggressive support from policy easing. Neither are anticipated.'

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