

Markets continue to rise but US dollar slides

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In the two weeks since the US Federal Reserve Board cut interest rates by half a percentage point in response to the crunch in credit markets, stock markets have taken off. On Monday, the Dow Jones index closed at over 14,000 points, a new record. Similar market rises have been registered around the world.

But while the interest rate cut has given equity markets a boost, there are clear signs that long-term problems in the global economy are coming to a head.

The area of greatest concern is the value of the US dollar, which has fallen continuously since the Fed's moves on interest rates.

An article in the *Economist* magazine last week posed the question: "When does a gentle slide become a dangerous skid?" The dollar, it noted, was now at a new low against a basket of major currencies. In the month of September, it fell by 4.5 percent against the euro, to reach a record low of almost \$1.43.

While the falling dollar provides a boost for American exports, it has the opposite effect on European exporters and the impact is starting to be felt. French president Nicolas Sarkozy recently stated that an increase in the euro above \$1.40 was a "problem" for euro zone competitiveness.

Jean-Claude Juncker, the prime minister and minister of finance of Luxembourg, said Europe could no longer accept footing the bill for global imbalances. The issue, he declared, would be discussed at the Group of Seven meeting of finance ministers and central bankers in Washington on October 20.

According to Sarkozy, the euro zone "should not be the only area in the world where the currency is not put at the service of growth." In other words, the currency should not be allowed to rise so high as to price European exports out of world markets. Nor should the European Central Bank set interest rates so high that they boost the value of the European currency. On what basis, then, should the value of the euro be set?

This question is always fraught with difficulties for central banks trying to regulate the exchange rate of their currencies. In the case of the euro, however, the problems are compounded by the fact that it is not the currency of a single nation, but of thirteen.

As *Financial Times* columnist Wolfgang Munchau noted in a comment on Monday, if the euro were set against a basket of currencies, including the British pound and a large number of central and eastern European currencies, this would imply devaluations against currencies of other member states in the European Union. In other words, the currencies of other countries in the EU would be rising against the dollar while the euro was going down. "I can think of no more effective way to blow up the single market," Munchau wrote.

Another problem posed by the falling dollar is the possibility that countries that have pegged their currencies to the US currency, and have made large investments in US financial assets, may start to look elsewhere. On September 18, a tremor went through financial markets immediately after the Fed's interest rate cut when the Saudi government did not follow suit, as it has done in the past. This was taken as an indication that the Saudi regime could be looking to shift some its financial reserves out of the US.

China is also adversely affected. If it wishes to maintain parity of its currency with the dollar, and so protect export markets, it will have to buy dollars at an even faster rate than at present. If, on the other hand, it decides to let the yuan rise, it will suffer a massive loss on the hundreds of billions of US financial assets that it currently holds. At the same time, there is the danger that if it starts to shift out of dollar assets it could set off a run on the US currency.

A *Financial Times* editorial on September 21 declared: "A decline in the dollar would be welcome if it was slow, but if foreign investors anticipate inflation

and start to dump some of their \$12,000 billion in US debt, it could turn into a rout. In the worst case the Fed would lose some control of monetary policy, with long-term rates responding to foreign selling no matter what the Fed did at the short end, and the economy plunged into recession.”

Further evidence of the general uncertainty in currency and financial markets is reflected in the fact that gold—an historical hedge against all forms of paper money—has been steadily rising over the past weeks and now stands at a 28-year high of around \$743 per ounce.

Even though share markets have received a boost, it appears that problems in credit markets are far from over. On Monday, the Swiss bank, UBS, announced that it had made a loss in the third quarter and the American bank, Citigroup, warned that profits for the quarter would drop by 60 percent compared to the same period in 2006.

UBS said its losses for the quarter would be between \$515 million and \$690 million as a result of a \$3.4 billion write down in the value of fixed-income assets, many of them securities backed by US subprime mortgages. Citigroup announced write-downs of \$1.4 billion on leveraged buyout commitments, as well as losses on mortgage-backed securities. It is expected to suffer a 60 percent fall in profits for the third quarter.

These losses are expected to extend to other banks. Deutsche Bank has warned that it will suffer a hit from the market turmoil, but has yet to reveal the extent.

Moreover bank losses may continue beyond the third quarter. According to the *Global Financial Stability Report*, published by the International Monetary Fund last week, the potential consequences of the credit crunch should not be underestimated and “the adjustment process is likely to be protracted.”

The report pointed out that the threat to financial stability came from a “funding mismatch” in which medium-term, illiquid and hard-to-value assets, such as complex credit securities, were being financed by very short-term money-market securities. In other words, for all its complexity, the credit crisis boils down to the disparity between short-term borrowing and long-term lending.

The IMF report noted that “while potentially helping [to] protect the financial system from concentrations of credit risks in banks, the dispersal of structured credit products [the process by which long-term debts were

brought together in large packages and then sold off] increased uncertainty about the extent of the risks and where they are ultimately held.”

This “originate and distribute” model meant that many institutions “could choose not to hold the credit risk they originated, reducing their incentives to monitor borrowers.” In other words, financial brokers could collect big bonuses on loans of dubious quality knowing that the debt would rapidly be sold off.

However since banks were often financing the purchasers of the “structured credit products” the result is that “risks that appear to have been distributed may return in various forms to the banks that distributed them.” To what extent remains to be seen, but, together with the fall in the dollar, this could be a significant factor in the creation of instability in financial markets in the coming period.



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