

A turbulent week on global financial markets

Nick Beams
19 May 2006

A correction or the start of something much bigger? That is the question hanging over financial markets following a major sell-off in currency, commodity and equity markets over the past few days.

In New York the Dow Jones industrial average fell a further 77 points on Thursday, following a 200-point drop the previous day. The high-tech Nasdaq index fell by 0.7 percent for its eighth straight daily decline—the longest losing streak since 1994. The S&P 500 index has fallen by 4.8 percent since May 10, when the Federal Reserve Board increase its benchmark interest rate to 5 percent. This is the biggest fall over a seven-day period since March 2003.

The immediate cause of the sell-off in equity markets is the fear that interest rates will continue to rise. Announcing its latest rise, the Fed's open market committee indicated that future increases may "yet be needed to address inflation risks". These fears were compounded by the announcement of a higher than expected inflation rate of 0.6 percent for April.

But it is not only the Fed's plans on interest rates causing concern. Across the world, central banks have been tightening rates. The Bank of Japan has ended its policy of ultra-liquidity introduced to combat deflation and could soon move back to a more normal interest rate regime, while the European Central Bank has indicated that it favours further rate increases. The Japanese move is particularly significant because Tokyo has been the source of cheap funds for so-called "carry trades" in which borrowed yen are used for more profitable investments in the rest of the world.

Whatever the developments over the next few days, there is a perception that the situation has turned. According to David Bowers, chief global investment strategist at Merrill Lynch in London: "The prospect that central banks will have to actually cool things off is a very frightening prospect. There is a macroeconomic vulnerability for stocks here that there

has not been before."

Little more than a week ago, the Dow Jones index was heading for an all-time high of 12,000. But now the atmosphere has changed. As a comment in the *Financial Times* noted: "There's a new term stalking the markets, one that hasn't really been voiced for a while—volatility. Global concerns about the outlook for inflation and growth, and fears of a collapse in the dollar, have been pushing up price volatility for stocks, bonds, currencies and commodities."

This represented a departure from the steady comfortable markets of recent years that were marked by general confidence, allowing investors to take on greater risks for higher returns.

While fears of interest rate rises may have provided the initial impetus for this week's large movements, the underlying causes lie in the unprecedented imbalances in the global economy. World economic growth, and especially the China boom, has become increasingly dependent on the increased indebtedness of the United States, where the balance of payments deficit is now around 7 percent of gross domestic product. At the same time, the transfer of the balance of payments surpluses from China and East Asia into the US financial system has kept interest rates at historically low levels, ensuring that consumer spending can continue to be funded through debt.

Besides funding consumption spending, record low interest rates have also led to the creation of a series of financial bubbles—in stocks, housing, "emerging market" equities, and, most recently, industrial commodities.

Between March 1 and May 11 alone, the price of copper rose by 80 percent, gold 40 percent, zinc 75 percent, nickel 45 percent, aluminium 38 percent and tin 20 percent.

Analysing the longer-term trends in a comment published on Monday, Morgan Stanley chief economist

Stephen Roach noted that over the past four years the prices of industrial commodities have risen by 53 percent, faster than has occurred in any of the four previous phases of global expansion. In real terms the increase is 42 percent, nearly double the 23 percent increase in the two commodity booms of the 1970s.

The increase is clearly not the result of rapid economic expansion. The average growth of world gross domestic product in the period 2002-2006 is likely to be 4.2 percent, compared to 4.4 percent in the four previous expansions.

Roach pointed out that while there is nothing exceptional about current rates of growth when compared to earlier periods of expansion, “the current surge in commodity prices has been off the charts when compared with those of the past”.

“In the midst of a slightly subpar upturn in global growth, a low-inflation world is experiencing the sharpest run-up in commodity prices in modern history.”

In other words, a large part of the rise in commodity prices is a financial bubble, in which an increase in prices induced by speculative inflow of funds leads to a further inflow, followed by another round of price increases.

Everything goes well, so long as the inflow of money continues and prices keep rising. But once the situation turns, the gains on the upswing turn into massive losses.

That turning point may have been reached if a report on Thursday’s trade by *Telegraph* journalist Ambrose Evans-Pritchard is anything to go by. “The risk of defaults” he wrote, “was hanging over the London Metal Exchange last night after a clutch of clients failed to meet margin calls on losing copper trades, leaving brokers struggling frantically to match their books.” According to one “market source” cited in the article: “The hedge books of the banks are seriously underwater on copper, but apart from that there are now brokers in trouble because clients can’t meet the margin payments.”

Much of the speculation in equity, commodity and currency markets is the result of the activities of hedge funds, which shift enormous amounts of money in the daily search for profits. It is estimated that somewhere between \$800 billion and \$1 trillion is invested in hedge funds.

This is five times the amount invested in September-October 1998 at the time of the financial crisis set off by the collapse of the Long Term Capital Management hedge fund, which had to be bailed out to the tune of more than \$3 billion.

Today there are between 7,000 and 9,000 hedge funds in the US and they are estimated to account for as much as 20 percent of all US stock trading. In a speech last Tuesday, Federal Reserve Board chairman Ben Bernanke warned that financial authorities had to stay attuned to the potential risks.

“Authorities should and will try to ensure that the lapses in risk management of 1998 do not happen again,” he said. But with increased turbulence in all markets, that may be easier said than done.



To contact the WSWWS and the
Socialist Equality Party visit:

wsws.org/contact