Speculative recovery sows seeds of an even greater economic crash

Barry Grey
10 November 2009

Last Wednesday the Federal Reserve Board's policy-making Federal Open Market Committee announced it was holding its target federal funds interest rate to the current level of zero to 0.25 percent. While that decision had been widely anticipated, there was much speculation that the Fed would employ language in its announcement to indicate that it would soon begin to raise interest rates.

In the event, the Fed repeated its recent mantra of keeping interest rates "exceptionally low" for "an extended period of time." A change in the formula from "an extended period of time" to "for some time" would have been seen as a signal that the Fed was preparing to shift from its policy of near-zero rates.

The Fed's signal of no early end to its extraordinarily cheap credit policy sent stock markets surging. Since the Fed announcement last Wednesday, the Dow Jones Industrial Average has surged hundreds of points, despite Friday's dire Labor Department report of an official US jobless rate of 10.2 percent. On Monday, the Dow Jones Industrial Average gained 205 points, closing at a 13-month high of 10,227.

This most recent surge in stock prices continued a trend that has emerged in recent weeks: stocks moved in close and inverse relation to the value of the dollar on world currency markets. Last Wednesday, the dollar fell the most in relation to the euro in two months. That trend continued Monday, with the dollar once again falling to $1.50 versus the euro.

Also in keeping with recent trends, oil, gold and other commodities surged as stocks rose and the dollar fell. The connection between soaring asset prices and a falling dollar points to the extraordinarily speculative and unstable character of what is being called a global recovery from the financial crisis and recession of 2008 and early 2009.

It is a recovery in corporate and bank profits and financial assets that is richly benefitting the most powerful financial interests in the US and around the world, even as joblessness and poverty soar and basic production remains mired in the deepest slump since the Great Depression. It is a "recovery" that is driven almost entirely by a surge in speculation in risky assets fuelled by the US government's policy of virtually free credit for the major banks and a vast buildup of debt.

As CNBC commentator Charles Gasparino put it in a November 6 column in the *Wall Street Journal*, "Interest rates are close to zero; in effect the Federal Reserve is subsidizing the risk-taking and bond trading that has allowed Goldman Sachs to produce billions in profits and that infamous $16 billion bonus pool (analysts say it could grow as high as $20 billion). The Treasury has lent banks money, guaranteed Wall Street's debt and declared every firm to be a commercial bank… They are all 'too big to fail' and so free to trade as they please—on the taxpayer dime."

The *Wall Street Journal* reported Monday that Morgan Stanley has concluded that the amount of cash circulating in the global economy is at its highest level by far since the firm began tracking it 30 years ago. This vast wave of hot money can find no profitable outlet in production, so it is being pumped into stock markets and speculation on commodity prices and currencies. The result is a colossal global asset bubble that must sooner or later burst.

Here are some indications of the scale of this bubble:

"Since its March 9 low, the Standard & Poor's 500 stock index has gained more than 50 percent. An index of stocks for 22 "emerging market" countries (including Brazil, China and India) has doubled from its recent low. Oil, now around $80 a barrel, has increased 150 percent from its recent low of $31. Gold is near an all-time high, around $1,090 an ounce." (Robert J. Samuelson in Monday's *Washington Post*).

A central component of this policy is a tacit encouragement of the ongoing fall in the dollar. Ultimately, the decline in the dollar is dictated by the objective decline in the global position of American capitalism. The financial crash and ensuing global recession, which began in the US, have further eroded global confidence in the dollar as it has diminished the weight of US gross domestic product relative to global gross domestic product.

This is a profoundly destabilizing factor in the world economy, which renders any recovery fragile and ultimately unsustainable. Increasingly, the unique role of the US dollar as the world's major reserve and trading currency is being called into question. This was highlighted last Tuesday when India's central bank announced it had purchased 200 metric tons of gold on offer by the International Monetary Fund.

In making the announcement, India's finance minister said that the US and European economies had "collapsed." The Indian purchase came a few months after China, which holds an estimated $1.4 trillion in dollar assets, revealed that it had almost doubled its gold reserves in the past six years.

The buildup of gold reserves is part of a growing move by creditor nations away from the dollar. As *BusinessWeek* reported last month: "Instead of buying just dollars for their foreign exchange reserves, they're diversifying into other currencies. The countries that reveal the composition of their reserve holdings put 63 percent of their new reserves into euros and yen in the second quarter, according to an analysis by Barclays Capital."

The mid- to long-term implications of the erosion in the world position of the dollar are massive. A strong and stable dollar was the bedrock of the international capitalist monetary system that was established at the

Bretton Woods conference at the end of World War II. The dollar has served for nearly seven decades as the world's supreme trading and reserve currency. The unique and privileged position of the dollar—which brought with it immense advantages for US capital—was based on the unchallenged economic supremacy of the US at the end of the war. That, in turn, was founded on the global dominance of American industry.

The long-term decline of American capitalism, reflected most importantly in the decay of its industrial base, resulted in the massive global imbalances between debtor nations—first and foremost, the US—and creditor nations, such as China, Japan and Germany, which led to the implosion of the world economy a year ago. It is the transformation of the US from the industrial powerhouse of the world to the center of global financial speculation and parasitism that, in the final analysis, underlies the erosion in the international position of the dollar.

This underscores the reckless character of US monetary policy. The United States is flirting with the disaster of a precipitous fall in the dollar, which has already declined 15 percent since its recent high last March against the currencies of Washington's major trading counterparts. A full-blown dollar crisis would wreak havoc on the US and world economy.

It would compel the US to sharply and precipitously raise interest rates, plunging the US economy into a depression and bankrupting major financial institutions. It would choke off the US market for export-oriented countries such as China, Japan and Germany and spark competitive currency devaluations and trade war measures.

Nevertheless, to gain a short-term trading advantage against its capitalist rivals and provide the liquidity to enable major US banks to reap bumper profits and award their executives and traders record bonuses, the US, through the Fed, has carried out the electronic equivalent of printing a trillion dollars and flooding the financial markets with cheap credit. It has done so knowing that the dollar will continue to fall, making US exports cheaper and foreign imports more expensive.

The short-term effect is an intensification of global monetary and trade tensions. Last Friday the US levied duties against Chinese steel pipe imports. This followed Washington's imposition two months ago of tariffs against Chinese tire imports. China responded Friday by denouncing "abusive protectionism" and pledging to retaliate against US autos and other exports to the Chinese market.

The provocative character of the US move on Friday is underscored by the fact that it precedes by less than a week President Barack Obama's trip to Asia.

Meanwhile, New York University economist Nouriel Roubini is sounding the alarm over an alternate scenario for the dollar that would likewise have disastrous economic consequences. Roubini, who came to prominence by predicting in 2006 the impending collapse of the housing bubble and financial meltdown, is warning of a short-term rally in the dollar that will result in a collapse of the global asset bubble.

In a November 1 *Financial Times* column entitled "Mother of All Carry Trades Faces an Inevitable Bust," Roubini writes: "Since March there has been a massive rally in all sorts of risky assets—equities, oil, energy and commodity prices… and an even bigger rally in emerging market asset classes (their stocks, bonds and currencies)."

He contends that at the heart of this rally is "the weakness of the US dollar, driven by the mother of all carry trades." The latter term refers to the speculative practice of borrowing cash in currencies with low interest rates and investing the cash in assets denominated in more expensive currencies.

The US dollar has supplanted the yen as the major funding currency in carry trades. Speculators are borrowing dollars in highly leveraged trades, betting that the dollar will decline further, and using their resulting profits to invest in risky assets around the world. As a result, speculators are effectively borrowing dollars not at the zero interest rate set by the Fed, but at very negative rates—as low as minus 10 or 20 percent on an annualized basis.

As a result, Roubini states, carry trade investors have been realizing total returns in the 50-70 percent range since March.

As the "reckless" US policy is forcing other countries to keep their interest rates artificially low, "the carry trade bubble will get worse… the perfectly correlated bubble across all global asset classes gets bigger by the day."

One day the bubble will burst, as economic factors or an external event—such as a military attack on Iran—lead the dollar to "reverse and suddenly appreciate." Roubini concludes: "But the longer and bigger the carry trades and the larger the asset bubble, the bigger will be the ensuing asset bubble crash. The Fed and other policymakers seem unaware of the monster bubble they are creating. The longer they remain blind, the harder the markets will fall."

Roubini is not alone. Last week, both the International Monetary Fund and the World Bank issued warnings of growing asset bubbles, fueled by hot money, in the Asian economies.

To the extent that the US and international bourgeoisie has a strategy to deal with the massive growth of debt that is funding the speculative "recovery," it is to impose the full cost of the crisis on the working class. Last month, the Organization for Economic Cooperation and Development (OECD) declared that spending on health, education and other social programs will have to be cut as countries deal with the high levels of debt incurred in the financial crisis and recession.

The OECD was seconded last week by the International Monetary Fund, which issued a statement calling for a decade of sweeping spending cuts and tax increases across the industrialized world. The IMF specifically urged a sharp reduction in the growth of spending for health care and pensions.

For its part, the Obama administration is committed to the same policy, pledging to reduce government and business costs for health care as a prelude to a regime of fiscal austerity. Its goal is to reduce the consumption of the working class, using mass unemployment to drive down wages, boost labor productivity, and turn the US into a cheap labor center for exports to the world market.