

War rally on Wall Street may be short-lived

Nick Beams
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There was something rather obscene, but at the same time instructive, in the way the US stockmarket completed its best weekly performance in more than 20 years last Friday. With bombs and missiles raining down on Baghdad, “investor confidence” pushed up the Dow Jones index for the eighth consecutive day, as if to underscore the symbiotic relationship between financial parasitism and militarism.

In the words of one broker, “investors are relieved by the progress of the conflict in Iraq.” Another commented: “Once the Iraq problem is resolved, businesses and consumers can begin to look further ahead and economic activity will likely improve.” But the hopes of the brokers and financial speculators that a swift victory in Iraq will spark a market boom like that which began after the first Gulf War in 1991 could prove to be short-lived.

This is because rather than the downturn in the market arising from “uncertainty” over Iraq, the decline in stocks over the past three years is a reflection of mounting problems in the US and global economy. As an article in the *Australian Financial Review* of March 24 warned, even a rapid military victory in Iraq “won’t be enough to sustain any so-called ‘relief rally’ in stocks.”

“Worse, such rallies might be preludes to further selling once investor attention turns to the frailty of the global economy and corporations still struggling with the legacy of balance sheet excesses of the late 1990s.”

Some analysts believe that the market rally may be anchored in little more than the belief that, after three years in decline, stocks will not record a fourth year of losses. Such views are completely misplaced. According to one economist cited in the AFR report, while the real return on US corporate assets is about 2 percent—the lowest since 1952—the equity market is still pricing companies as if they were making the greatest profits in history. In other words, share prices still have

a considerable way to fall.

The value of the share market has assumed considerable importance because of its relationship to the increasingly precarious financial structure of the US. Over the past decade the US has become dependent on an ever-greater inflow of foreign capital to finance its balance of payments deficit. That presented few problems under conditions where both the US dollar and share prices were rising. Overseas investors were able to enjoy a greater rate of return by placing their money in the US than almost anywhere else in the world.

However, with the decline in the value of the dollar over the past year—it is down by 25 percent against the euro and 14 percent on a trade-weighted basis compared to its peak—maintaining capital inflow has become problematic.

As the *Financial Times* pointed out in an editorial on March 8, net private foreign purchases of US assets declined by almost a half between 2000 and 2002. The US needs an inflow of \$500 billion a year but if both the dollar and the share market fall it becomes increasingly difficult to attract such funds. A European investor, the editorial noted, would have lost 43 percent over the past year with an investment on the S&P 500 index, compared with a 28 percent drop in US dollar terms.

“The risk, therefore, is that a declining appetite by foreigners to buy net US assets becomes an aversion to them, transforming the gradual and welcome depreciation of the dollar into a dangerous rout. The US is vulnerable to a drop in demand for dollar assets—foreigners own more than 40 percent of government debt, 26 percent of corporate bonds, and 13 percent of equities—and in such circumstances the dollar’s recent troubles would seem trivial indeed. The result would be huge economic instability, curbing US imports and exporting recession to Asia and Europe.

Investors could not expect other financial markets to be immune from serious swings in the currency market.”

The latest flow of funds analysis published by the Financial Markets Center in the US also points to the growing financial weakness of the US economy. The report, prepared by economist Jane D’Arista, pointed out that falling profits in 2002 plagued US companies and heightened concerns about their credit worthiness.

Even though borrowing in the bond market helped some firms lower the cost of outstanding debt, the corporate sector as a whole “struggled to service existing debt.”

D’Arista pointed out that the US economy was characterised by a series of imbalances that will be exacerbated by the costs of the war against Iraq. The strong dollar strategy of the 1990s was at the core of a policy which saw US economic expansion become increasingly dependent on savings borrowed from abroad. That policy has now become increasingly difficult to sustain.

“Towering levels of external and domestic debt, persisting overhangs of excess capacity, and faltering economic performance have now left the US more vulnerable to a shift in foreign-investor sentiment—and a potential fall in the exchange rate—than it has been at any time since the dollar’s collapse at the end of the 1970s.”

The US countered that dollar collapse with massive interest rate hikes in the early 1980s as Federal Reserve Board chairman Paul Volcker pushed the prime rate to 20 percent.

Today, however, US corporations and financial institutions have become so dependent on low interest rates that any return to Volcker-type methods would produce a disaster.

It would “devastate US labour markets, deflate housing prices, widen state budget deficits and dramatically accelerate loan delinquencies, bond defaults and personal bankruptcies.” Significantly higher interest rates would also “test the solvency” of some of the largest American financial institutions, non-financial corporations and pension plans.

The war against Iraq will bring increased financial pressures. Unlike the first Gulf War, when a considerable portion of the funds was supplied by Japan and Europe, the US will have to finance its military operations through increased deficits. This will

lead to pressure on interest rates in order to attract funds both from domestic and international sources. But any increase in interest rates, even if only relatively small, will have a significant adverse impact on the US economy.

The market may experience further rises with fresh “victories” but the underlying imbalances within the US economy will only be intensified as the military onslaught continues.



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