Global financial turmoil continues on fears of slower growth

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China's stock market was closed early Thursday for the second time in four days as stocks plunged as soon as it opened. A key index dropped by 5 percent, forcing an automatic 15-minute freeze. When the markets re-opened the losses continued and the market was shut for the day when they hit 7 percent.

The China plunge came after a day of turbulence in European and US markets on Wednesday, prompted by a further drop in oil prices, rising concerns over Chinese growth and financial stability, and worries over emerging market debt. Reports of a North Korean hydrogen bomb test added to the uncertainty.

In the US, the major indexes fell by more than 1 percent, with the Dow and the S&P 500 ending the day below 17,000 and 2,000, respectively. The US share sell-off followed sharp declines in Japan and other parts of Asia, as well across Europe.

The main factor at work is the deepening trend toward recession in the global economy, which is starting to undermine the financial bubble that has been created by the pumping of trillions of dollars into global financial markets by the US Fed and other major central banks.

Market analysts speaking to the American business channel CNBC cited China and signs of a worsening situation globally and in the US. "It's pretty much the same story. You've got China growth problems," and "the US manufacturing sector seems to be in recession territory," one commentator said.

Another commented that the "biggest thing affecting markets" is that "we're coming in with an assumption that the global economy is slowing more" in 2015 than 2016. "We're worried about China."

Another analyst told the *Los Angeles Times* that markets were "trading on fear that Chinese growth is going to collapse and that… lower oil prices are going to lead to a growing number of defaults in the high-yield bond market."

Those fears have been compounded by the fall in the price of Brent crude to below $35 per barrel for the first time since 2004, while the price of American crude hit its lowest point in seven years. The falling oil price feeds directly into energy markets via energy-based companies and into the high-yield or "junk" bond market, which saw an infusion of cheap money when oil was trading at more than $100 a barrel barely 18 months ago.

The worsening situation in China is evidenced both in the economy and the financial system. Chinese growth is already down to its lowest levels in a quarter of a century, with manufacturing activity experiencing lower growth for five months in a row and exports down for each of the last 15 months. But a new cause for concern appeared on Wednesday with the news that the services sector had experienced its lowest growth for 17 months. The official policy of the Chinese government is that it is making a transition to a more service-based economy.

Chinese stock market and financial turbulence, which rattled world markets in August last year, has also returned. On the first day of trading, markets were automatically shut down following a drop of almost 7 percent, as the date for the lifting of government restrictions on share trading imposed in August approached.

As in the crisis five months ago, there are concerns about the stability of the Chinese currency, the renminbi. It has now reached its lowest point in five years, as the gap between its value in the more tightly controlled domestic market and the offshore market widens to record levels. The offshore value of the renminbi has dropped by more than 2 percent this week, recalling the events of August, when its surprise devaluation sent shock waves through world markets.

In a research note published on Wednesday, Timothy Moe, Goldman Sachs' chief Asia-Pacific strategist, wrote: "During our investor meetings in December, the most significant risk that investors were worried about was a substantial devaluation of the renminbi."

The concerns are two-fold: first, that a significant fall in the Chinese currency will lead to devaluations in Asian and other currencies, sending a new wave of deflationary pressures through the world economy, and second, that it will spark an increase in capital outflows from China that could cause major financial problems.

The People's Bank of China (PBoC) has been intervening in financial markets in an effort to limit the fall in the renminbi, running down its global currency reserves. At the same time, the PBoC wants the currency to fall gradually in order to improve China's trade position.

There are concerns that the situation is getting out of the control of financial authorities. Last August, they changed the method of determining the value of the renminbi by deciding to tie it to the previous day's close. But on Wednesday, this new rule was broken when the PBoC fixed the rate significantly above the close for Tuesday, prompting concerns that the movement in the daily fix would only increase market volatility.

Financial Times commentator Gavyn Davies noted that the risk of large scale devaluation of the renminbi was "again spooking financial markets, which are firmly convinced that this is a very bad contingency for global risk assets in 2016." Since the start of the new year, "investors have become much more concerned that a larger devaluation may be in the in works, either through the choice of the Chinese authorities, or because the outflow of private capital is getting out of hand."

Some were even worried that China could be suffering from "a genuine exchange rate crisis, in which its enormous foreign currency reserves could be quickly drained."

There are also growing concerns about financial stability in other emerging markets, which the International Monetary Fund has estimated are "over-borrowed" to the tune of $3 trillion. The prevailing conventional wisdom is that such over-indebtedness is not the concern it was in the past because most of it has been concentrated in the corporate rather than the government sector, and therefore the risk of a sovereign debt crisis is reduced.

But doubt has been cast on this reassuring assessment by an article published Wednesday in the *Financial Times*. It noted that more than $800 billion of sovereign debt was being camouflaged by the use of bonds that offer implicit state backing without always appearing on government balance sheets. The article noted that the stock of these "quasi-sovereign bonds" had risen in the past 12 months "to overtake that of all emerging market sovereign debt by the end of 2015."

In other words, while the official debt to gross domestic product ratio may appear quite low by global standards for countries such as India, Russia and China, the amount of debt they have to cover in the event of a crisis could be much higher than official figures indicate.

The worsening global economic situation was underscored by a World Bank report issued Wednesday that cut the bank's growth forecast for the third year in a row. It said larger-than-anticipated contractions in Brazil and Russia, combined with lower growth in the world's major economies, had caused it to downgrade its growth forecast by 0.4 percentage points to 2.9 percent. While this was up slightly from the downwardly revised estimate of 2.6 percent for 2015, the report presented a gloomy outlook.

The World Bank cut its forecasts for developing countries as a whole by more than 0.5 percentage points and warned that this estimate was made on the basis of a smooth Chinese slowdown, a stabilisation of commodity prices, and only a gradual increase in borrowing costs. "All of these assumptions, however, are subject to substantial downside risks," it stated.

The bank pointed out that it has now downwardly revised growth in the major developing countries for three years in a row, the first time this has happened since the 1980s, and noted that recoveries in the US and Europe were weaker than expected, while slowing world trade was having an impact.

Summing up the situation, the bank's chief economist Kaushik Basu said: "There are severe fault lines beneath the surface."