

Markets continue to "rollercoaster down"

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Central banks around the world have followed the lead of the US Federal Reserve Board and cut interest rates in an attempt to prevent a global recession. But their measures have so far failed to halt the slide on international financial markets.

On Thursday, the Dow Jones index fell by another 4 percent, bringing the total decline since Wall Street re-opened on Monday to almost 13 percent, and setting up conditions for its biggest-ever one-week point drop. One commentator described the market as "rollercoastering down."

The continued decline could prompt further action by the Fed, possibly as early as next week, with some analysts calling for a rate cut of 2 percent—a figure that would put interest rates into negative territory, when inflation is taken into account.

But the cuts appear to be having little impact on the world economy and forecasts of economic growth are all being rapidly revised down. While the terrorist attacks on New York and Washington have certainly had a direct economic impact, their main effect has been as a catalyst, speeding up processes that were already well under way before September 11.

In its first assessment of the new situation, the financial group ABN Amro warned: "The US economy has suffered a massive shock ... and is likely to go into recession. The short-term shock will flow right through the global economy, lowering forecasts from growth, corporate cash flows and profits." The group cut its 2002 gross domestic product growth forecast for the United States to zero from the 2.5 percent prediction before the terrorist attacks, sliced almost one percentage point off its forecast for world growth both this year and next, and warned that world trade could fall by more than 1 percent.

The mounting crisis is having a severe impact on Japan, where the economy has already entered a recession. The Bank of Japan intervened in the currency markets this week to try to push down the value of the yen in order to maintain Japanese exports. On Thursday it revised down its assessment of the economy for the fourth time in as many months, with official figures revealing a 47.2 percent decline

in the country's trade surplus.

Falling exports, which are likely to decline even further as the US market contracts, were having a "negative impact on jobs and income conditions", the bank said. This could lead in turn to falling demand within Japan and a protracted downturn.

A report in the *Financial Times* summed up the situation as follows: "The economic picture in Japan is darkening by the day as the stock market remains in the doldrums, the bank sector faces a grave future, and the Japanese authorities are forced to intervene in the foreign exchange markets to stop the dollar from weakening and undermining efforts to stem deflation."

The continued fall in the stock market threatens to create a major crisis for the Japanese banks, which have significant shareholdings. So far the losses are all on paper, but at the end of the month the banks will be forced to reveal the extent of these losses when they present results for the fiscal half-year. If the losses are too great, the capital base of the banks will erode, putting in jeopardy plans to write off bad loans as part of the "restructuring" of the Japanese economy.

In such a situation the government would have to undertake a further injection of funds. But this may not be sufficient and there are calls for more radical measures. The chief strategist at Deutsche Bank, Ryoji Musha, has warned that the terrorist attacks have deepened Japan's crisis and that the banking system is on the edge of a meltdown. "The only way out of Japan's predicament is the partial and temporary nationalisation of all the country's major banks," he said.

In an editorial published on September 19 under the title "World must work to stem panic", the *Daily Yomiuri* breathed a sigh of relief that the US had averted a crash when markets re-opened on Monday. It warned, however, that Japan's "easy money" policy was "far from enough to quell fears of a global recession." The Japanese economy, "among others", appeared to be "headed in the direction of a deflationary spiral, posing a threat to the global economy."

In Korea, the world's 11th biggest economy, the central bank joined its international counterparts and reduced the country's interest rates to their lowest-ever level. In a

statement accompanying the move, the Bank of Korea warned that there was “an increased likelihood that the economic slowdown will be both serious and prolonged.”

These sentiments were echoed in a statement issued by the commerce ministry. “There are concerns over the worsening of profitability and cash-flow in the corporate sector ... This could increase corporate credit risk and deepen a ‘flight-to-quality’, possibly bringing about a contraction in both bank lending to the corporate sector and the corporate bond market,” it said.

An editorial in *The Korea Times* warned that “the global economy is again showing signs of serious turmoil” and that the “Korean economy, which largely depends on global trends, is expected to face a more serious crisis than before.” It said the government could not rule out the “worst scenario” and called on it to draw up “contingency programs” in collaboration with the business sector.

The recessionary tendencies in the global economy are also being manifested in Australia, which, up to this point, has experienced one of the highest growth rates internationally. But behind the growth façade lie mounting problems.

This week Pasminco, the world largest integrated zinc producer, joined the country’s growing list of corporate collapses, announcing it was placing itself under voluntary administration. Pasminco, which has debts of \$A2.79 billion, has been hit by falling metal prices—an outcome of the downturn in the global economy—and the fall in the Australian dollar, which has increased the cost of financing its debt burden, much of which is denominated in US dollars.

Pasminco’s demise followed just days after the collapse of the country’s second-biggest airline, Ansett, in a year which has already seen the demise of the insurance giant HIH, the telecom company One.Tel and the retailer Harris Scarfe.

The accelerating global downturn has led to calls for concerted international action to prop up the world economy. One of those making this call, *Financial Times* economics commentator Martin Wolf, pointed out that global output had already declined in the second quarter of this year.

Figures cited by Wolf point to the fact that the developing global slump is directly connected to the Asian crisis of 1997-98. New capital flows to the “emerging market economies” fell from \$233 billion in 1996 to just \$2 billion last year. “The effect was to make the world extraordinarily dependent on a US economy that generated two-fifths of the increase in global demand (at market prices) over the past five years. That motor has now stalled.”

One of the chief reasons for the US slowdown has been the fall in profits, with the share of corporate profits dropping by one quarter from its peak in 1997. For a time, the decline in

profits was covered up by the rise in the share market. But with the collapse of the bubble from around the middle of last year, investment spending has been cut back, resulting in a deepening downturn in both the US and global economy.

These processes have been intensified by the economic shocks emanating from the terrorist attacks—the crisis in the airline industry and the losses incurred by the insurance industry, to name just two.

But some economic pundits are predicting a steeper upswing will follow. According to their argument, the spending measures already announced by the US government, as well as its boost to the military, will provide a stimulus to the economy.

Almost overnight, it seems, the economic theories of the British economist John Maynard Keynes, declared a virtual “dead dog” for the past 25 years, are suddenly back in fashion. But hopes for a Keynesian boost to the world economy ignore some fundamental features of the present situation.

In the first place, the downturn is not the result of falling consumer demand—were it not for sustained consumption spending the US would have already fallen into recession—but overcapacity, falling profit rates and cutbacks in investment. Under these conditions, increased government spending and budget deficits can tend to lift long-term interest rates, tending to choke off any upturn. The recent increases in the long-term bond rate may well be the first signs of such a process.

Moreover, hopes for a neo-Keynesian solution are contradicted by recent experiences in Japan. Since the collapse of its share market bubble at the beginning of the 1990s, government attempts to pump-prime the economy have failed. As a result, Japan is entering its third recession in ten years, while government debt has risen to 130 percent of GDP.

The similarities between the Japanese and American financial bubbles suggest that the hopes of a Keynesian “quick fix” to the US and global slump will prove to be illusory.



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