After Fed rate hike, global economic fault lines deepen

Nick Beams
19 December 2015

After an initial rise following the decision by the US Federal Reserve to lift interest rates by 0.25 percentage points on Wednesday, stock markets around the world have experienced significant declines over the past two days.

The biggest falls were in the United States, where the Dow was down by 368 points at the close of trade on Friday, a drop of more than 2 percent, while the more broadly based S&P 500 fell by 1.8 percent. The CBOE VIX index, which measures market volatility and is often referred to as the “fear gauge,” went over 20, a level regarded as indicating a high degree of market stress.

Markets also fell around the world after rising in the immediate aftermath of the Fed decision. The Euro Stoxx index dropped by 1.4 percent on Friday after rising earlier in the week. In Japan, the Nikkei index closed 1.9 percent lower.

Underlying the volatility on share markets are a series of widening fault lines in the global economy produced by the deepening trend toward stagnation and slump. The increased turbulence in financial markets is an expression of the fact that massive financial speculation, fuelled by the Fed and other central banks’ pumping of trillions of dollars into the banking system since the 2008 Wall Street crash, is being overwhelmed by developments in the real economy, particularly the decline in industrial production.

So far, this interaction has found its sharpest expression in the market for high-yield, or “junk,” corporate bonds, particularly in the energy sector, because of the sharp fall in oil and other energy prices, coupled with the decline in basic industrial commodity prices to their lowest levels since the global financial crisis.

This week, the price of Brent crude oil hit a seven-year low of $36.33 per barrel, further heightening problems in the energy junk bond market, where money poured in to finance risky ventures when the price of oil was trading at around $100 per barrel less than two years ago.

But the turbulence is not confined to energy-related finance. According Lipper, a Thomson Reuters company that supplies information to financial markets, investors withdrew $5.1 billion from US mutual funds that purchase bonds rated as investment grade by credit-rating agencies—the largest such withdrawal since 1992. This was accompanied by a further withdrawal of $3 billion from junk bond funds. In the week to December 16, it is estimated that $15.4 billion was withdrawn from taxable bond funds.

In a report on the state of financial markets issued this week, the Office of Financial Research (OFR), set up by the US Treasury after the 2008 crisis, painted a picture of, in the words of *Financial Times* economic commentator Gill Tett, a “distinctly distorted American financial system” resulting from seven years of ultra-low interest rates.

The OFR said that “credit risk in the US non-financial business sector is elevated and rising.” It went on to warn that “higher base rates may create refinancing risks… and potentially precipitate a broader default cycle.”

In other words, a situation has been created where a default or a series of defaults in high risk areas could set off a chain reaction in the system as a whole, recalling the effects of the sub-prime mortgage collapse. When that crisis emerged in 2006 and 2007, then-Fed Chairman Ben Bernanke brushed it off as a relatively small problem that could be easily contained.

The worsening financial situation is compounded by the divergence in the policies of the world’s major central banks. While the Fed has moved towards tightening, although at a very gradual pace, the European Central Bank and the Bank of Japan are continuing with various forms of “quantitative easing” aimed at pumping more money into the financial system.

In the midst of growing financial turbulence, however, the official mantra is that the US is in the midst of an expanding economic recovery and is considered to be a "bright spot" in the world economy.

This soothing scenario is belied by both longer-term developments and the immediate situation. Since the US economy started growing in the June quarter of 2009, its gross domestic product has increased by only 2.2 percent per year, the lowest pace for any post-recession phase in post-World War II history. As a result, it took five years for the US economy just to make up for the loss of employment and economic output sustained as a result of the financial crisis.

Now figures from the industrial sector point to another downturn. US industrial production last month was down by a seasonally adjusted 0.6 percent from October, the biggest drop since March 2012 and the third straight month it has fallen. Manufacturing output, which comprises three quarters of industrial production, was flat. Mining output was down 1.1 percent for the month and is now 8.2 percent below the level of a year ago.

According to a report published in the *Financial Times* on Tuesday, a common theme of major companies supplying industry, such as Caterpillar and Deer & Co, is that "tough times are back," with some even pointing to "the arrival of an industrial recession."

The stagnation in US industry is part of an emerging global trend. Data on industrial employment in China—the world's major manufacturing centre—shows that aggregate employment in manufacturing fell by 1.9 percent in the year ending in October. In the third quarter, employment growth in the sector was at its lowest rate on a quarterly basis since 2000. The biggest declines are in heavy industry, with iron ore mining and processing employment down by 12 percent, coal mining down 7 percent, and steel employment down 6 percent.

The slowdown in China is impacting on so-called emerging markets more generally. Of 22 big emerging markets tracked by JPMorgan Chase, 21 have had their growth forecasts for 2016 downgraded. Brazil, which is highly dependent on the Chinese economy, is the sharpest expression of this trend. Its economy is contracting by 4.5 percent according to the latest data. Brazil's worsening situation was highlighted this week when Fitch became the second of the major credit rating agencies to downgrade the country's debt to junk status.

The World Bank has warned of "the beginning of an era of weak growth for emerging markets." This will have a significant impact, as these economies account for almost 40 percent of global output. They could also be hit by significant financial turbulence, with the International Monetary Fund warning that they have incurred $3 trillion more in debt than is warranted by commodity prices and global demand.

Two inescapable conclusions flow from the latest economic data and the growing turbulence in financial markets.

First, the supply of trillions of dollars of ultra-cheap money by the Fed and other central banks has done nothing either to resolve the crisis which erupted in 2008 or bring about a genuine economic recovery.

It has, however, subsidized a vast transfer of wealth from the bottom to the top, fuelling a tripling of stock prices, record corporate profits and CEO bonuses, and ever greater levels of social inequality. The vast sums handed to the banks and hedge funds have not, for the most part, been invested in production, but used instead to fund parasitic activities such as job-slashing corporate mergers, stock buybacks and dividend increases. To pay for the resulting bankrupting of state treasuries, governments around the world have imposed brutal austerity measures against the working class.

Second, these policies have only created the conditions for another financial crisis, whose consequences are potentially even more devastating than those triggered by the sub-prime mortgage collapse. The deepening decline in the real economy and the mounting signs of financial distress demonstrate that the source of the global economic crisis is the capitalist system itself, which cannot be reformed, but must be overthrown and replaced by the international working class in the fight for socialism.