Wild gyrations on world markets

Nick Beams
17 August 2007

Despite continuing interventions by the world's central banks, global stock markets have continued to fluctuate wildly amid fears that the credit crisis that started in the US subprime mortgage market is spreading to other sectors.

On Thursday, Wall Street experienced a day of violent swings, plunging by 343 points at one stage, to finally end the day 15.69 points down.

Earlier, Asian and Europeans markets were hit by a wave of selling following Wednesday's drop on Wall Street, which saw the Dow fall below 13,000, registering a more than 800-point loss in five days.

The Australian market closed down by 1.54 percent, after plunging more than 5 percent earlier in the day. The Japanese market was off by 2 percent, Singapore by 4.3 percent, Mumbai 3.7 percent and Manila 6 percent. In South Korea, where banks and investors are expected to lose at least 10 percent on their holdings of $850 million in US subprime-mortgage-related bonds, stocks dived almost 7 percent, despite urgings by the country's president Roh Moohyun that investors should not panic.

But across the region, fear was the order of the day. As one Malaysian financial analyst told Bloomberg: "Blood is hitting the streets. Everyone seems to be panicking, and there's a reason to panic. There's been so much blow-up, we don't know where it's going to end. Liquidity is drying up."

The sell-off continued in Europe, where Britain's FTSE index dropped 4 percent to end below 6,000 for the first time since March, bringing the total losses on leading stocks during the past week to $216.9 billion. The biggest declines were in financial stocks, reflecting concerns over credit conditions. But metal stocks also showed a significant decline, amid fears that the financial crisis would impact on global economic growth.

In France, the CAC index dropped by almost 2.5 percent, while Germany's DAX index fell nearly 2 percent. Analysts at Credit Suisse told the *Wall Street Journal* that Thursday's trading could mark a "watershed between a 'healthy' correction to riskier assets and something far more sinister which could lead to real economic distress."

When Wall Street opened Thursday, the Dow immediately dropped 80 points on warnings that the market for commercial paper—the means by which major companies raise short-term loans, and considered one of the safest investments—had all but dried up. The *Wall Street Journal* reported that a real estate unit at the private equity giant Kohlberg Kravis Roberts was trying to postpone repaying $5 billion in commercial paper, describing the move as "the biggest blowup" to hit that market.

The potential consequences of such a crisis were indicated in a sell recommendation for America's largest home-mortgage lender, Countrywide Financial, issued by Merrill Lynch analyst Kenneth Bruce, in which he warned that the firm could go bankrupt.

"If enough financial pressure is placed on Countrywide, or if the market loses confidence in its ability to function properly," he wrote on Wednesday, "then the model can break, leading to an effective insolvency." If liquidations occurred in a weak market, then it was possible for Countrywide "to go bankrupt."

Before the market opened Thursday, Countrywide advised that it had drawn down an $11.5 billion credit line provided by a group of 40 banks. Countrywide shares, which have already lost more than half their value so far this year, continued to drop on the news.

The extent of the recession in home building, one of the causes of the crisis in mortgage financing, was underlined by figures from the Commerce Department showing a more than 6 percent decline in new housing starts for the month of July. New home starts are now at their lowest level for more than a decade, with no sign of an end to the 18-month recession.

Global Insight economist Brian Bethune told Bloomberg the housing market was "still in a downward spiral" with "weak demand" being "hollowed out further by much tighter lending conditions in the mortgage credit markets." At the same time, sales of existing homes fell in 41 states, with home prices down in one-third of metropolitan areas.

In his first public comment on the financial market downturn, US Treasury Secretary Henry Paulson said that while the turmoil would "extract a penalty on the growth of the economy" both the markets and the US economy were "strong enough" to absorb the losses without provoking a recession. He told the *Wall Street Journal* that the turbulence was taking place "against a backdrop of a very healthy global economy with strong fundamentals."

Paulson, a former chairman and chief executive officer of Goldman Sachs, said that looking back over the periods of stress he had seen in his 32-year career on Wall Street "this is the strongest global economy we've had."

This was the major difference, Paulson said, between the present crisis and the situation in 1998 when the Russian default and the collapse of the US hedge fund Long Term Capital Management threatened a seizure of global credit markets.

While the US economy had slowed, the International Monetary Fund recently forecast that the world economy would expand by more than 5 percent this year after three years of unusually strong growth.

The strong growth in the world economy over the recent period does not mean, however, that the present crisis is merely some kind of "market storm" that will soon blow over. This is because the turbulence is itself a product of two fundamental processes—the expansion of credit and cuts in real wages—underlying the present phase of world economic growth.

Cutting interest rates

The origins of the present crisis go back more than a decade to the US stock market bubble that developed from the mid-1990s. By 1996, as subsequent minutes of its meetings made clear, the Federal Reserve Board and its chairman, Alan Greenspan, were aware that the rise of the market was increasingly unrelated to growth in the underlying real economy.

But after ferocious opposition to an interest rate rise in early 1997, Greenspan dropped any notion of trying to curb "irrational exuberance." The financial bubble expanded even more rapidly in the wake of the interest rate cuts that followed the 1997 Asian financial crisis and the Russian default.

As the market reached new heights, the Fed chairman became its chief booster, declaring that the inflated share values were the product of productivity gains produced by technological advances in the "new economy." Shares continued to rise as money poured into the markets. But while this giant Ponzi scheme could continue for a period, the extent of the rise was limited, in the final analysis, by the underlying profit rate on the capital represented by the shares.

And here, as the US national accounts figures demonstrate, the movement was in the other direction. While share prices escalated rapidly after 1997, the rate of profit for US non-financial corporations was going down. This led to the market downturn of 2000-2001 and the exposure of the fraudulent operations of such market high-flyers as Enron and WorldComm.

In Greenspan's view, the chief lesson of this experience was not that the Fed should try to prevent financial bubbles from forming, but that when they burst it had to cut interest rates—in other words, create a new bubble. Accordingly, the Fed began cutting rates in 2001, reducing the benchmark short-term rate to just 1 percent in May 2003, where it remained until June 2004, when incremental increases of 0.25 percentage points were initiated.

The interest rate cuts created the conditions for a new financial bubble—this time in the home mortgage market. As house prices climbed, Wall Street finance houses seized on the opportunity to boost profits by buying and selling collateralized debt obligations (CDOs) created by slicing up large numbers of home mortgages and repackaging them according to different levels of risk. And the biggest profits were to be made in the areas of highest risk—the so-called sub-prime mortgages, given to people who could not afford them.

The first no-documentation loans were made in the mid-1990s, but for no more than 70 percent of the purchase price of the house. After 2001 this changed, and Wall Street firms offered to buy 90 percent and then 100 percent no-document loans. Consequently, lenders made more and more subprime loans, secure in the knowledge such loans would be taken off their hands by the big financial institutions. New subprime loans totaled more than $600 billion in 2005 and 2006, compared to just $160 billion in 2001.

Wages stagnate while profits soar

So long as interest rates remained low and money kept flowing into the market, the housing bubble continued to grow. But it was soon to run into one of the other fundamental features of the present-day US and global economy—the stagnation in real wages and the shift in the distribution of national income from wages to profits.

On March 29, the Center on Budget and Policy Priorities noted that, according to Commerce Department figures, the share of national income going to wages and salaries in 2006 was the lowest since records began. The share going to profits was the highest on record.

Furthermore, in the period of economic recovery since 2001, corporate profits had grown at a faster rate than in any equivalent period since World War II. Only 34 percent of the increase in national income since the end of 2001 had gone to increases in workers' pay. Moreover, for the first time on record, profits captured a larger share—46 percent—of the increase in national income than wages.

If the recovery after the 2001 recession had followed the pattern of the 1990s, the share of national income going to wages would have been 1.5 percentage points higher than it is today. Since each percentage point of national income represents about $117 billion, this means that more than $160 billion has been redistributed from the wages of ordinary working people to the bottom line of the major financial institutions and corporations.

It was this redistribution of income, so significant for the maintenance of profit rates, that signified the housing bubble was destined to end. Definite limits had been placed on the capacity of working people to continue to pay ever-increasing house prices.

The collapse of the subprime market, and the increasing problems in the mortgage market as a whole, have now led to the eruption of a global financial storm. It is surely a measure of the historic crisis of the world capitalist economy that a global economic disaster could now occur because of the dependence of major financial institutions on dubious financial schemes aimed at taking advantage of the daily struggle of millions of working people to secure a family home.