

Clouds gather over world economy

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While the official forecasts are still for strong economic growth, a number of storm clouds are gathering over the world economy. They include: recession or near-recession conditions in a number of eurozone countries, doubts about the direction of the US economy and concerns that financial markets could face considerable turmoil if major hedge funds start to run into trouble.

The continued failure of the eurozone to provide a stimulus to world growth was highlighted by data from Italy and France last week. Italy has now officially moved into a recession with figures showing that the country's gross domestic product (GDP) fell by 0.5 percent in the first quarter, following a 0.4 percent decline for the previous three months. The downturn is one of the deepest experienced by a eurozone country since the introduction of the common currency in 1999.

France could shortly go the same way. Up to now it has been one of the strongest of the eurozone economies but the latest figures show that manufacturing output was down by 0.3 percent for the first three months of the year, with a drop of 0.9 percent from February to March. While Italy has now joined the Netherlands in recession, the eurozone as a whole is still growing. Overall GDP rose by 0.5 percent in the first quarter, after a 0.2 percent increase in the previous three months. But there are concerns that the trend could be soon reversed because of the impact of higher oil prices and the increase in the euro's value against the dollar that took place last year.

Across the Atlantic, the US economy is slowing amid warnings that it is entering another "soft patch". Last month the Bureau of Economic Analysis reported that real GDP increased at an annual rate of 3.1 percent in the first quarter, down from the rate of 3.8 percent in the last quarter of 2004. While these figures indicate that the US is still on a "recovery" path from the recession of 2001, a different picture emerges from

employment and wage numbers.

These figures show there are still 22,000 fewer private sector jobs than when the recession started in March 2001 and that real wages have fallen in the past six months. Since the start of the recovery in the fourth quarter of 2001, real private wage and salary income has only increased by 5.3 percent. As the Economic Policy Institute noted, the average increase for all economic recoveries lasting 11 quarters or more from 1947 to 1982 is 18.3 percent and even in the "jobless recovery" of the early 1990s there was an 8.1 percent growth in wages. What these figures indicate is that rather than experiencing a recovery, the US economy may well have entered a period of sustained stagnation.

Unlike previous recoveries, growth has not been sustained by increased business investment and rising consumption, driven by expanding employment and rising wages, but by historically-low interest rates and a corresponding expansion of debt.

In the four years from 2000 to 2004, home mortgages have risen from an annual rate of \$386.3 billion to \$884.9 billion while credit has expanded by almost \$10 trillion over the same period, compared to a growth in nominal GDP of \$1.9 trillion. In other words, unlike the experience in all previous turns in the post-war business cycle, the growth of debt has been the biggest factor in sustaining the present US recovery phase.

Perhaps the most telling symptom of the real state of health of the US economy is the May 5 decision by Standard & Poor's to downgrade the debts of General Motors and Ford to junk grade status. The downgrades cover a total debt of \$453 billion—\$292 billion for GM and \$161 billion—an amount bigger than the GDP of a number of countries and equivalent to around three quarters of the GDP of a medium-sized capitalist country like Australia.

In a comment on the downgrade, the *Economist* noted that in the credit-default swaps market where protection

against the possibility of default is bought and sold, the “cumulative probability” that GM will default in the next five years is rated at 63 percent and the default probability of Ford, GMAC and Ford Credit at between 52 percent and 42 percent. “That does not mean the companies will default, but it does suggest that people take the risk seriously enough to pay for protection.”

Even though it was widely expected, the downgrade has nevertheless sent shock waves through financial markets, in particularly focusing attention on the role of hedge funds, some of whom were wrong-footed by the decision. As the *Financial Times* noted in an editorial on May 12, while there was “no evidence that any hedge fund faces a big liquidity crisis, market jitters over their potential exposure highlight the sensitivities surrounding these sophisticated investment vehicles”.

“Hedge funds,” it continued, “have become such large and integral players in the global financial system in recent years that their exposure and investment strategies need to be better understood by regulators. Hedge funds regularly account for a quarter to a third of equity trading volume in New York and London. They have become some of the biggest and most profitable customers for investment banks”.

The increasing importance of hedge funds in the global financial system and the potential dangers they bring was the subject of a major speech last month by Timothy Geithner, the president of the New York Federal Reserve.

Speaking to the Bond Market Association’s annual meeting, he pointed out that while the US financial system seemed less vulnerable and better able to absorb large shocks than in the past, “changes in the structure of the financial system and an increase in product complexity could make a crisis more difficult to manage and perhaps more damaging.”

According to Geithner, while the probability of a major crisis induced by the failure of a major institution was lower, the damage associated with such an event could be higher than in the past.

“The substantial increase in the role of hedge funds in our financial system also complicates the task of risk management. Although hedge funds help improve the efficiency of our system and may also contribute to greater stability over time by absorbing risks that other institutions would not absorb, they may also introduce some uncertainty into market dynamics in conditions of

stress.

“The rapid growth in instruments for risk transfer, most recently in the credit world, has produced a large universe of exposures in complex products, whose future value is uncertain and difficult to model. The risk-reducing benefits of these innovations, for individual institutions and for the system as a whole, are substantial, but these benefits are to some extent qualified by the limits of our knowledge of how they will perform in conditions of stress.”

In other words, no one really knows how financial markets will function in response to a major crisis. In September 1998 when the hedge fund Long Term Capital Management collapsed, the Federal Reserve Board organised a \$3 billion intervention to prevent a global financial crisis. In the six and a half years since then, banks have become more dependent on hedge fund profits and the global financial system has become more complex with the development of new financial instruments aimed at lessening risk.

In theory, these instruments should bring increased stability as they allow some investors to lessen the risk in their portfolios and others to increase theirs if they believe the returns will justify it. However such a balancing may not always occur.

As the *Financial Times* columnist Philip Coggan noted in an article last Saturday, a hedge fund collapse would cause a few institutional investors to suffer a loss in part of their portfolios, but not a disaster. “But a problem could emerge if a number of hedge funds had all made a bet in the same direction and had been backed up by the trading desks of investment banks. That would lead to a mad dash for the exits with everyone trying to leave the same positions at once.”



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