

Global market slide may have further to go

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The global market slide, which started in the second week of May, has wiped off at least \$2 trillion from the value of shares, with predictions that it still has some distance to run.

The extent of the turbulence was exemplified in a wave of selling last Tuesday, which saw more than 4 percent wiped off the value of the Japanese market, together with even larger falls in so-called emerging markets. In Russia, the RTS index plunged 9.4 percent, Indian markets dropped 4.4 percent, Turkey 5.7 percent, while European markets fell 2.1 percent.

In the US, Wall Street was hit by a two-week decline that wiped out the year's gains in every major index before a rebound on Wednesday, which saw the Dow climb by 110 points. Sometimes referred to as Wall Street's fear gauge, the Vix index, which measures market volatility, has been at its highest level in more than two years.

The most widespread explanation for the slide is that investors have been dumping stocks, so-called "emerging market" assets, metals and other commodities because of fears that interest rates world-wide are going to tighten.

Clear indications have emerged that the US Federal Reserve Board, which has been steadily increasing rates over the past two years, has at least one further increase in the pipeline and possibly more. Commenting in early June on US price data, which showed a core inflation rate of 2.3 percent in the year to May, Fed chairman Ben Bernanke said inflation was "at or above the upper end of the range that many economists, including myself, would consider consistent with price stability and the promotion of maximum long-run growth".

Since Bernanke's remarks, six other Fed officials have made comments that they consider the present level of inflation too high. Those sentiments are certain to have been strengthened by data released on Wednesday, which put the US annualised rate of inflation for the past three months at 3.8 percent—the highest since March 1995. The next meeting of the Fed's open market committee, scheduled for June 28, is expected to make another

interest rate increase of 0.25 percentage points—the 17th such rise since the central bank started lifting rates in 2004.

There is a general tightening of interest rates around the world. Bank of England governor Mervyn King warned in a speech in Edinburgh this week that global interest rates may have been too low for too long. His remarks followed the release of data showing that prices in Britain had increased 2.2 percent from a year earlier.

Another key factor in the market turnaround appears to be the decision by the Bank of Japan (BoJ) in mid-March to end its policy of super-liquidity and start to return to a more normal interest rate regime. The BoJ has not yet officially abandoned its zero interest rate regime. But its tightening moves have had an impact on "carry trades" in which investors borrow money at super-low rates in Japan to finance transactions in other markets with higher rates of return. In the two months from mid-March to mid-May, it is estimated that the BoJ took out \$140 billion from the country's banks, cutting the money supply by 10 percent.

Besides interest rate rises, there are concerns in financial markets over global economic growth. In its April economic outlook, the International Monetary Fund forecast continued global expansion at rates not seen for 30 years. But that view may have been somewhat optimistic, at least if remarks by IMF managing director Rodrigo de Rato are anything to go by.

Addressing the National Press Club in the Australian capital Canberra this week he again warned that financial imbalances associated with the US current account deficit could push the world into recession.

Pointing to the forecast of a global growth rate of 5 percent this year, he asked: "Should we describe the global economy as being as good as it gets, or too good to be true?"

De Rato said that while the market sell-off was a "modest correction," rising inflation and concerns that interest rate increases could cut growth meant that "the balancing act that central banks around the world must undertake has become more difficult".

Addressing the longer-term issue of the US deficit, he emphasised that it could not be indefinitely supported by the inflow of capital from other countries. There was a risk that “if nothing is done, imbalances will not be reduced gradually, but suddenly and in a disruptive way”.

While fluctuations in the business cycle appear to provide some of the explanation, there are also concerns that the sell-off may have deeper causes and could signify the collapse of the series of asset and financial bubbles that have emerged as a result of the low interest rate regime of the past five years.

A report issued this week by the Bank for International Settlements—sometimes known as the central bankers’ bank—indicated that rather than any reassessment of growth and inflation rates, the sell-off may have resulted from “a weakening of investors’ appetite for risk”.

The first four months of the year saw shifts into riskier assets as “equity, commodity and high-yield debt prices all soared”. Emerging equity markets rose by 19 percent from the end of 2005 to mid-May, copper prices doubled over the same period, while the price of gold rose by 40 percent.

But amid these developments there were warnings of troubles ahead and the potential for “negative developments in one market to spill over to other markets”. In late February a downgrading by the credit-rating agency Fitch of Iceland’s debt position sent the krona tumbling by 7 percent. Normally this would not have affected other markets but within hours the disturbance in Iceland “led to sharp, albeit brief, falls in other high-yielding currencies like those of Australia, Brazil, Hungary, New Zealand and South Africa”.

The Iceland events and now the plunge in world markets over the past month point to the possibility that the very measures used by central banks in making interest rate policy—lowering rates when prices fall and increasing them when they rise—may have contributed to the present financial instability.

In a comment published on Monday, *Financial Times* columnist John Plender warned that an exclusive focus on price stability in determining central bank monetary policy would only work under conditions where inflation is rising.

The provision of easy credit under conditions of lower prices caused by “supply shocks”—such as that resulting from the integration of low-cost production from China and India into the world market—would “accentuate financial boom and bust” and “compound imbalances to the detriment of economic stability”.

A number of signs point in this direction. The generally low-inflation environment of the recent period, resulting from cut-throat competition in all areas of the economy and the shift to low-cost production in China and India, is indicative of downward pressure on profit rates.

Another expression of the same phenomenon is the fact that since 2002, the corporate sector in the US has been a net provider of savings. In normal circumstances, the flow of funds is the other way around as corporations borrow money from financial institutions to increase their productive capacity. But for the past four years American corporations have been providing funds to financial institutions as they attempt to increase their profits by financial means.

In the longer term, the profits obtained by financial institutions represent an appropriation of profits produced elsewhere in the economy. But in the interim, it is possible to make money out of money, so long as the price of financial assets keeps rising because of the supply of cheap money by the central banks. That is, to the extent that the low inflation and increased financial speculation of the past five years are interconnected, low central bank interest rates—in line with the policy of targeting inflation—may have contributed to the creation of financial bubbles, thereby increasing the potential for global instability.

If this is the case, then the present slide on equity and commodity markets could signal the beginning of much greater financial turbulence.



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