Wild swings on Wall Street

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The Dow Jones Industrial Average plunged 209 points when trading opened on Thursday, then recovered to end the day at 34 points down. The violent movement, following Tuesday's plunge of 415 points, was a clear indication that the recent market turbulence may be more than a so-called "correction."

Thursday's roller coaster came after markets in Asia fell, following Tuesday's near 9 percent drop on the Chinese market, which sparked the latest round of turbulence. Asian and European markets have fallen for the past three days, their worst slump in more than four years, resulting in more than $1.5 trillion being wiped off share values.

One of the factors sending down Asian markets is believed to have been comments by a Japanese official that the central bank will not back down from its decision to tighten monetary policy. Low interest rates in Japanese markets have boosted the so-called carry trades that have played a significant role in providing liquidity to financial markets.

There were also market rumours that a major lender was experiencing distress.

While the US market was calmed by reassurances from US Federal Reserve Board chairman Ben Bernanke that the growth outlook was still positive—following the warning by former Fed chief Alan Greenspan on Monday that a recession could hit by the end of the year—a growing number of reports have pointed to underlying, structural problems in the world financial system.

An article in the *Wall Street Journal* yesterday noted that the plunge in stocks raised the possibility that investors were becoming increasingly "risk averse"—a development that "could have big consequences for the US and world economies."

"In recent years, investors have poured money into risky investments from subprime mortgages and emerging-market debt to Chinese stocks. In the process, they have accepted ever-narrower returns or 'risk premiums'. That has helped distressed companies avoid bankruptcy, financed a record leveraged buyout spree, fuelled surging profits on Wall Street, enabled poor countries to finance domestic spending and even made insurance easier for consumers to obtain," the newspaper noted.

But now that process, fuelled by increased liquidity, may be coming to an end. One indication is that problems in the US subprime mortgage market—loans made to borrowers with low credit ratings—appear to be spreading. According to the *Wall Street Journal*, default rates on so-called Alt-A mortgages, considered less risky than subprimes, are starting to increase. Last year Alt-As accounted for 16 percent of new mortgages and subprimes 24 per cent.

During the US housing boom, financial institutions made profitable interventions into the subprime market by providing finance to companies making loans to homebuyers and then packaging the debt into bonds and trading them. Now insurance premiums on the potential default of these bonds has risen significantly, indicating concerns about the level of debt exposure.

According to an article published in the *New York Times* yesterday, there is now also a "major concern" over whether "the problems of subprime lending will spill over into the broader mortgage market, which at $6.5 trillion at the end of 2006 is the biggest bond market."

The move of major financial institutions into the subprime market is an expression of a more general process—the shift of finance capital into ever more risky ventures in the search for profit. The extent of this movement can be seen in the fall of the risk assessment premium.

Three years ago, investors demanded that companies pay about 6 percent more than the interest on US Treasury notes—considered to be the closest thing to a risk-free investment—in order to obtain funds. Now the risk premium on junk bonds is as low as 2 percent.

As the gap has narrowed, so the global issuance of junk bonds has risen—more than $350 billion last year compared to $145 billion in 2002. Among other things, the flow of cheap money has helped finance a surge in leveraged buyouts in the US, which hit $418 billion last year, more than triple the level in 2005.

It has also had a major impact on so-called emerging markets. While it has risen slightly in the recent period, the spread of emerging market bonds over treasuries is still half the level of two years ago.

While all the so-called emerging markets have been soaring in the recent period, the boom in China has assumed global significance. Last year the stock market rose 130 percent and in the six trading days before Tuesday's reversal it had climbed by 11 percent.

Even though the Chinese market is still relatively small—comprising just 2.2 percent of global share values compared to 34 percent for Wall Street—the effect of the downturn was magnified because of fears for what it might signify for the Chinese economy as a whole.

China is only a fifth the size of the American economy, but it is growing five times as fast and therefore contributes as much as the US to the growth of the world economy as a whole. There are fears, however, that this growth is becoming increasingly unbalanced and the Chinese economy is heading for a crash.

It has been estimated that last year fixed asset investment was more than 45 percent of Chinese gross domestic product (GDP). Investment on this scale has never been seen before. Even at the height of the post-World War II expansion, when its economy was growing at 10 percent per year, Japan's investment ratio never exceeded 34 percent of GDP.

These figures point to an acute contradiction at the heart of the world economy. On the one hand, world economic growth is ever more dependent on the China boom. But if fixed asset investment continues to grow at the rate of 26 percent it has averaged over the past four years, the Chinese economy will soon experience problems of overcapacity and a slump. It is this contradiction that underlies this week's market gyrations.

There is a quip which has been doing the rounds in the past few days to the effect that, like everything else, economic turbulence is now "made in China." It points to fact that the world capitalist economy is resting on increasingly shaky foundations.