New fears of stockmarket slide

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After the dramatic surge on Wall Street in the last weeks of 1998, fears are once again growing that the US share market could be headed for a sharp decline, which, if sustained, would have far-reaching consequences for the global economy.

One of the immediate concerns is the effect of rising interest rates on stock values resulting from the decision by the Japanese government to try to finance its growing budget deficit through a record issue of bonds this year. It is expected that Japan will sell an additional $517 billion worth of bonds, bringing the total on issue to $2,500 billion--some $300 billion more than the US.

As more bonds are sold on the open market, the price falls, bringing a rise in yields and an increase in long-term interest rates. According to Mitsuru Saito, the chief economist at Sanwa Bank, bond markets in Europe and Japan are already starting to fall sharply and Japanese institutional investors have begun to sell US bonds, with worrying implications for global markets.

"US 30-year Treasury bonds have risen to 5.4 percent, which is a very critical level that may affect the stock market," he said.

The fear in the market is that with stock market values having being driven up by falling bond yields, the reversal of this trend will set in motion a slide on Wall Street. The size of the potential fall is indicated by the unprecedented rise in share values over the past three years.

By the end of December 1998 the value of all US stocks had risen to $12.9 trillion, equivalent to 148.3 percent of the gross domestic product. This compares with previous peaks in bull markets of 78 percent in December 1972 and 81.4 percent in August 1929.

Even more significant is the rate of increase. In January 1990 the value of stocks was just 51 percent of GDP. In December 1996 when US Federal Reserve Board chairman Alan Greenspan warned that the market was showing "irrational exuberance" the value of stocks was still around 60 percent of GDP. Since then the S&P composite index has increased by two thirds and the value of shares compared to GDP has more than doubled.

While warning of the dangers of the stock market bubble, the activities of the Federal Reserve Board have played a crucial role in maintaining it. Up to 1995, the annual increase in the US money supply was about 1 percent--a rate of increase it had sustained over the previous five years. Since 1995, however, the money supply has been expanding at an annual rate of about 8 percent. In other words, Greenspan has acted rather like a temperance preacher, who, after denouncing the wickedness of alcohol consumption, has decided that, as he is unable to prevent it, he should become a supplier.

One of the chief motivating factors behind US monetary policy has been the fear that if action is taken to collapse the stock market bubble, this will set off a recession in the United States, and precipitate a global slump.

Already, global economic growth is predicted to be no more than 1.6 percent this year, the lowest level since the recession of 1982. The Japanese economy is estimated to have shrunk by 3 percent in the past year and the rise in bond yields spells a further contraction in 1999. Meanwhile, the German economy, the key to European growth, appears, in the words of a recent article in the *Financial Times,* "to have hit a brick wall".

The rate of growth across the euro zone is forecast by Goldman Sachs to be only 1.9 percent this year, down from the 2.9 percent growth last year. In the year to December euro zone industrial production was up by only 1 percent. Unemployment has stopped falling and now averages 10.8 percent across the region.

The world economy has only been held up by the increase in expenditure in the United States, fuelled to a great extent by the stock market rise. But, as a recent article by economists Wynne Godley and Bill Martin, published by the Jerome Levy Economics Institute draws out, this situation is inherently unsustainable because US economic growth has been financed to a great degree by a rapid increase in debt.

The authors begin their analysis by recalling Clinton's remarks at the end of 1997 that the unfolding Asian financial crisis represented only a "few small glitches in

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the road". In the short-term, they note, this appeared to be an accurate prediction as consumer spending and investment in the United States roared ahead and sustained the growth of the world economy as a whole. But, as they go on to point out, in concentrating on the short term commentators overlook the long-term "strategic perspective".

"Looking ahead to the next few years," they write, "it seems to us wholly improbable that the United States can continue to act as the world's spender of last resort. Indeed, if present policies continue, the medium-term outlook for American economic activity appears exceedingly bleak."

In the face of a bigger budget surplus and worsening trade performance, demand has only remained high because of a "burst of spending by households and companies well in excess of the advance in after-tax incomes". This has given rise to an "unprecedentedly large and growing gap between private spending and income," financed primarily by an increase in borrowing.

"In 1998 the volume of private spending rose by about 6 percent, almost twice the increase in disposable income. The impact of this excess private spending financed by increased net borrowing has been profound; without it, the economy would have stagnated.

"Can this pattern of demand growth continue? The answer is a resounding no. Without a fiscal boost, private spending would need to continue to rise faster than private income to offset the drag on activity arising from long-established adverse trends in US trade performance. The result would be a fabulous increase in indebtedness, both domestic and overseas."

They calculate that to maintain growth in demand "private spending would eventually have to exceed income by an amount double the unprecedented 1998 level and equivalent to over 8 percent of the gross domestic product. The flow of net lending to the private sector would have to rise higher than ever before to over 20 percent of disposable income, and external net debt would rise to over 30 percent of GDP, thanks to a large and widening trade gap. These calculations have to be only very roughly right to be truly worrying."

Because the present acceleration of debt is unsustainable, they conclude that at some point expenditure will have to fall in line with income, leading to a fall in production and income and a decline in economic growth internationally. If it had not already done so, the stock market bubble would then burst, amplifying the deflationary process.

The two economists pointed to the situation in Britain at the end of the 1980s where the private sector overspent by an amount equivalent to 6 percent of GDP, leading to a "deep and brutal recession" over the next three years.

"But even if we assume in the case of the United States a much less marked reversion in saving behaviour, we find that the shock could potentially wipe out economic growth on average over the next five years. Unemployment would soar."

This would result in severe "collateral damage" to the rest of the world, with countries dependent on exports to the United States the worst affected.

"In addition, escalating trade deficits would make Latin America highly vulnerable to the sort of capital flight that devastated the Asian economies...

"Thanks to their much lower exposure, Europe and Japan would suffer least from an American stagnation. However, a further shock to a depressed Japan hardly bears contemplation, and with mass unemployment continuing in much of Europe, the large adjustments in the balance of payments brought about by American retrenchment would risk rekindling trade disputes."

The authors conclude their analysis by calling for a "radical rethink" by economic policymakers, involving an expansion of government spending on a global scale without which "the world may face not simply 'a few small glitches in the road', but a road disfigured by ruts and potholes, if not an occasional abyss".

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