Markets rise as global economic outlook worsens

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The extent to which financial markets have become completely divorced from underlying economic reality was again exemplified in their reaction to two major announcements last Friday.

European Central Bank president Mario Draghi indicated that the ECB was ready to go ahead with an expansion of its asset-purchasing program, possibly including government bonds, in view of the worsening outlook for the euro zone economy, particularly as reflected in low inflation.

At the same time, the People's Bank of China cut its benchmark lending rate by 0.4 percentage points, amid fears that the Chinese economy is slowing.

The measures mean that the two central banks will increase the supply of cheap money available to financial markets. Consequently, notwithstanding the fact that they were taken in response to a worsening economic outlook, the markets celebrated.

The American S&P 500 index, which accounts for more than half of global equity market value, ended the week with its 45th record close for the year. Markets in Europe also rose.

Market analysts could not decide whether Draghi's remarks or the Chinese central bank decision had the bigger effect. Whichever was the case, the response highlighted the yawning gap that has opened up between the financial markets, and the fortunes being made out of speculation using cheap central-bank-supplied money, and the real economy of lower growth, stagnation and outright recession.

Speaking at a meeting of bankers in Frankfurt, Draghi painted a bleak picture of the euro zone economy, saying inflation was "excessively low." The ECB would "do what we must to raise inflation and inflation expectations as fast as possible."

"If … our policy is not effective enough to achieve this, or further risks to the inflation outlook materialise, we would step up the pressure and broaden even more the channels through which we intervene, by altering accordingly the size, pace and composition of our purchases."

This was music to the ears of financial markets because it indicated that Draghi was preparing the way to expand purchases of asset-backed securities, as well as moving toward buying government bonds. This latter step has been vigorously opposed by Germany, which maintains that such purchases exceed the ECB mandate.

Supporters of the move insist that the ECB may not be able to fulfil its commitment to expand the bank's balance sheet by €1 trillion without such purchases.

Draghi's remarks were issued in the wake of new data showing that the slide toward euro zone recession is continuing. An initial estimate put the zone's growth rate at just 0.2 percent for the past quarter and inflation at 0.4 percent, well below the bank's target rate of 2 percent.

The most significant feature of latest figures is that the downturn is mainly the result of deteriorating conditions in the so-called core economies. A widely-followed purchasing managers' index compiled by the data firm Markit fell to its lowest level for a year and a half for November, signalling weakening economic activity in the months ahead.

Markit chief economist Chris Williamson said the readings were a "reflection of sluggish domestic demand," with French and Italian consumer confidence anaemic and Germany's manufacturing sector showing weakness.

The worsening euro zone performance formed the main thrust of an interview with ECB chief economist Peter Praet, published in the *Financial Times* last

Tuesday. The economic situation, he said, had to be taken "quite seriously … But what worries me the most is that you have a sort of growth pessimism, longer term growth pessimism, filtering through to expectations."

In other words, stagnation is feeding on itself. As worsening numbers are published, spending plans are cut back, leading to further economic decline.

Praet insisted that for longer term growth "there is only one thing: structural reforms." This is a program aimed at removing any remaining protection for workers, allowing employers more easily to effect dismissals and cut wages and conditions. European financial leaders enviously cast their eyes toward the United States, where such measures are already firmly in place.

The impact of the worsening European situation on the global economy is being compounded by the slowdown in China, the world's second-largest economy, which prompted the rate-cut decision by the People's Bank of China (PBoC).

Growth in the Chinese economy slowed to its lowest pace in five years in the third quarter. Fixed-asset investment, a central driving force of the Chinese economy since the 2008 eruption of the global financial crisis, fell to a 13-year low in October.

Zhu Haibin, the chief China economist at JP Morgan Chase in Hong Kong, wrote in a note that the PBoC move reflected "government concern about [the] near-term growth outlook, and the desperate attempts to lower the funding costs for the corporate sector."

The chief Asia economist at Hong Kong-based Mizuho Securities, Shen Jianguang, said the rate cut "indicated the worsening economic situation and rising deflation risk."

Most economists are of the view that the central bank's move will do little to boost the economy.

Chinese economic authorities are reluctant to return to the rapid expansion of credit that followed the 2008 financial crisis, fearing that such a move will only create more problems.

Bad loans held by Chinese banks were reported earlier this month to be at their highest levels since 2008 as a result of falls in the property and real estate markets. According to most market commentators, "systemic risk" to the entire banking system remains likely to be contained.

Nevertheless, there are warnings that the situation may be more serious than official figures so far indicate. According to Yu Xuejun, a senior official at the China Banking Regulatory Commission, cited by the *Financial Times*, bad loans reported by the banks were only "the tip of the iceberg."

Following the global financial crisis, the Chinese government not only initiated a spending package of more than $500 billion but gave the banks the go-ahead for a massive expansion of credit. "The large amount of loans handed out at that time without due caution have today become bad loans or potential bad loans," Yu said.

Even as these risks rise, financial markets continue their surge on the promise of cheap money, thereby magnifying the potential global consequences of a financial crisis in China or any other part of the world.