

# Mounting problems in global economy and financial system

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If there is one word to sum up assessments of the state of the world economy and the related question of the state of financial markets, it would be confusion.

No one has any clear estimate for the path of global growth, how long the present surge in inflation will extend as well as its impact and when supply chain problems will ease. Despite the much-vaunted insistence by central banks they provide “forward guidance,” there is no idea about where they are headed on crucial aspects of monetary policy, leading to turbulence in bond markets.

On top of this there is the impact of the latest surge in COVID-19 infections in Eastern Europe, amid warnings from the World Health Organisation there could be another 500,000 more coronavirus deaths in Europe by February, on top of the 1.4 million who have already died.

A *Wall Street Journal* article last weekend pointed to the perplexity in ruling circles. It stated that the global economy’s “comeback” from the deep contraction last year was “approaching a delicate juncture, as policy markets and executives grapple with the bumpy transition from the post-pandemic reopening to a more normalized pace of growth.”

Central banks, it said, were trying to chart a path that will curb inflation but not choke off growth as they “navigate the process of weaning economies off the extraordinary measures—including rock-bottom interest rates and enormous bond-buying programs—deployed to support their economies.”

The plan of central banks and government authorities—insofar as they had one—was that after an initial surge of inflation, higher prices would prove to be “transitory” and the economy would move back to a “normal” path of development.

That happy scenario has been blown apart. Inflation in the US is running at 5 percent, with little sign of abating. In the UK it is predicted by the Bank of England to reach 5 percent next year and it is surging in the euro zone.

Speaking to reporters after the meeting of the US Federal Reserve last Wednesday, Fed chair Jerome Powell said it was “very, very difficult to forecast and not easy to set

policy.”

“Inflation has come in higher than expected and bottlenecks have been more persistent and more prevalent. We see that they’re now on track to persist well into next year. That was not expected by us, not by other macro forecasters.”

The US growth rate slowed markedly in the third quarter, experiencing its lowest level since the start of the recovery from the pandemic recession.

In China, the world’s second largest economy, concerns over its growth rate mount as the problems in the real estate sector, one of key drivers in the economy, continue.

It was announced on Friday that shares in the property developer Kaisa Group Holdings had been suspended in Hong Kong after the company announced it had missed payments on debt. It pointed to “unprecedented pressure on its liquidity”—the same issue which caused the property giant Evergrande to miss payments on offshore debt.

The Japanese finance company Nomura has warned that Chinese growth will slow to an annual rate of 3 to 4 percent over the next few quarters. Kevin Lai, chief economist at Daiwa Capital Markets, told the *Journal* that the Chinese slowdown “is going to be bigger and longer than anyone has seen in the past 10 years.”

Germany, Europe’s biggest economy and the world’s fourth largest, “is expected to stall over the coming months as supply bottlenecks weigh on the nation’s powerful manufacturing sector, particularly in the auto industry.” Manufacturing output was 10 percent below pre-pandemic levels in September.

The highly uncertain outlook for Europe goes a long way to explaining why European Central Bank president Christine Lagarde has been so insistent that, despite pressure to tighten monetary policy due to increased inflation, a rate rise in 2022 is “off the chart.”

Lagarde’s comment points to the dilemma facing all central banks. On the one hand, inflation is pressuring them to tighten rates. On the other, they fear that if they do so lower growth combined with high levels of debt—the result

of the quantitative easing policies over the past decade and more that have seen \$23 trillion pumped into the financial system—will bring major economic and financial turbulence and even a crisis.

However, mixed messaging and rising inflation are causing major problems. Initially, major investors bought into the central banks' scenario that price rises would be short-lived and made their speculative bets accordingly. But the persistence of inflation caused yields in the short end of the market to rise and bond prices to fall—the two have an inverse relationship.

This trend was fuelled by comments from the governor of the Bank of England, Andrew Bailey, in October that the central bank would “have to act” if inflation proved to be stubbornly high. In the event, the BoE decided last week not to raise its rate, sparking violent moves in the other direction.

Some major hedge funds have lost large amounts of money, running into billions of dollars. While the movement in rates may be relatively small, the losses can be high because hedge funds borrow large amounts of money to make their bets.

According to reports in the financial press, the London-based hedge fund Rokos Capital, which manages \$12.5 billion in assets and has been something of a market leader because of past successes, has lost 27 percent so far this year and 18 percent last month.

Amid the turbulence in the short end of the bond market last month—the *Financial Times* (FT) described it as an “inferno”—there is a longer-term issue. This concerns the operation of the \$22 trillion Treasury market and the meltdown it suffered in March 2020 at the start of the pandemic.

This market, which forms the basis of the global financial system, is supposedly the most liquid and safest in the world. However, at the start the pandemic, it virtually froze when no buyers could be found for US government bonds. Rather than seeking a “safe haven” in purchases of government debt, there was a “dash for cash.”

The universal opinion in financial policy circles is that such an event, which had the potential to set off a crisis going beyond that of 2008, must never be allowed happen again.

There have been a series of investigations into the source of the crisis. It was only ended through the massive intervention of the Fed, which doubled its holdings of financial assets from \$4 trillion to more than \$8 trillion virtually overnight. But no definite diagnosis has emerged, much less a possible solution.

An article by FT columnist John Dizard at the weekend noted that the US Treasury market was “ill-equipped to

finance” whatever spending packages are finally delivered by Congress. This was known by the administration and market regulators, and they have been working on developing a new market structure.

“The Treasury, the Fed and regulators like [Gary] Gensler [chairman of the Securities and Exchange Commission] are haunted by the Treasury market’s seize-up in March last year, which shook global markets,” he wrote.

But so far, no plan has been developed. One of the problems is the increased involvement of hedge funds.

A research paper published by the Fed in October noted that “hedge funds play an increasingly important role in the US Treasury market.” It found that the Treasury market exposure of large hedge funds “doubled from early 2018 to February 2020, reaching \$1.45 trillion and \$0.94 trillion in long and short exposure, respectively.”

The Fed paper reported that the doubling was driven by relative arbitrage trading supported by corresponding increases in repo borrowing.

Arbitrage trading refers to investors, largely hedge funds, taking advantage of small and fleeting differences in various parts of the market to make money with the financial bets financed by repurchase agreements (repos), essentially very short-term borrowings, either from the Fed or other banks and finance houses.

In normal times, such operations can assist the smooth functioning of the market, but under conditions of a sudden shock, such as the onset of the pandemic, they can become the source of a crisis.

Dizard reported that one of the plans under consideration is a clearing house mechanism which would simultaneously act as a seller to all buyers and a buyer to all sellers. But he cited a report from the Securities and Financial Markets Association which cast doubt on its efficacy.

In a note issued last March, the report said: “Even with most Treasury trades being centrally cleared, it is highly unlikely that sufficient capacity would have been freed up to absorb the ‘dash-for-cash’ by investors that occurred last year.”

The recent turbulence in bond markets, under conditions of completely unanticipated problems, such as inflation, supply chain problems and the continuation of the pandemic, is an indication that the crisis which erupted 20 months ago could be coming to the surface again.



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