Wall Street surge another sign of instability

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Instability in the global economy is not solely indicated by sharp falls in financial markets. Large swings and rapid rises can, at times, also point to mounting problems. The events of last week were one such occasion.

It began with the plunge of the Russian rouble under the impact of falling oil prices, down more than 40 percent since June, and of tightening economic sanctions which have cut off the access of Russian corporations to capital on global financial markets.

The turbulence surrounding Russia, which saw the central bank announce at midnight on Monday the lifting of its rate to 17 percent, sent tremors through the markets amid fears that there could be a repeat of the 1998 financial crisis, when Russia defaulted on its debts.

However, the rate hike of 6.5 percentage points failed to halt the plunge. On Tuesday, the deputy chief of the Russian central bank, Sergei Shvetsov, described the situation as “a nightmare that we could not even have imagined a year ago.”

Despite such concerns, the week ended with a three-day surge on Wall Street which took the Dow and the S&P 500 indexes close to their record highs. The Dow experienced a rise of more than 700 points, with a one-day rise on Thursday of more than 400 points.

The impetus for the turnaround came on Wednesday when the US Federal Reserve announced that it was not going to cut off the supply of ultra-cheap money to financial markets any time soon. The key phrase in the Fed’s statement was that it would be “patient in beginning to normalize the stance of monetary policy.”

Concerns had been expressed in financial circles that a change from the previous language that interest rates would remain between zero and 0.25 percent “for a considerable time” would signal a rapid tightening. Fed chair Janet Yellen was at pains to reassure the markets. The new language, she said, did not represent a change in policy intentions.

And so, like a drug addict being informed that his supplier would continue to meet his cravings, the markets celebrated.

But even amid the euphoria there were signs that all is far from well. The *New York Times* noted that a “major fear is that sluggishness in large overseas markets will eventual eat into confidence and corporate earnings.” Europe is the major centre of concern because economic output has not even returned to the level it reached before the eruption of the global financial crisis more than six years ago.

The article pointed out that yields on 10-year treasury bonds had fallen, implying a worsening outlook for the American economy. It cited a hedge fund analyst who said that, while the most abundant commodity on Wall Street was optimism, “we appear to have gone off the road and the disconnect between stock prices and the real economy is being stretched.”

Notwithstanding the halt to the rouble’s plunge and a slight upturn in oil prices in recent days, Russian financial markets remain on a knife-edge with the rouble having lost half its value in the course of a year.

Companies that need dollars to roll over their debts are being denied access to international capital markets because of the sanctions imposed by the United States and the European Union. As a result they have dumped roubles on the market to try to meet their requirements, putting downward pressure on the currency. According to financial analysts, the downgrading of Russian debt to junk status is only a matter of time.

The mounting financial crisis in the Ukraine could be indicative of what is coming. Last week the country’s credit rating was further cut by Standard & Poor’s—it now stands well below junk status—amid warnings that “a default could become inevitable in the next few months” unless present circumstances change.

The Ukrainian government needs an additional $15

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billion on top of a $17 billion bailout. S&P said that delays in disbursements from the International Monetary Fund and a rundown in foreign currency reserves "increases the risk that the … government might not be able to meet its obligations."

There are, of course, particular circumstances driving the financial turbulence in Russia and the Ukraine—the impact of international sanctions in Russia and the ongoing war in the Ukraine. However, both countries are an expression of a deeper set of financial problems that are beginning to confront so-called emerging market economies.

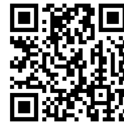
The quantitative easing program of the US Fed, which has seen up to $4 trillion pumped into the financial system over the past six years, has fuelled an explosion of debt in these countries, most of it dollar denominated. This means any move towards normalisation of the interest regime in the US, leading to an increase in the value of dollar, increases the debt and interest rate burden of these countries and their corporations.

The numbers involved are significant. According to the Bank for International Settlements, there is $2.6 trillion worth of outstanding international debt securities issued by corporations in emerging market economies, three quarters of which are in dollars.

On top of this, international banks have lent some $3.1 trillion in hard currency to emerging market borrowers. In other words, $5.7 trillion worth of debt is vulnerable to a rise in US interest rates and the dollar. The scene is being set for a repeat of the Asian financial crisis of 1997-98, only on a much larger scale because emerging markets are far more integrated into the global financial system than they were then and their economies now account for around half of global economic output.

There are signs that financial stress is extending beyond those countries, such as Nigeria, Russia and Venezuela, immediately affected by the oil slump. The Turkish lira has fallen throughout this month and is down by 12 percent and Indonesian authorities had to intervene last week to defend the rupiah. The Brazilian real is at a 10-year low against the dollar as is an index of emerging markets currencies.

There is an inherent contradiction in the present situation. The more the US economy shows evidence of a "recovery," the greater will be the upward pressure on interest rates and the US dollar. But such a movement could well set in motion a crisis in emerging markets which will rapidly impact on the US and global financial system.



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