Dollar fears spark market jitters

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This week is expected to be another nervous one for international financial markets amid growing fears that a rapid fall in the value of the US dollar could set off a sharp sell-off on Wall Street.

At the end of last week the dollar was trading at around 114 yen compared to 125 yen on May 20, while the euro was trading at around $1.07, after falling to near parity at the beginning of last month.

The dollar slide is being fueled by the widening US balance of payments current account deficit (comprising the trade deficit and the deficit on income) which is anticipated to be around $300 billion this year.

The financing of this deficit requires a continuous inflow of foreign capital into US bond and equity markets. But the foreign investors will only continue to place their funds in US markets provided the dollar maintains its value and so preserves the value of their holdings.

While it is generally accepted in financial markets that the dollar needs to come down to reduce the US trade deficit, there is a fear that if the decline proceeds too rapidly it could set off a panic and the development of a vicious circle. A too rapid fall in the dollar will lead to a sell-off of US assets, bringing a rise in interest rates, precipitating a fall in the stockmarket, a further withdrawal of funds and another fall in the dollar.

As the August 6 edition of the *Financial Times* noted in a comment on the relationship between the sharemarket, capital inflow and the dollar “take away either the dollar or asset market pillar and the whole precarious edifice could come crashing down.” While the decline of the dollar has been relatively slow so far “financial market participants say US policymakers are only too aware of the potential for a gentle decline to turn into freefall. ‘Treasury officials don't scoff when you put the nightmare scenario to them,' said one.”

Bond markets were also showing signs of the jitters in trading at the end of last week as interest rates rose, spreads between government and corporate bonds widened and rumours circulated that a major financial market trader had suffered heavy losses on a derivatives deal.

The yield on the benchmark 30-year Treasury bond rose to 6.17 percent, its highest level for 20 months, while the yield on 10-year Treasury bonds broke the 6 percent mark.

Further evidence of the nervousness is seen in the yield spread between Treasury securities, regarded as the safest form of investment, and AAA-rated corporate bonds. At the height of the financial crisis last October, in the wake of the collapse of the hedge fund Long Term Capital Management, the spread was 1.18 per cent. Today it is getting close to 1 per cent.

According to the widely-followed market commentator Barton Riggs of Morgan Stanley Dean Witter, the widening spreads “may be signaling that something is amiss.”

“Corporate bankruptcies in America are at record levels in the midst of unprecedented prosperity, and there does seem to be backsliding in some of the developing countries. The troubles in Korea, Argentina and in other Latin American countries are disconcerting.”

Morgan Stanley analyst Stephen Roach warned that the interest movements could impact on global economic growth.

“To date, we should not judge the recent shift in the credit cycle as a serious threat to global growth. Nevertheless, I do concede that a continuation of this trend would certainly run against the grain of our global healing scenario.”

The financial markets are also displaying considerable sensitivity to the situation in the labour market. The development of the sharemarket boom over the past decade and a half, and the escalation of equity values in the past three years in particular, has seen the emergence of various claims that a “new economic paradigm” is operating in the United States in which profits emerge out of new technology, unrelated to labour.

In fact, the sharemarket boom is the outcome of continuous pressure on the working class through downsizing, cuts in real wages and the elimination of health benefits and other conditions.

This relationship has been clearly in evidence in recent weeks. Two weeks ago the market suffered a 300-point decline in the wake of news that the employment cost index had increased more rapidly than expected. Last week it fell in response to news that the average hourly wage rate had risen by 0.5 percent from June to July, increasing from $13.23 to $13.29 and that the numbers of jobs in the economy rose by 310,000 in comparison to market expectations of 200,000.

The fear in the markets is that this apparent “tightening” in the labour market is almost certain to result in a further increase in interest rates when the Federal Reserve Board next meets on August 24.