Share sell-off points to further instability in global financial markets

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The global share market sell-off at the end of last week, following news that members of the Federal Open Market Committee (FOMC) of the US Federal Reserve had concerns about the future of the Fed's quantitative easing program, underscores the instability of the entire global financial system.

Over the past several months, the world economy has been marked by the yawning contradiction between the deepening slump in almost all of the major capitalist countries and the rise of share prices.

While the US, Japan, Britain and the euro zone all recorded negative growth in the fourth quarter of 2012, with little prospect of improvement in 2013, Wall Street's Dow Jones index has approached its highest-ever level. Last week, however, it recorded its first weekly fall for the year.

The sell-off was even more marked in the Asian and Australian markets. Australian share prices dropped 2 percent while, in the words of the *Financial Times*, Asian markets took a "battering" on Thursday, with the Shanghai index dropping 3 percent. According to the *Financial Times*, while profit-taking played a role, with investors cashing in on the 13 percent rise in the index since last November, "there's no mistaking investors' fears of what the authorities in Asia as well as the US might do if they decide that credit growth must now be curbed to prevent asset bubbles and inflation."

The global sell-off was sparked by the release of FOMC minutes for January, which noted that "many" of the participants in the meeting "expressed some concerns about the potential costs and risks arising from further asset purchases."

Another factor contributing to the instability was the emergence of differences within the Bank of England over its version of quantitative easing. A majority of the UK central bank's governing body opposed a proposal by retiring Bank of England chief Mervyn King to engage in another round of purchases, citing concerns about the inflationary consequences of the program.

Under its quantitative easing program, the Fed is printing money at the rate of $85 billion per month ($1 trillion per year) through its purchases of bonds. It is doing this in order to supply the major banks and finances houses with ultra-cheap cash with which to fund their speculative activities in the financial markets.

The FOMC minutes also noted that "a number of participants stated that an ongoing evaluation of the efficacy, costs and risks of asset purchases might well lead the committee to taper or end its purchases before it judged that a substantial improvement in the outlook for the labour market had occurred."

Fed Chairman Ben Bernanke has justified the quantitative easing program on the grounds that it is necessary to boost the US economy and has stated that it will continue until the labour market improves. Given the fact that US unemployment remains persistently high and there is virtually no evidence that the money-printing operations does anything to improve the real economy, this amounts to an open-ended commitment to keep supplying the financial markets with ultra-cheap money.

While a majority of the FOMC continues to support Bernanke, the market reaction to the possibility that the Fed might end the policy sooner than expected brought home the fact that, in the words of one commentator, "equities are floating on a sea of central bank liquidity." The commentator continued. "Forget valuations or fundamentals: what matters is the Fed's willingness to create money."

While there are differing views among those beginning to question the policy, the overriding concern is that the Fed's policy may be sowing the seeds of another financial crisis.

In a speech delivered on February 7, Jeremy Stein, a member of the Fed's Board of Governors, warned that "a period of prolonged low interest rates, of the sort we are experiencing today, can create incentives for agents to take on greater duration of credit risks, or to employ additional financial leverage in an effort to 'reach for yield.'" In other words, there could well be a repeat of the conditions that led to the sub-prime crisis that provided the trigger for the financial collapse of September 2008.

The Fed's program means that the situation is potentially even more dangerous than that of September 2008. Its massive purchases mean that it is now directly tied into bond and other financial markets, unlike the situation at that time. If the Fed were to start to withdraw from its quantitative easing program by selling bonds--lowering their price and thereby lifting interest rates--this could spark a "rush for the exits," as other investors tried to liquidate their holdings as well, creating the potential for a full-scale collapse.

In such a situation, the Fed and other central banks would not be able to play the role they did in the past when they provided "lender of last resort" facilities to the banks and investment houses. This is because they themselves would be suffering major losses, compromising their own balance sheets and raising the spectre of insolvency.

This possibility points to the fact, notwithstanding the apparent return of some stability to financial markets, that the underlying crisis, far from being resolved, is deepening.

The financial crisis started with the insolvency of major US banks and investment houses, which were bailed out with public funds. It then extended to the threat of bankruptcy of European governments and the collapse of the euro--a threat which still remains, despite the commitment by European Central Bank Governor Mario Draghi to do "whatever it takes" to prevent such an occurrence. Now the very measures undertaken to restore stability to financial markets pose the threat that central banks themselves could become bankrupt.

In an editorial published last Friday entitled "The Queasy Case of QE", the *Australian Financial Review* warned of the dangers of the "accommodative" monetary policy. "The divisions which have become apparent among central banks in the UK and US show there is real concern about how far they can go before their looser policies cause instability that could fly beyond control," an issue of "fundamental concern for all."