Global markets stabilise but risks increase

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Money markets have stabilised over the past week following a sharp downturn, but nervousness is on the rise throughout the global financial system amid concerns over rising inflation rates, tightening monetary conditions, the prospects of an economic slowdown and potential problems in the Chinese economy.

In an interview this week, International Monetary Fund director-general Rodrigo de Rato repeated earlier warnings that the risks of a downturn in the global economy had increased.

The IMF still held to its prediction of 5 percent growth for 2006, he said, but the recent market turbulence was the result of uncertainties which signify that "the risks to the future outlook are larger".

Earlier this month, de Rato told the National Press Club in Australia that the imbalances between the United States and the rest of the world, chiefly the US balance of payments deficit, were "not sustainable" and could result in a "disorderly adjustment" if they were not reduced.

The latest data from the US show that the current account deficit fell to an annual rate of $835 billion in the first quarter of this year, a decrease of 6.5 percent or $58 billion on the previous quarter. While the result reflected the impact of a decline in the dollar—one of the measures favoured by the IMF and other economic institutions—it was still the second worse on record. And there are fears that the deficit will widen again because of the impact of higher oil prices.

Next week all eyes in the financial markets will be on the US Federal Reserve Board's open market committee, which meets to decide whether to lift interest rates. While it is generally agreed that another rise of 0.25 percentage points is coming, the crucial question will be whether the accompanying statement gives an indication of future increases. There are fears that if rates rise too high they could bring about a recession.

In a report from UCLA Anderson Forecast this week, economists warned that the US could see a combination of increased inflation, because of oil price hikes, and a slowing economy, triggered by a fall in the housing market. Anderson's senior economist, David Shulman, described the central bank as being in a box. "For the first time in several years, the Fed will soon be faced with rising measured inflation alongside weakening economic growth, sort of a low-grade stagflation."

Globally, monetary conditions continue to tighten with the European Central Bank (ECB) making clear that it plans more rate increases even if this has an adverse impact on economic growth. The ECB has raised borrowing costs three times since last December to 2.75 percent and there are predictions of a further rise of 0.5 percentage points this year.

In an indication of further rises, ECB president Jean-Claude Trichet told a European Parliament committee that the bank was "not satisfied with what we are observing with regard to inflation in our own area" and would "continue to do all that's necessary to counter inflationary risks and anchor inflationary expectations." This is a clear warning to financial markets of further interest rate rises.

Credit tightening has also extended to China where the central bank is endeavouring to bring an investment and property boom under control without provoking a crisis. This week the bank announced that it was raising the required reserve ratio for commercial lenders by half a percentage point to 8 percent. The move came less than two months after the bank lifted interest rates 0.27 percentage points at the end of April.

Monetary data show the reasons for the bank's move. China's money supply at the end of May was 19.1 percent higher than a year earlier—3 percentage points above the central bank's target. Loans for the first five months of the year were almost three quarters of the bank's target for the entire year. Over the same five months, investment in fixed assets in urban areas jumped 30.3 percent from a year ago.

The bank said its measures would "further curb excessive loan growth", control "rapid investment growth", "strengthen management over liquidity in the banking system" and "continue to guide commercial banks in keeping the pace and scale of their medium- and long-term loans at a reasonable level." It affirmed its commitment to policies that will promote "stability in the financial markets and overall economic stability".

How successful it will be is another question. Long-time China observer Stephen Roach, the chief economist at Morgan Stanley, cast doubt on whether the latest measures would prove sufficient, not least because of the rapid growth in the Chinese economy.

In the period from 2000 to 2005, he noted, Chinese fixed investment surged from about $400 billion to $1.1 trillion—a growth rate that "dwarfs anything the world has seen in recent years". The very size of the Chinese economy—it is 35 percent larger than in 2004 when similar cooling measures were undertaken—suggested that "Chinese policy makers need to do more if they are to succeed in containing the excesses of their overheated economy".

If Chinese authorities tighten too hard, however, they risk bringing about the collapse of shaky enterprises dependent on the supply of cheap credit. The Fitch credit rating agency estimates that Chinese lending institutions—the four state-owned banks, city commercial banks and rural cooperatives—have a combined total of $206 billion in non-performing loans as well as $270 billion in other loans that could go bad. A collapse of the investment bubble would have enormous social consequences, as millions of workers were made unemployed.

In a recent comment on China, the US thinktank Stratfor noted: "What must be understood is that China now is moving from an economic problem to a socio-political one. The financial problem is a symptom; the fundamental problem is that tremendous irrationality has been built into the Chinese economy. Enterprises that are not economically viable continue to function through infusions of cash. Some of the cash comes from borrowing, some by exporting at economically unsustainable prices.... If interest rates were to rise and lending were to become disciplined, many of China's enterprises would fail."

So far the central bank has been able to sustain the boom and prevent the social and political upheaval that an economic collapse would bring. However, it was one thing to carry out this task under the easy money regime that has prevailed over the past five years. It is quite another to maintain economic balance as financial conditions begin to tighten globally.