Global markets slide after China sell-off

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Global stock markets tumbled on Tuesday after a near 9 percent drop in the Chinese market—the biggest fall in a decade—sparked fears that a series of financial imbalances in the global economy could start to cause serious problems.

The global sell-off, which hit all major markets, culminated in a drop of more than 415 points on Wall Street or more than 3 percent. This was the biggest one-day decline since the markets re-opened after the September 11, 2001 terrorist attacks. At one point, the Dow was down by 545 points for the day, while two other key indexes, the Standard & Poor's 500 and the Nasdaq Composite fell 3.5 percent and 3.9 percent respectively.

When trading opened on Wednesday, the Australian stockmarket, highly sensitive to economic developments in China, joined the global slide, falling by more than 3 percent and wiping off about $45 billion in stock values.

The immediate cause for the China slump appears to have been concerns that financial authorities were about to take action to curb speculation, including a lift in interest rates and a capital gains tax. The rumoured action has sparked fears that riskier financial trades and investments around the world could now be in danger.

"What we're looking at here is a big move away from risk," David Durrant, a currency analyst with a New York investment management firm, told Reuters. "The big fall in Chinese stocks especially has got some people nervous about the carry trade."

The carry trade refers to the process in which financial investors borrow money in one currency at a low interest rate and then place it in high-risk assets in other markets. This process causes what are considered distortions in currency exchange rates. For example, while the Japanese currency should be strengthening because of increased economic growth, the carry trade has seen a fall in the value of the yen as investors transfer yen holdings elsewhere.

Large profits can be made from these transactions but they depend on market stability. Once that comes into question, with an event like the China sell-off, there can be a rush for the exits.

Yesterday, International Monetary Fund managing director, Rodrigo Rato, warned that carry trades "could lead to more entrenched exchange rate misalignments that worsen global imbalances." Rato said the actual size of the carry trade—estimated to be anywhere from $200 billion to $1 trillion—was unknown, adding that there was no "simple solution" to the problems. Financial markets and countries would be exposed if there were a sudden unwinding of financial flows, he warned.

A number of other factors appear to have fed into the Wall Street slide. According to figures released by the US Commerce Department, orders placed with factories for durable goods dropped by 7.8 percent in January, more than the predicted decline, as excess inventories caused companies to limit spending. Orders for business equipment experienced their biggest decline for three years.

The decline in durable goods orders is another sign that the US gross domestic product (GDP) is slowing and adds weight to predictions that the economy could move into a recession later this year.

Speaking via satellite link to a business conference in Hong Kong on Monday, former Federal Reserve Bank chairman Alan Greenspan warned that there was a possibility of recession by the end of 2007. The US economy had been expanding since 2001 and now there were signs that the cycle was coming to an end.

"When you get this far away from a recession, invariably forces build up for the next recession and indeed we are beginning to see that sign. For example in the US, profit margins ... have begun to stabilise, which is an early sign we are in the later stages of a

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cycle," he said.

Tuesday's slide—and there could be more to come—will confirm the view of those economists and analysts who have insisted that, while the world economy has been growing, it is inherently unstable because of massive financial imbalances—above all, the US balance of payments deficit. These critics have voiced concerns that the continuous expansion of liquidity by the central banks has given a distorted picture of actual risk levels.

In a comment published on Monday, Morgan Stanley chief economist Stephen Roach warned that a "new level of complacency" had set in. "It's not just a financial-market thing—extremely tight spreads on risky assets and sharply reduced volatility in major equity and bond markets. It's also an outgrowth of the increasingly cavalier attitude of policy markets. That's true not only of central bankers but also .... [of] the global authorities charged with managing the world's financial architecture. ... After four fat years, convictions are deep that nothing can derail a Teflon-like global economy. That's the time to worry the most."

Roach warned that an exceptionally low level of nominal interest rates had fuelled "the great liquidity binge that underpins an extraordinary degree of risk taking still evident in world financial markets."

In a conversation with Roach, a former central banker had declared: "Who are we to judge the state of the markets?" Reporting the remark, Roach said it was indicative of a "very narrow perspective of the role and purpose of central banking. Most importantly, it relegates financial stability to a secondary consideration at precisely the time when financial globalisation and innovation could be inherently destabilising."

Whatever the immediate outcome of the latest market turbulence, the events of yesterday are a reminder of how rapidly the situation can turn in conditions where trillions of dollars shift around the world every day.

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