Capital markets are "not functioning"

Wall Street suffers worst quarter since 1987

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The US stock market has completed its worst quarter since the crash of 1987 and seems set to record three years of consecutive decline for the first time in more than 60 years.

At the close of trade on Monday, the Dow Jones was down 17.9 percent for the three months to the end of September, its biggest drop since the 25.3 percent fall in the fourth quarter of 1987. The S&P index was down by 17.6 percent and the Nasdaq by 19.9 percent.

The Wilshire 5000 total market index dropped 17 percent in the quarter, wiping out about $1.9 trillion in market value, and bringing to more than $8 trillion the total loss of share market wealth since the peak in early 2000.

The nervousness in financial markets has been reflected, not just in the share market decline, but also in the rising price of Treasury bonds, regarded as a safe haven in troubled times. Interest yields on the bonds, which move in the opposite direction to price, have fallen to their lowest point in more than 40 years.

The international situation presents no better picture, with some European markets faring even worse than Wall Street. In Germany, the Frankfurt Dax, the main stock market index, has fallen by 46 percent this year with no sign of the decline coming to an end. London's FTSE index lost more than 20 percent in the quarter. Across Europe, banks and insurance companies have been hit particularly hard because of their exposure to technology and telecommunications companies.

Comments on the equity markets from various analysts have included phrases such as "caving in", "deep depth of uncertainty" and "tremendous disillusionment." According to Michael Hartnett, the director of European economics and strategy at Merrill Lynch in London: "Capital markets are the beating heart of the capitalist system and they are not functioning at the moment with equity prices falling and credit spreads [the divergence between secure and more risky assets] rising."

The financial markets are expecting the US Federal Reserve Board will shortly make another cut in its benchmark interest rate from 1.75 to 1.5 percent. But since the record rate cuts of the past two years have failed to boost the US economy and equity markets, another one is not regarded as likely to make any difference.

Under conditions where the global economy is facing growing problems and the prospects of economic recovery are seemingly petering out, one might have expected last weekend's meeting of the Group of Seven (G-7) major industrial economies and International Monetary Fund meeting of finance ministers to launch new economic initiatives. The G-7 communiqué, however, simply declared that existing policies would bring about stronger economic growth in the period ahead.

US Treasury Secretary Paul O'Neill—who has already distinguished himself with the claim that the record American external debt is really a sign of the strength of the US economy—told reporters that he did not find the world such a "gloomy" place. "I don't choose to find the world to be a place where hand wringers should prevail, but people who have leadership responsibilities get on with it," he said.

But the major criticism of financial commentators is that this is exactly what is not taking place. Rather than taking new initiatives, the G-7 meeting simply reiterated a commitment to "sound economic policies and structural reforms."

The *Economist* noted that while statements from such gatherings are always bland, given the "widespread concern about the outlook for the global economy" this communiqué was "verging on the complacent." The reason, it continued, was the "confusion, tension and disagreement" colouring the final statement, which got "messier" once the meeting was over.

The confusions arose from a dispute between Japanese finance minister, Masajuro Shiokawa, and his own officials over whether the government was preparing to bail out the banks. When the finance ministry in Tokyo said no such commitment had been made, Shiokawa insisted that it had.

While the Japanese government is embroiled in disputes over how to tackle the country's financial crisis, European governments face problems of their own. The growth and stability pact agreed upon when the euro was introduced places limits on budget deficits. Originally this was aimed at countries such as Italy, but now Germany and France are falling foul of these limits.

Overshadowing proceedings were concerns over the economic impact of a US-led war against Iraq, which the meeting avoided discussing. As Peter Hartcher, Washington correspondent of the *Australian Financial Review*, commented, the finance ministers met "in the midst of three particular disasters"—the war against Iraq, the Japanese implosion and the unfolding debt crisis in Latin America—any one of which "points the way to general global economic crisis." But denial and procrastination won the day.

The finance ministers may have chosen to ignore the growing instability in the world economy, but it is unlikely to ignore them for long. The prospect of a financial crisis centring on Brazil is becoming increasingly likely. Last week the Brazilian real sank to a record low against the US dollar, down 28 percent from its level of August 7, when the IMF announced a record $30 billion loan.

Brazil has debts of more than $335 billion, compared to Argentina's $130 billion debt in 2001 when it defaulted. Net public debt in Brazil is equal to 62 percent of gross domestic product (GDP), compared to 54 percent for Argentina, and much of it is denominated in dollars. This means that when the real falls, the debt gets larger.

Aside from the problems caused by the continued slide in global stock markets, there are growing concerns that a financial crisis could be set off by the "risk models" used by companies and financial market investors. The danger of such models is that they can lead to large losses when so-called "low probability events" take place. That was the fate that befell Long Term Capital Management in September 1998. Its collapse, which required a $3 billion bailout organised by the Federal Reserve, was not triggered by some highly speculative venture. It resulted from unusual market conditions, where currencies moved in a way that were calculated to be highly unlikely.

The potential for the eruption of similar "low probability events" is a product of contradictions in the global economy. The United States is running a balance of payments deficit of more than 4 percent of GDP, which requires a capital inflow of more than $1 billion per day. If present trends continue, this figure will increase to around $2 billion and the US external debt will blow out from its already record level of $2.3 trillion.

Closing the US payments gap and halting the rise of external debt requires a significant fall in the value of the US dollar, thereby boosting exports and cutting imports. But a fall in the dollar would signify a rise in the value of the euro and the yen. For such an adjustment to take place without a major disruption, the growth rates of the European and Japanese economies would need to markedly increase. However, with its banking crisis going from bad to worse and growth rates for this year expected to be negative, Japan is not going to provide a boost to the international economy. Rather than rising, the yen is likely to decline.

While the euro has risen in recent months against the dollar, the prospects for a further rise seem small, given the slow growth in the European economy. Germany's finance minister has cut the government's growth forecast for 2003 by a full percentage point to just 1.5 percent—not enough to provide a stimulus for the rest of Europe, let alone the world.

But if the US dollar continues to remain high relative to the yen and the euro, the balance of payments gap will continue to widen and the external debt to mount. This can be sustained only as long as US investment prospects continue to attract capital inflow from the rest of the world. But that is no longer the case. Capital could therefore suddenly start to move in the other direction.

Rather than a smooth adjustment, the conditions are being created for a major financial crisis erupting at the very centre of the world economy.